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CHAPTER 1
NATURE, OBJECTIVE AND SCOPE OF AUDIT

Question 1

In case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Explain such assertions or subject matters. (Old SM, RTP Nov'23)

Answer 1

In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Question 2

RAG is proprietorship firm engaged in the manufacturing of textile and handloom products. It sells its finished products both in the domestic as well as in the international market. The company is making total turnover of Rs. 30 crores. It has also availed cash credit limit of Rs. 5 crores from Canara Bank. In the year 2017-18, proprietor of the firm is worried about the financial position of the company and is under the impression that since he is out of India, therefore firm might run into losses. He approaches a CA about advantages of getting his accounts audited throughout the year so that he may not suffer due to accounting weaknesses. Advise regarding advantages of getting accounts audited. (MTP 5 Marks March '18)

OR

PACE is proprietorship firm of Mr. Abhinav engaged in the manufacturing of textile and handloom products. It sells its finished products both in the domestic as well as in the international market. The company is making total turnover of Rs. 50 crores. It has also availed cash credit limit of Rs. 5 crores from Axis Bank. In the year 2017-18, proprietor of the firm is worried about the financial position of the company and is under the impression that since he is out of India, therefore firm might run into losses. He approaches CA Mahesh about advantages of getting his accounts audited throughout the year so that he may not suffer due to accounting weaknesses. Advise regarding advantages of getting accounts audited. (MTP 5 Marks Oct 18)

OR

The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organizations where audit is not compulsory. Explain. (RTP Nov '18)

Answer 2

The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory, these advantages are given below:

(a) It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders, bankers, FI's, public at large etc.

(b) It acts as a moral check on the employees from committing defalcations or embezzlement.

(c) Audited statements of account are helpful in settling liability for taxes, negotiating loans and for determining the purchase consideration for a business.

(d) These are also useful for settling trade disputes for higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.

(e) An audit can also help in the detection of wastages and losses to show the different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures.

(f) Audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect.

(g) As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies, etc., in them.

(h) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.

(i) Government may require audited and certified statement before it gives assistance or issues a license for a particular trade.

Question 3

"An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

Explain stating clearly how the person conducting this task should take care to ensure that financial statements would not mislead anybody. (MTP 4 Marks Oct 19)

The person conducting audit should take care to ensure that financial statements would not mislead anybody. Explain stating clearly the meaning of Auditing. (RTP May '20)

Answer 3

"An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

Analysis of the Definition

1. Audit is Independent examination of Financial information.
2. of any entity – that entity may be profit oriented or not and irrespective of its size or legal form. For example – Profit oriented – Audit of Listed company engaged in business. On the other hand, Audit of NGO – not profit oriented.
3. The objective of the audit is to express an opinion on the financial statements.
   The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:
   (i) the accounts have been drawn up with reference to entries in the books of account;
   (ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;
   (iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;
   (iv) the information conveyed by the statements is clear and unambiguous;
   (v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.

Question 4

The relationship between auditing and law is very close one. (MTP 4 Marks Oct 19, RTP Nov '18)

Answer 4

The relationship between auditing and law: The relationship between auditing and law is very close one. Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into. It necessitates that an auditor should have a good knowledge of business laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc.

The knowledge of taxation laws is also inevitable as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws. In analysing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws.

Question 5

Examine with reasons (in short) whether the following statements are correct or incorrect: Mr. Z, a team member of auditor of Grateful and Competent Limited was of the opinion that while conducting an audit of a company no distinction is required to be made between revenue expenditure and capital expenditure. (MTP 2 Marks Oct 20)

Answer 5

Incorrect: The opinion of Mr. Z is incorrect because one of the important aspects to be followed while conducting audit of a company is that a distinction is required to be made properly between revenue expenditure and capital expenditure.

Question 6

Examine with reasons (in short) whether the following statement is correct or incorrect: The preparation of financial statements involves judgment by management. (MTP 2 Marks Nov '21, Mar'22)

Answer 6

Correct: The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.

Question 7

Examine with reasons (in short) whether the following statements are correct or incorrect.

The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. (MTP 2 Marks March '23, New SM)

Answer 7

Correct: As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

Question 8

Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities.

He said, "an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true" Explain stating clearly the qualities of an auditor. (MTP 4 Marks March '21, RTP May'19)

OR

Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities.

Explain stating the qualities an auditor should possess. (MTP 4 Marks Oct '21)

Answer 8

It is not enough to realise what an auditor should be. He is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, Code of ethics mentions integrity, objectivity and independence as one of the fundamental principles of professional ethics.

He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. The Companies Act need special mention but mercantile law,

specially the law relating to contracts, is no less important. Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.

He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of auditing. He must know thoroughly all accounting principles and techniques.

Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, "an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true".

Question 9

The person conducting the audit should take care to ensure that financial statements would not mislead anybody. Explain (MTP 4 Marks Oct '21)

Answer 9

The person conducting the audit should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:

i. The accounts have been drawn up with reference to entries in the books of account;
ii. The entries in the books of account are adequately supported by sufficient and appropriate evidence;
iii. None of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;
iv. The information conveyed by the statements is clear and unambiguous;
v. The financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and
vi. The statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.

Question 10

The auditor has to form an opinion on the financial statements within a reasonable period of time and at a reasonable cost. Explain the above statement with reference to "Timeliness of Financial Reporting and the Balance between Benefit and Cost". (MTP 4 Marks April 22, RTP-May'18]

Answer 10

Timeliness of Financial Reporting and the Balance between Benefit and Cost: The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit.

Notwithstanding this, the 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. There is an expectation by users of financial statements that the auditor will form an opi nion on the financial statements within a reasonable period of time and at a reasonable cost, recognizing that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

Question 11

Examine with reasons (in short) whether the following statement is correct or incorrect : The objective of audit is to obtain absolute assurance about whether the financial statements as a whole are free from material misstatement. (MTP 2 Marks April 19, RTP May'23, RTP May'18)

OR

The auditor is expected to and can reduce audit risk to zero (MTP 2 Marks May 20, MTP 2 Marks Oct'21)

Answer 11

Incorrect: The objective of audit is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. In auditing, reasonable assurance can be given which is high level assurance but not absolute assurance. 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.

Question 12

Examine with reasons (in short) whether the following statements are correct or incorrect

The Auditor is expected to reduce audit risk to zero and can therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. (MTP 2 Marks Oct'22, MTP 2 Marks Oct'21, PYP 2 Marks Jan 21)

Answer 12

Incorrect: As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", The auditor is 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.

Question 13

Examine with reasons (in short) whether the following statements are correct or incorrect: There are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being conclusive rather than persuasive. (MTP 2 Marks April '21)

Answer 13

Incorrect: As per SA 200, 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, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

Question 14

Discuss the following:

CA Jatin is the auditor of JP Ltd. The auditor expressed his opinion on the financial statements without ascertaining as to whether the financial statements as a whole were free from material misstatements. Explain w.r.t SA 200. (MTP 3 Marks April '23)

OR

Mr. Z, auditor of the Company, Different and Capable Limited for the financial year 2022-23, explained to audit team members about the objectives of the Independent Auditor in accordance with the relevant Standard on Auditing. Explain those objectives. (RTP Nov '23) (PYP 3 Marks May '22)

Answer 14

Overall Objectives of the Independent Auditor: As per SA-200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", in conducting an audit of financial statements, the overall objectives of the auditor are:

i. 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

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

In the given case of JP Ltd, CA Jatin expressed his opinion on the financial statements of JP Ltd without obtaining reasonable assurance about whether the financial statements as a whole are free from material misstatement or not. Therefore, it can be concluded that CA Jatin did not comply with the objective of audit as stated in SA 200.

Question 15

Both accounting and auditing are closely related with each other. Explain (RTP Nov'20)

Answer 15

Both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process. It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements. In fact, auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities. To begin with, it may be noted that the discipline of auditing itself is a logical construct and everything done in auditing must be bound by the rules of logic. Ethical precepts are the basis on which the foundation of the entire accounting profession rests. The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work.

Question 16

State with reason (in short) whether the following statements are true or false:

The preparation of financial statements does not involve judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. (RTP May '19)

Answer 16

Incorrect: The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.

Question 17

State with reason (in short) whether the following statements are true or false: An audit is an official investigation into alleged wrongdoing. (RTP May '19, Nov'18)

Answer 17

Incorrect: An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Question 18

State with reason (in short) whether the following statements are true or false:

There is no difference between "audit" and "review." .(RTP Nov'22)

Answer 18

Incorrect: "Audit" and "Review" are two different terms. Audit is a reasonable assurance engagement, and its objective is reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement. However, "review" is a limited assurance engagement, and its objective is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement

Question 19

The knowledge of human behavior is indeed very essential for an auditor so as to effectively discharge his duties. Explain. (RTP Nov '21)

Answer 19

The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.

The discipline of behavioral science is closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the

financial statements but he shall be required to interact with a lot of people in the organization. As against the financial Audi tor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures. One of the basic elements in designing the internal control system is personnel. Howsoever, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the organization are competent and honest. The knowledge of human behavior is indeed very essential for an auditor so as to effectively discharge his duties.

Question 20

An audit is distinct from investigation. However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor. Discuss. (RTP May '23, Old SM)

Answer 20

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 as we have already discussed, 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.

Therefore, audit is never started with a pre-conceived notion about state of affairs; about wrong-doing; about some wrong having been committed. The auditor seeks to report what he finds in normal course of examination of accounts.

However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor. It may happen that auditor has given some findings of serious concern. Such findings may prompt for calling an investigation.

Question 21

Explain the objectives of an Audit as per SA 200. (RTP May '20, May'19)

Answer 21

As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:

a. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement; and
b. To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

Question 22

In case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Explain such assertions or subject matters. (RTP May '20, PYP 3 Marks July '21)

Answer 22

Other Matters that Affect the Limitations of an Audit: In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

Fraud, particularly fraud involving senior management or collusion.

- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Question 23

State with reason (in short) whether the following statements are true or false:

The auditor's opinion helps determination of the true and correct view of the financial position and operating results of an enterprise. (RTP May '21)

Answer 23

Incorrect: The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise.

Question 24

There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain giving examples. (RTP Nov '21, May'20, Old SM)

Answer 24

There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
2. Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Question 25

State with reason (in short) whether the following statements are true or false:

The matter of difficulty, time, or cost involved is in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative. (RTP Nov '18, RTP Nov'21)

Answer 25

Incorrect: The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the 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.

Question 26

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. (RTP Nov '18, New SM))

Answer 26

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. The inherent limitations of an audit arise from:

i. **The Nature of Financial Reporting:** The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.

ii. **The Nature of Audit Procedures:** There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

   1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
   2. Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

iii. **Timeliness of Financial Reporting and the Balance between Benefit and Cost:** The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the 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.

iv. **Other Matters that Affect the Limitations of an Audit:** In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant.

Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Question 27

There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain giving examples. Also explain the difference between audit and investigation. (RTP Nov 22, Nov'23)

Answer 27

The Nature of Audit Procedures: There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
2. Fraud may involve sophisticated and carefully organized schemes designed to conceal it.

   Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

We have to clearly understand that 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 as we have already discussed, 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.

Therefore, audit is never started with a pre-conceived notion about state of affairs; about wrongdoing; about some wrong having been committed. The auditor seeks to report what he finds in normal course of examination of accounts. However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor. It may happen that auditor has given some findings of serious concern. Such findings may prompt for calling an investigation.

Question 28

Standards on Auditing (SAs) apply in "audit of historical financial information" whereas Standards on Review Engagements (SREs) apply in "review of historical financial information." Explain in detail giving examples. (RTP May '22)

Answer 28

It is to be understood that Standards on Auditing (SAs) apply in "audit of historical financial information" whereas Standards on Review Engagements (SREs) apply in "review of historical financial information".

Remember that Standards on auditing apply in "audit" of historical financial information which is a reasonable assurance engagement whereas Standards on Review Engagements apply in "review" of historical financial information which is a limited assurance engagement only.

"Historical financial information means" information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

Here, we have to broadly understand that "audit" and "review" are two different terms. Audit is a reasonable assurance engagement, and its objective is reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement. However, "review" is a limited assurance engagement, and its objective is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, Standards on Auditing have been issued on wide spectrum of issues in the field of auditing including (but not limited to) overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit evidence, audit sampling, going concern and forming an opinion and reporting on financial statements.

Some examples of Standards on Auditing are:

i. SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
ii. SA 230 Audit Documentation
iii. SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
iv. SA 500 Audit Evidence
v. Revised SA 700 Forming an Opinion and Reporting on Financial Statements Examples of Standards on Review engagements are

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

MULTIPLE CHOICE QUESTIONS (MCQS)

1. The persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity are :

(a) management

(b) Those charged with governance –

(c) audit committee

(d) board of directors **(MTP 1 Marks March '21, Oct'23, RTP May '21, Nov'21, Nov'23)**

Ans: (b)

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2. The Auditor of a Sole Proprietor Concern is appointed by

(a) CAG

(b) Bank

(c) Sole Proprietor himself

(d) District Administration **(MTP 1 Mark April 22)**

Ans: (c)

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3. Which of the following is Incorrect:

(a) An auditor conducting an audit in accordance with SAs is responsible for obtaining absolute assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

(b) As described in SA 200, owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

(c) The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error.

(d) The risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud. **(MTP 1 Mark March '23)**

Ans: (a)

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4. With respect to auditing, which of the following statement is correct:

(a) Audited financial statements are absolutely free from all material misstatement due to fraud or error.

(b) An audit is an official investigation into alleged wrongdoing and auditor has specific legal powers to conduct investigation

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

(d) An auditor's opinion is an assurance as the future viability of the enterprise or the efficiency or effectiveness of the management. **(MTP 1 Marks April '23)**

Ans: (c)

5. The matter of difficulty, time, or cost involved is :

(a) not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

(b) in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

(c) not in itself a valid basis for the auditor to omit an audit procedure for which alternative exists.

(d) not in itself a valid basis for the auditor to omit an audit procedure. **(MTP 1 Mark March '19)**

Ans: (a)

6. Determining a percentage to be applied to a chosen benchmark (in relation to materiality) involves the exercise of

(a) Independence

(b) Professional Judgement

(c) Professional skepticism

(d) All of the above **(MTP 1 Mark April'19)**

Ans: (b)

7. Which of the following is the responsibility of the auditor:

(a) Preparation and presentation of the financial statements in accordance with applicable financial reporting

(b) Design, implementation and maintenance of internal controls

(c) Express an opinion on the Financial Statements

(d) To obtain limited assurance. **(MTP1 Mark April 22)**

Ans: (c)

8. The persons with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity are

(a) Management

(b) those charged with governance

(c) audit committee

(d) board of directors **(RTP May '21, Nov'21)**

Ans: (b)

9. M/s KYC & Co. is a reputed Audit firm in Mumbai. They are appointed as Statutory Auditors of Blessed Ltd. Which of the below is the responsibility of M/s KYC & Co.

(a) Preparation of financial statements

(b) Designing, implementation and maintenance of internal control system

(c) Reporting on true and fair view of financial statements

(d) Compliance with the applicable law and regulation. **(RTP Nov'20)**

Ans:(c)

CASE STUDY - 1

Rohit, Gurpreet, Ali and Goreti are friends since their school days based in Mumbai. They have cleared CA foundation exams in the same attempt and now plan to appear for CA Intermediate exams. All of them are avid news listeners and regularly keep track of business news even on social media.

They are trying to understand new subjects including auditing. Rohit, Gurpreet and Ali have also started attending Live Coaching Classes (LCC) being conducted by Board of studies of ICAI. Goreti has not been able to join Live Coaching Classes yet as she was away on a holiday with her parents.

However, she plans to catch it up with her friends very soon. Ali had also joined the classes but he had skipped some lectures.

During one informal get together, their discussions centred around new subject of auditing. They discussed many things regarding its nature, scope, benefits and other general practical issues. Goreti was regular in keeping track of audited results of companies being published in leading newspapers.

Her view was that audited financial statements of companies give 100% guarantee to different stake holders. It is the main reason behind so much reliance upon auditing. But she could not understand why wrong doings in financial matters are being discovered after many years have gone by.

Ali also concurred with her view and added that when financial statements are audited, each and every transaction appearing in books of accounts is verified. However, he could not give clarity to Goreti.

Gurpreet was of the opinion that audit was conducted on the basis of sample checking. He was also of the view that audited financial statements are not a guarantee against probable wrong doings in financial matters of the companies.

Not to be left behind, Rohit also jumped in the fray. He supported Gurpreet and also added something of his own.

MULTIPLE CHOICE QUESTIONS (MCQS)

Based on above, answer the following questions: -

1. Gurpreet was of the view that audited financial statements are not a guarantee against probable wrong doings in financial matters of companies. What kind of assurance does audit of financial statements provide?

(a) It provides reasonable assurance meaning a moderate level of assurance.

(b) It provides reasonable assurance meaning a low level of assurance.

(c) It provides reasonable assurance meaning a high level of assurance.

(d) It provides reasonable assurance meaning an absolute level of assurance.

Ans: (c)

2. Rohit added that auditor can force an employee of the company to provide him required information and documents. Can he do so?

(a) Yes, he can do so. It is necessary to obtain audit evidence.

(b) Yes, he can do so. There are express rights given to him in this respect.

(c) No, he cannot do so. He can only request for providing him with necessary information and documents. But it cannot be forced by him.

(d) No, he cannot do so. He has no right of seeking information and documents.

Therefore, question of forcing does not arise.

Ans: (c)

3. Ali had listened in one of the classes that audit covers all aspects of an entity and concluded that each and every transaction of entity is verified by auditor. Goreti also seemed to be in agreement with him but she was of the view that besides this, it also meant that audit should be so organized to cover all areas of an entity. Which of following statements is appropriate in this regard?

(a) Only view of Ali is correct.

(b) Only view of Goreti is correct.

(c) Views of both Ali and Goreti are correct.

(d) Views of both Ali and Goreti are incorrect.

Ans: (d)

4. All of them also discussed about benefits of auditing. Which of the following is not a likely benefit of auditing?

(a) Since auditing is connected to future events, audited information can be easily relied upon by users.

(b) Errors or frauds may be discovered during audit.

(c) Government authorities can make use of audited accounts for different purposes.

(d) It can help in bringing out deficiencies in maintenance of financial records.

Ans: (a)

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5. Goreti told her friends that she had read a news report about how a company had misled its auditors by producing some fabricated documents. Which of following statements seems to be appropriate in this regard?

(a) It was wrong on the part of auditor to rely upon fabricated documents. He must have discovered it as the same falls within the scope of his duties.

(b) Although it was wrong on the part of auditor to rely upon fabricated documents, he cannot do anything in the matter. He has to report on the basis of documents provided to him. He has no duty in this regard.

(c) Auditor has to conduct audit by exercising professional skill. But he is not an expert in discovering genuineness of documents. Hence, management consisting of dishonest persons may have led him to rely upon fabricated documents deliberately.

(d) Management cannot mislead auditor due to high level of knowledge and expertise possessed by him. The above is an outlier case-one of the rare odd cases.

Ans: (c)

CASE STUDY-2

Me and You Private Limited has been newly incorporated. The plant of the company has recently started production with the help of funds provided by a bank for purchase and installation of machinery.

Further, the company is also utilizing working capital credit facilities from the same bank for meeting its day to day working capital requirements like for purchase of raw materials, labour payment etc.

However, just within six months of its operations, the management feels that working capital funds are inadequate and situation is creating liquidity issues in the company.

The management of the company has approached its bankers and requested for enhancement in working capital credit facilities. The bank manager is insisting upon financial statements of the company for half year along with report providing assurance in this respect duly signed by

Chartered Accountant as audit is far away. It also requires projected financial statements for coming years along with a report from CA providing assurance regarding these projections to consider request of management.

The management approaches CA P, who has qualified recently and started practising. Reports providing assurance for half yearly results and projected financial statements are sought from CA P. The

Management provides necessary information and records to him in this regard.

Assume, in above case, the company only provides trial balance, financial statements in draft/ preliminary form along with accompanying records for the relevant half year to CA P and requests him to provide duly signed financial statements with a report for mutually agreed professional fees.

MULTIPLE CHOICE QUESTIONS (MCQS)

Based on above, answer the following questions: -

1. The management of company has engaged CA P to issue a duly signed report for half year. Which of the following standards, if any, issued by ICAI are relevant for CA P?

(a) Standards on Review Engagements

(b) Standards on Auditing

(c) Standards on Related Services

(d) There are no standards for issuing report in such situation.

Ans: (c)

2. Which of the following statements is MOST APRROPRIATE in given case situation?

(a) CA P can assist management in preparation of financial statements of the company. However, issue of a report in such a case is outside the scope of work.

(b) CA P can assist management in preparation of financial statements of the company and he can issue an audit report.

(c) CA P can assist management in preparation of financial statements of the company and he can issue a compilation report in this respect.

(d) The responsibility of preparation of financial statement is of company's management. CA P cannot assist management in preparation of financial statements of the company. However, he can issue a review report.

Ans: (c)

3. In the above said scenario for issuance of signed financial statements for half year by CA P, as discussed in last para of Case Study, identify the MOST APPROPRIATE statement: -

(a) Standard on Quality control (SQC 1) is not applicable as CA P cannot issue audit report.

(b) Standard on Quality Control (SQC 1) is not applicable as CA P cannot issue review report.

(c) Standard on Quality Control (SQC 1) is applicable in such type of engagement.

(d) Standard on Quality Control (SQC 1) is not applicable as CA P is barred from issuing any report in such type of engagement.

Ans: (c)

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4. The banker of company has also requested for projected financial statements for coming years along with a report from CA regarding these projections to consider request of management. Which of the following standards issued by ICAI are relevant for CA P in such a situation, if any?

(a) Standards on Review Engagements

(b) There are no standards for issuing such type of reports.

(c) Standards on Related Services

(d) Standards on Assurance Engagements

Ans: (d)

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5. Suppose CA P also accepts work of issuing projected financial statements with a report to be signed by him. The management has projected turnover of ₹100 core for the next year, ₹150 crore & ₹200 crore for following years respectively as compared to present turnover of ₹25 crore in current half year. Identify the MOST APPROPRIATE statement in this situation: -

(a) CA P has to satisfy himself regarding arithmetical accuracy of projected data.

(b) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover and its consistency with actuals.

(c) CA P has to satisfy himself regarding arithmetical accuracy of data along with its proper presentation to banker.

(d) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover, its consistency with actuals, disclosure and presentation.

Ans: (d)

TEST YOUR KNOWLEDGE

6. Which of the following is not an advantage of audit?

(a) It provides high quality financial information.

(b) It acts as a moral check on employees.

(c) It enhances risk of management bias.

(d) It helps in safeguarding interests of shareholders.

Ans: (c)

7. Which of the following is NOT TRUE about an assurance engagement?

(a) It relates to providing assurance about historical financial information only.

(b) The practitioner obtains sufficient appropriate evidence.

(c) There is some information to be examined by practitioner.

(d) A written assurance report in appropriate form is issued by practitioner.

Ans: (a)

8. Which of the following is TRUE about Engagement Standards?

(a) Engagement standards ensure proper rights to practitioners in course of performance of their duties.

(b) Engagement standards ensure preparation and presentation of financial statements in a standardized manner.

(c) Engagement standards ensure uniformity by practitioners in course of performance of their duties.

(d) Engagement standards ensure savings in resources of clients.

Ans: (c)

9. Consider following statements in relation to "Limited assurance engagement":-

Statement I - It involves obtaining sufficient appropriate evidence to draw reasonable conclusions.

Statement II - Review of interim financial information of a company is an example of limited assurance engagement.

(a) Statement I is correct. Statement II is incorrect.

(b) Both Statements I and II are correct.

(c) Both Statements I and II are incorrect.

(d) Statement I is incorrect. Statement II is correct.

Ans: (d)

10. Which of the following is TRUE about Standards on auditing?

(a) These deal mainly with voluntary responsibilities of auditors.

(b) These deal mainly with mandatory responsibilities of auditors.

(c) Their sole purpose is to help government authorities in augmenting revenues.

(d) These deal mainly in carrying out audit according to legal provisions.

Ans: (b)

Correct /Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

(i) The basic objective of audit does not change with reference to nature, size or form of an entity.

Ans: Correct: An audit is an independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity.

(ii) The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.

Ans: Correct: As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

(iii) 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.

Ans: Correct: As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the auditor is 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, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

Theoretical Questions Answer

Question 1

"Choosing of appropriate accounting policies in relation to accounting issues is responsibility of management". Do you agree? Discuss duty of auditor, if any, in relation to accounting policies.

Answer 1

Choosing of appropriate accounting policies is responsibility of management. The role of auditor lies in evaluating selection and consistent application of accounting policies by management.

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 organized 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.

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 of 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.

Understand that financial statements of an entity are prepared on historical financial information basis. "Historical financial information" means information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

Question 2

Assurance engagements are not restricted to audit of financial statements alone. Discuss.

Answer 2

Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

It means that the practitioner gives an opinion about specific information due to which users of information are able to make confident decisions knowing well that chance of information being incorrect is diminished.

Question 3

An assurance engagement involves a three party relationship. Discuss meaning of three parties in such an engagement.

Answer 3

Following elements comprise an assurance engagement: -

1. A three party relationship involving a practitioner, a responsible party, and intended users

An assurance engagement involves abovesaid three parties. A practitioner is a person who provides the assurance. The term practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.

A responsible party is the party responsible for preparation of subject matter. Intended users are the persons for whom an assurance report is prepared. These persons may use the report in making decisions.

2. An appropriate subject matter

It refers to the information to be examined by the practitioner. For example, financial information contained in financial statements while conducting audit of financial statements.

3. Suitable criteria

These refer to benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.

4. Sufficient appropriate evidence

The practitioner performs an assurance engagement to obtain sufficient appropriate evidence. It is on the basis of evidence that conclusions are arrived and an opinion is formed by auditor.

"Sufficient" relates to quantity of evidence obtained by auditor. "Appropriate" relates to quality of evidence obtained by auditor. One evidence may be providing more comfort to auditor than the other evidence. The evidence providing more comfort is qualitative and, therefore, appropriate.

Evidence should be both sufficient and appropriate.

5. A written assurance report in appropriate form

A written report is provided containing conclusion that conveys the assurance about the subject matter. A written assurance report is the outcome of an assurance engagement.

Question 4

A Chartered Accountant is specifically asked to check accounts whether fraud exists. State with reasons whether it is an example of reasonable assurance engagement.

Answer 4

It is not a reasonable assurance engagement. It is in nature of investigation.

Question 5

An audit does not provide absolute assurance. Discuss how nature of audit procedures itself is one of the reasons due to which audit cannot provide absolute assurance.

Answer 5

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.

The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud.

It may be engaged in concealing fraud by designing sophisticated and carefully organized schemes which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.

We have already discussed under section on scope of audit that an auditor is not an expert in authentication of documents. Therefore, he may be led to accept invalid audit evidence on the basis of unauthentic documents.

It is quite possible that entity may have entered into some transactions with related parties. Such transactions may be only paper transactions and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.

Test Your Understanding

Question 1

Lalji Bhai has purchased shares of a company listed on NSE. The audited financial statements of the company provide picture of healthy financial performance having robust turnover, low debt and good profits. On above basis, he is absolutely satisfied that money invested by him is safe and there is no chance of losing his money. Do audited results and audit reports of companies provide such assurance to investors like Lalji Bhai? Is thinking of Lalji Bhai correct?

Answer 1

An audit does not provide assurance to investor in shares regarding safety of his money. Share prices of securities are affected by range of factors. An audit only provides reasonable assurance that financial statements are free from material misstatement whether due to fraud or error. Hence, thinking of Lalji Bhai is not correct.

Question 2

Good deeds Limited is engaged in business of recycling of wastes from dumping grounds of municipal corporation of Indore to usable manure. It is, in this way, also, helping to make the city clean.

During course of audit by Zoha & Zoha, a firm of auditors, it is observed by auditors that company has received a notice from Central Bench of National Green Tribunal for not following certain environmental regulations involving imposition of hefty monetary penalty on the company. The company is yet to reply to the notice. The auditors point out that same is not stated in notes to accounts in financial statements. The company points out that auditors are going beyond scope of their work. Does such a matter fall within scope of audit?

Answer 2

Proper disclosure of financial information is well within scope of audit.

Question 3

A huge fire broke out in NOIDA plant of KT Limited. Plant assets comprising building, machinery and inventories were insured from branch of a public sector insurance company. Apart from an insurance surveyor who was deputed for assessing loss, the regional office of insurance PSU also appointed a CA for verification of books of accounts/ financial records of the company and circumstances surrounding the loss. He was also requested to submit an early report. Would the report by CA in nature of audit report?

Answer 3

Appointment of CA for verification of books of accounts/financial records and circumstances surrounding the loss is for a specific objective to determine genuineness of loss and any issue affecting liability of insurance company. It is an investigation and not in nature of audit report.

Question 4

Zeeba Products is a partnership firm engaged in trading of designer dresses. The firm has appointed JJ & Co, Chartered accountants to audit their accounts for a year. The auditors were satisfied with control systems of firm, carried out required procedures and necessary verifications. In particular, they carried out sample checking of purchases, traced purchase bills to GST portal and also made confirmations from suppliers. They were satisfied with audit evidence obtained by them as part of audit exercise. An audit report was submitted to the firm giving an opinion that financial statements reflected true and fair view of state of affairs of the firm.

However, later on, it was discovered that purchase manager responsible for procuring dresses from one location was also booking fake purchases of small values by colluding with unethical dealers. Payments to these dealers were also made in connivance with accountant through banking channel.

The partners of firm blame auditors for futile audit exercise. Are partners of firm correct in their view point? Imagine any probable reason for such a situation.

Answer 4

It is example of failure of internal controls of the firm. The internal control has not operated due to collusion between employees which is a limitation of internal control itself. The auditor has relied upon internal controls. It is very nature of financial reporting that management is responsible for devising suitable internal controls. This is an inherent limitation of audit.

Question 5

The management of Exotic Tours and Travels Limited requests its auditor Raja & Co.to provide an assurance report on the financial information for first quarter of a year by skipping required detailed procedures.

Can Raja & Co. provide such a report? What would be nature of such a report? Would it be necessary for them to obtain sufficient appropriate evidence in such a case?

Answer 5

Such report would be in nature of "review". However, auditors would have to obtain sufficient appropriate evidence.

Question 6

CA. P Babu is conducting audit of financial statements of Quick Buy Private Limited. He was not able to obtain external confirmations from certain debtors due to practical difficulties and peculiar circumstances. However, such a procedure is mandated under one of Standards on Auditing.

Unable to obtain external confirmations from these debtors, he relied upon sale details to these parties, e-invoices, e-way bills and also traced payments from these parties in bank accounts of the company.

He was reasonably satisfied with audit evidence obtained. Is there any other reporting duty cast upon him relating to not following a mandated procedure in one of Standards on Auditing?

Answer 6

He is required to document how alternative procedures performed achieve the purpose of required procedure. Reason for departure has to be documented unless it is clear. His report should draw attention to such departure.

CHAPTER 2
AUDIT STRATEGY, AUDIT PLANNING AND AUDIT PROGRAMME

Question 1

The engagement partner of AST AND ASSOCIATES, firm of Chartered Accountants appointed as auditor of Fabric India Ltd is considering as to management of key resources to be employed to conduct audit. Discuss how overall audit strategy would assist the auditor. (MTP 5 Marks March '18, Oct '18)

OR

Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. The process of establishing the overall. (RTP May '20 & Nov '18) (PYP 4 Marks May '19, Old SM)

Answer 1

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:

1. 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;
2. 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;
3. When these resources are to be deployed, such as whether at an interim audit stage or at key cutoff dates; and
4. 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.

In establishing the overall audit strategy, the auditor shall

- **Ascertain the nature, timing and extent of resources necessary to perform the engagement.**

Example

- **The selection of engagement team and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.**

- **Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement. (As per Addition in May 21)**

Question 2

Examine with reasons (in short) whether the following statement is correct or incorrect:

The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (MTP 2 Marks Aug '18)

Answer 2

Correct: The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks.

Question 3

The auditor 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. Explain. (MTP 5 Marks Aug '18, RTP Nov '20 & Nov '18)

Answer 3

The auditor shall document:

(a) the overall audit strategy;

(b) the audit plan; and

(c) any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures t hat can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects

the appropriate response to the significant changes occurring during the audit.

For instance-

The following things should form part of auditor's documentation:

- A summary of discussions with the entity's key decision makers
- Documentation of audit committee pre-approval of services, where required
- Audit documentation access letters
- Other communications or agreements with management or those charged with governance regarding the scope, or changes in scope, of our services
- auditor's report on the entity's financial statements.
- Other reports as specified in the engagement agreement (e.g., debt covenant compliance letter)

Question 4

Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Discuss stating clearly the broad points you would be covering in framing plan to conduct audit in an efficient and effective manner. (MTP 5 Marks Oct 18)

OR

"The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business" Discuss stating clearly the broad points you would be covering in framing plan to conduct audit in an efficient and effective manner. (MTP 4 Marks March), (19, MTP 5 Marks March '18), (RTP Nov 18, Nov 19 & May '19, May'23)

Answer 4

"The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business".

Plans should be made to cover, among other things:

(a) acquiring knowledge of the client's accounting systems, policies and internal control procedures;

(b) establishing the expected degree of reliance to be placed on internal control;

(c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and

(d) coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit.

SA-300, "Planning an Audit of Financial Statements" further expounds this principle. According to it, **planning is not a discrete phase of an audit, but rather a continual and iterative process** that often begins shortly after (or in connection with) the completion of the previous audit and continues

until the completion of the current audit engagement. 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.

Question 5

The establishment of the overall audit strategy and the detailed audit plan are closely inter-related.

Explain (MTP 3 Marks March '19)

Answer 5

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.

Question 6

M & Co. was appointed as auditor of IGI Ltd. As an auditor what are the factors that would be considered in the development of overall audit plan? (MTP 4 Marks April 19, PYP 5 Marks, May '18)

OR

Your firm has been appointed as an auditor to audit the accounts of an auto parts manufacturer, ABC LTD. Elucidate the matters to be considered by an auditor in developing his overall plan for the expected scope and conduct of audit. (MTP 4 Marks Oct 20)

Answer 6

Development of an Overall Plan: The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit-

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are

interested and with whom transactions are likely.

- The degree of reliance he expects to be able to place on accounting system and internal control.
- Possible rotation of emphasis on specific audit areas.
- The nature and extent of audit evidence to be obtained.
- The work of internal auditors and the extent of their involvement, if any, in the audit.
- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.
- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.

  Establishing and coordinating staffing requirements.

Question 7

The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. Explain the factors due to which above varies. (MTP 4 Marks May 20, RTP Nov '20)

Answer 7

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

   Example

   An increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work.
4. The capabilities and competence of the individual team members performing the audit work.

   Example

   We may have identified a problem related to the production process that raised concerns about inventory obsolescence. After obtaining an understanding of the entity's process that raised concerns about inventory obsolescence (which we had identified as a significant class of transactions), we concluded that additional tests of details were required. Therefore, the senior will likely take part, along with the team, in the discussions with management about the provision for obsolescence and examine related documentation supporting the provision, rather than just reading the memo on file. These procedures should be completed as the work is being performed rather than as an after the fact review. The extent of the senior's involvement requires judgment, taking into consideration the complexity of the area and the experience of the team.

Question 8

Examine with reasons (in short) whether the following statements are correct or incorrect:

A detailed Audit Programme once prepared for a business can be used for all business under all circumstances. (MTP 2 Marks Oct 20, Nov '21, March 22 & Oct 22, Old & New SM)

OR

Evolving one audit programmer applicable to all business under all circumstances is not practicable.

Explain (RTP May '19 & May '18)

Answer 8

Incorrect. 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.

Question 9

The auditor should update and revise the audit plan as and when required, however, the overall audit strategy once established cannot be changed during the course of audit. (MTP 2 Marks March'21)

OR

Once the audit plan has been drafted and communicated, it is obligatory on the auditor to follow the same. (MTP 2 Marks April '23, PYP 2 Marks Nov '18)

Answer 9

Incorrect: The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures.

Question 10

"The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner." Explain stating the matters to be covered in plans. (MTP 4 Marks March '21)

Answer 10

"The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business".

Plans should be made to cover, among other things:

(i) acquiring knowledge of the client's accounting systems, policies and internal control procedures;

(ii) establishing the expected degree of reliance to be placed on internal control;

(iii) determining and programming the nature, timing, and extent of the audit procedures to be performed; and

(iv) coordinating the work to be performed.

Question 11

"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 3 Marks Oct '21 & MTP 4 Marks April '22, RTP Nov'23)

Answer 11

In establishing the overall audit strategy, the auditor shall:

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

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

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

(d) 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

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

Question 12

In establishing overall audit strategy, the auditor shall ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required. Elucidate those cases by which auditor can ascertain the reporting objectives of the engagement. (MTP 4 Marks Nov '21 & April '23, RTP Nov'23, PYP 4 Marks Nov '19)

Answer 12

In establishing the overall audit strategy, auditor shall ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required. The cases by which auditor can ascertain the reporting objectives of the engagement are:

(i) The entity's timetable for reporting, such as at interim and final stages.

(ii) The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.

(iii) The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.

(iv) The discussion with management regarding the expected communications on the status of audit work throughout the engagement.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Most of the Examinees mentioned about the audit strategy with respect to reporting objectives only without focusing on strategy to plan the timing of the audit and the nature of the communications required.

Question 13

CA Vikas Jain discussed with his audit team about advantages and disadvantages of audit programme.

He explained to his team that –"work may become mechanical" as disadvantage of the audit programme. Discuss explaining the disadvantages of an audit programme (MTP 4 Marks March 22)

Answer 13

Some disadvantages are there in the use of audit programme. The disadvantages are:

(i) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.

(ii) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in

staff or internal control may render precaution necessary at points different from those originally decided upon.

(iii) Inefficient assistants may take shelter behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.

(iv) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

Question 14

Examine with reasons (in short) whether the following statements are correct or incorrect: (2 Marks) (Sep'22)

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. (MTP 2 Marks Sep'22)

Answer 14

Correct: The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy, and the object of the audit may be altogether lost in the mass of entries and vouchers.

Question 15

"An adequate planning benefits the audit of financial statements." Discuss. (MTP 4 Marks Sep'22 & March '23, PYP 5 Marks, Nov '18, RTP May '19, May '23,Nov '19,Nov '21,May '18)

Answer 15

Benefits of Planning in the audit of financial statements: Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

1. Helping the auditor to devote appropriate attention to important areas of the audit.
2. Helping the auditor identify and resolve potential problems on a timely basis.
3. Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
4. Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
5. Facilitating the direction and supervision of engagement team members and the review of their work.
6. Assisting, where applicable, in coordination of work done by auditors of components and experts.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Few examinees wrote wrongly about the benefits of audit to the auditee organization, like for settlement of tax disputes, achieving organizational goals etc . which was not required.

Question 16

XYZ & associates are appointed as the statutory auditors of Fisco Ltd. for the FY 2021 -22. While constructing the audit programme, the engagement partner, CA X, should keep in mind various points. List such points. (MTP 4 Marks Oct'22)

OR

Arpan Hospitals Ltd having Gross Professional Charges of ₹ 50 crores are engaged in providing healthcare services. STP & Co., a firm of auditors is appointed as its auditors.

Advise what special points to be kept in mind for the purpose of construction of an Audit programmer.

Explain. (RTP May '18 & Nov '22, PYP 3 Marks, May '19)

OR

Discuss the points to be considered by auditor for the purpose of constructing an audit program me. (PYP 4 Marks Nov,19)

Answer 16

For the purpose of audit programme construction, CA X should keep in mind the following points:

(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.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Examinees have written general answers on meaning and advantages of Audit programme instead of focusing on aspects to be looked into for construction of an Audit programme.

Question 17

Examine with reasons (in short) whether the following statements are correct or incorrect.

Understanding the Internal Control of a company will not help the auditor in developing an Audit Programme. (MTP 2 Marks March '23)

Answer 17

Incorrect: Understanding the Internal Control of a company will help in developing an Audit Programme because it will assist the auditor and his team to understand as to how much they can rely on internal control of the company and what audit procedures would be appropriate to be used during the course of audit.

Question 18

Examine with reasons (in short) whether the following statements are correct or incorrect.

Planning is a discrete phase of an audit. (MTP 2 Marks March '23, RTP Nov'19, Old & New SM)

Answer 18

Incorrect: Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures.

Question 19

As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan. Explain (RTP Nov '19 & Nov '18, PYP 2 Marks May 22)

Answer 19

The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

Question 20

Examine with reasons (in short) whether the following statements are correct or incorrect:

The overall audit strategy is more detailed than the audit plan. (MTP 2 Marks Sep '23, PYP 2 Marks Nov '20, Old & New SM)

Answer 20

Incorrect: 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. Once the overall audit strategy has been established, an audit plan can be developed to achieve the audit objectives through the efficient use of the auditor's resources.

Question 21

State with reason (in short) whether the following statements are true or false:(RTP Nov'19)

The auditor need not discuss elements of planning with the entity's management in any case.

Answer 21

Incorrect: The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement.

Question 22

Plans should be further developed and revised as necessary during the course of the audit. Explain. (RTP May '20)

Answer 22

Plans should be further developed and revised as necessary during the course of the audit.

SA-300, "Planning an Audit of Financial Statements" further expounds this principle. According to it, planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. 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.

Question 23

State with reason (in short) whether the following statements are true or false:

Overall audit plan sets the scope, timing and direction of the audit, and guides the development of the more detailed audit strategy. (RTP Nov'20, Old & New SM)

Answer 23

Incorrect: Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

Question 24

Evolving one audit programme applicable to all business under all circumstances is not practicable.

Explain clearly stating in detail the meaning of audit programmer. (RTP Nov'20)

Answer 24

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 programmer applicable to all business under all circumstances is not practicable. However, it becomes a necessity to specify in detail in the audit programmer the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

It is desirable that in respect of each audit and more particularly for bigger audits an audit programmer should be drawn up. Audit programmer 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 discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client.

Definition: An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements.

In other words, an audit programmer is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

Question 25

State with reason (in short) whether the following statements are true or false:

When establishing the overall audit strategy, the auditor need not determine materiality for the financial statements as a whole. (RTP May '21)

Answer 25

Incorrect: When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole.

Question 26

Without adequate knowledge of client's business, a proper audit is not possible. It is one of the important principles in developing an overall audit plan. Explain in context with relevant SA, knowledge to be obtained by the auditor in establishing overall plan. Also explain how such an understanding would be helpful to the auditor. (RTP May '21)

Answer 26

Without adequate knowledge of client's business, a proper audit is not possible. It is one of the important principles in developing an overall audit plan. As per SA-315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment", the auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory and other external factors including the applicable financial reporting framework.

(b) The nature of the entity, including:
   (i) its operations;
   (ii) its ownership and governance structures;
   (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
   (iv) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(e) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations and to make judgements regarding the appropriateness of accounting policies and disclosures.

Question 27

Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after the completion of the previous audit and continues until the completion of the current audit engagement. Planning includes the need to consider certain matters prior to the auditor's identification and assessment of the risks of material misstatement. Explain clearly stating those matters also. (RTP May '21 & Nov '19, Old SM)

Answer 27

In the context of recurring audits, as per SA-300, "Planning an Audit of Financial Statements", Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, 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.

Question 28

State with reason (in short) whether the following statements are true or false:

Planning is not a discrete phase of an audit, but rather a continual and iterative process. (RTP Nov 18 & May 19)

Answer 28

Correct: According to SA-300, "Planning an Audit of Financial Statements", planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.

Question 29

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 programmer may be removed. Explain (RTP May '19)

Answer 29

Periodic Review of the Audit Programme

There should be periodic review of the audit program me 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 program me and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

Example- if the audit program me for the audit of a branch of a financing house, drawn up a number of years ago, fails to take into consideration that the previous policy of financing of a vehicle has been changed to financing of real estate acquisition, the whole audit conducted thereunder would be entirely misdirected and may even result into nothing more than a farce. [Pacific Acceptance Corporation Ltd. v. Forsyth and Others.]

The utility of the audit program me can be retained and enhanced only by keeping the program me as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the program me may be removed. However, as a basic feature, audit program me 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 program me is not officially changed by the principal, every assist- ant 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 program me. This is not true provided the periodic review is undertaken to keep the program me as upto-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

Question 30

Without adequate knowledge of client's business, a proper audit is not possible. The auditor shall obtain an understanding of the entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. Explain giving examples. (RTP May '22)

Answer 30

Knowledge of the client's business is one of the important principles in developing an overall audit plan.

In fact without adequate knowledge of client's business, a proper audit is not possible. As per SA-315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and

Its Environment", the auditor shall obtain an understanding of the entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

Example

1. If one of management's objectives is to grow the business, management may develop a strategy of steady but regular growth through specific marketing campaigns and development of new markets. Alternatively, management may develop a more aggressive, complex strategy of acquiring competitors. Each of these strategies gives rise to differing business risks and potentially differing risks of material misstatement.
2. Examples of potential business risks include:
   (i) Failure to keep up to date with new products, technologies or services.
   (ii) Excessive reliance on a key supplier, product or individual, such as the owner.
   (iii) Lack of personnel with expertise to react to changes in the industry.
   (iv) Insufficient or excessive production capacity caused by inaccurate estimation of demand.

Loss of financing due to the entity's inability to meet financial covenants

Question 31

State with reason (in short) whether the following statements are true or false

Development of an audit plan is important before the establishment of the overall audit strategy to address the various matters. (RTP Nov'22)

Answer 31

Incorrect: As per SA-300, "Planning an Audit of Financial Statements", 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. 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.

Question 32

The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors. Discuss those factors. (RTP Nov'22, Nov '21, Old & New SM)

Answer 32

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:

• The size and complexity of the entity.

• The area of the audit.

• The assessed risks of material misstatement (for example, an increase in the assessed risk of material

misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work).

The capabilities and competence of the individual team members performing the audit work

Question 33

Explain what do you mean by documentation of audit plan. Discuss the purpose served by it and also elaborate the tools used by the auditor to reflect the particular engagement circumstances. (RTP Nov'22)

Answer 33

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.

The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances

Question 34

State with reason (in short) whether the following statements are true or false:

Once the overall audit has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy. The establishment of the overall audit strategy and the detailed audit plan are closely inter -related. (RTP May '23)

Answer 34

Correct: 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.

Question 35

In establishing the overall audit strategy, the auditor shall identify the characteristics of the engagement that define its scope. Explain with example. (RTP May '23)

Answer 35

In establishing the overall audit strategy, the auditor shall Identify the characteristics of the engagement that define its scope.

For Example:

- The expected audit coverage, including the number and locations of components to be included.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.

Question 36

The audit plan includes the nature, timing and extent of audit procedures to be performed by engagement team members. Explain. (RTP Nov '23, Old SM)

OR

Engagement Partner CA Hitesh Kapur of Kapur and Associates wanted to develop an audit plan of Sampurna Fabrics Ltd. Discuss the matters to be described in such an audit plan. (RTP May'22)

Answer 36

The auditor shall develop an audit plan that shall include a description of

(a) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".

(b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".

(c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

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.

Example

Planning of the auditor's risk assessment procedures occurs early in the audit process.

However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

Question 37

State with reason (in short) whether the following statements are true or false:

There is no relation between Audit Plans and knowledge of the client's business (RTP May '19, RTP Nov'18)

Answer 37

Incorrect: The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business

Question 38

Examine with reasons whether the following statements are correct or incorrect.

Under a properly framed audit programme by the auditor, the danger is significantly less and audit can proceed systematically (PYP 2 Marks, Nov'19)

Answer 38

Correct: Without a written and pre-determined program me, 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. Thus under a properly framed program me, the danger is significantly less and the audit can proceed systematically.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Many examinees attempted the question but few examinees did not correlate with the advantages of audit programme which was required.

Question 39

Examine with reasons whether the following statements are correct or incorrect. It is not necessary for the auditor to periodically review the audit program me. (PYP 2 Marks, Nov'20)

Answer 39

Incorrect: There should be periodic review of the audit program me 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 program me. and for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

Question 40

Documentation of audit plan serves as a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. What all activities in the planning phase should form part of auditor's documentation? State with examples. (PYP 4 Marks, July'21)

Answer 40

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.

Example

The following things should form part of auditor's documentation:

- A summary of discussions with the entity's key decision makers.
- Documentation of audit committee pre-approval of services, where required.
- Audit documentation access letters.
- Other communications or agreements with management or those charged with governance regarding the scope, or changes in scope, of our services.
- Auditor's report on the entity's financial statements.
- Other reports as specified in the engagement agreement (e.g., debt covenant compliance letter).

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

All activities in the planning stage form part of auditor's documentation : Most of the examinees did not have fair knowledge of the topic and did not discuss about the examples.

They generally discussed about the audit plan, which was not required of the question.

Question 41

You have been appointed as an auditor of a health care service provider. Briefly discuss the special points that should be kept in mind as an auditor for developing an audit program me. (PYP 4 Marks July 21) (Includes concepts of Audit of Different Type of Entities) (RTP May '19)

Answer 41

The special points to be kept in mind as an auditor for developing an audit program me of healthcare service provider are:

1. **Register of Patients:** Auditors to vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.
2. **Collection of Cash:** Auditor to check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

3. **Income from Investments, Rent etc.** See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities have been collected.
4. **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
5. **Reconciliation of Subscriptions:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).
6. **Authorization and Sanctions:** Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorized.
7. **Grants and TDS:** Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.
8. **Budgets:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.
9. **Internal Check:** Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorization.
10. **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.
11. **Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.
12. **Inventories:** Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.
13. **Management Representation and Certificate:** Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Alternative Answer

Developing the Audit Programme:

1. **Written Audit Programme:** The auditor should prepare a written audit program me setting forth the procedures that are needed to implement the audit plan.
2. **Audit Objective and Instruction to Assistants:** The program me may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.
3. **Reliance on Internal Controls:** In preparing the audit program me, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures.

The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.

4. **Timings of Performance of Audit Procedures:** The auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.
5. **Audit Planning:** The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related program me, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Most of the examinees answered in general sense instead of giving special points of consideration for development of audit programme.

Question 42

M/s TP & Co., a firm of Chartered Accountants, is auditor of KSR Ltd. for many years. KSR Ltd. has diversified their business into newer areas during the last year. The senior member of the audit team handed over the standard audit programme of earlier years to the audit assistants and instructed them to follow the same. The assistants are conducting the audit accordingly. Whether the attitude of the audit assistants is justified or they are required to keep an open mind? Guide them. (PYP 4 Marks Dec '21)

Answer 42

The Assistant Engaged – Be Encouraged to Keep an Open Mind:

To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme. As experience is gained by actually carrying out the work, the programme may be altered to take care of situations which were left out originally, but are found relevant for the particular concern. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped. The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him. He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

In the given case, the attitude of assistants of TP & Co. is not justified. They should keep an open mind and go beyond the programme to take care of newer areas of the business of KSR Ltd. into which the Company has diversified.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

The Assistant Engaged - Be Encouraged to Keep an Open Mind: Most of the examinees concluded well but failed to justify the conclusion. They did not write about discussions with seniors, dropping of irrelevant parts of earlier audit programme etc., rather some examinees wrote about professional skepticism and auditor's independence which was not required.

Question 43

"Planning is not a discrete phase of an audit, but rather a continual and iterative process." Discuss. (PYP 5 Marks, Nov '18)

Answer 43

Audit Planning- a Continuous Process

Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

(i) The analytical procedures to be applied as risk assessment procedures.

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

(iii) The determination of materiality.

(iv) The involvement of experts.

(v) The performance of other risk assessment procedures.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Examinees could not understand the question and mentioned either the benefits of planning or simply focused as audit planning is a continuous process. They did not explain fields where the audit planning as a continuous process is required.

Question 44

The "documentation of the overall audit strategy" is a record of the audit evidence considered necessary to properly plan the audit and to assign various audit functions to the engagement team. (PYP 2 Marks May '23)

Answer 44

Incorrect: The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

MULTIPLE CHOICE QUESTIONS (MCQS)

TEST YOUR KNOWLEDGE

1. When planning the audit,

(a) the auditor considers what would make the financial information materially misstated.

(b) the auditor need not consider what would make the financial information materially misstated.

(c) the auditor need not consider what would make the financial information materially misstated at planning stage

(d) the auditor needs to consider what would make the financial information materially misstated while conducting audit only **(MTP 1 Mark March '19)**

Ans: (a)

2. With reference to SA 300, the auditor shall document:

(a) The overall audit strategy

(b) The audit plan

(c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

(d) All of the above **(MTP 1 Mark April'19)**

Ans: (d)

3. Planning an audit involves

(a) establishing the overall audit strategy for the engagement and developing an audit plan.

(b) establishing the overall audit plan for the engagement and developing an audit strategy.

(c) establishing the overall audit plan for the engagement

(d) developing an audit strategy. **(MTP 1 Mark Oct 19)**

Ans: (a)

4. According to SA 300,

(a) planning is not a continual and iterative phase of an audit, but rather a discrete process

(b) planning is not a discrete phase of an audit, but rather a continual and iterative process

(c) planning is not continual and iterative process

(d) planning is not a discrete phase of an audit **(MTP 1 Mark Oct 19)**

Ans: (b)

5. The auditor shall update and change as necessary during the course of the audit.

(a) overall strategy

(b) the overall audit strategy and the audit plan

(c) audit plan

(d) audit program **(MTP 2 Marks May 20)**

Ans: (b)

6. CA R illustrated to his team that 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 recurrent assessment. Which attribute of the Audit Programme is highlighted here?

(a) Static Review
(b) Mechanical Review
(c) Periodic Review
(d) Obsolete Review **(MTP 2 Marks Oct 21)**

Ans: (c)

7. The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

(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.

Which of the following is correct?

(a) (i),(ii),(iii)
(b) (i),(ii),(iii), (iv), (v)
(c) (iz), (ii), (iv), (v)
(d) (i),(ii),(iii), (iv) **(MTP (1 Marks March 22)**

Ans: (b)

8. Sets the scope, timing & direction of the audit and guides the development of the more detailed plan.

(a) Audit Programme
(b) Overall Audit Strategy
(c) Completion Memorandum
(d) Audit Plan **(MTP 1 Mark April 22)**

Ans: (b)

9. The overall audit strategy and the audit plan remain the responsibility.

a) auditor's

b) management's

c) those charged with governance.

d) both management and those charged with governance. **(MTP 1 Mark March '23)**

Ans: (a)

10. Which of the following statements is MOST APPROPRIATE?

(a) Audit programme is a detailed plan of audit strategy

(b) Audit programme cannot be reviewed

(c) Audit programme is a detailed plan of applying audit procedures

(d) Audit programme is relevant for year for which it is prepared, it is useless for subsequent years. **(RTP Nov'22)**

Ans: (c)

CASE STUDY

Kaur & Associates, a sole proprietor firm of Simran Kaur, is offered appointment as auditor of a company engaged in manufacturing of automobile components for the first time. She is fact checking about the integrity of promoters of the company and key managerial persons. Matters such as competence of staff to perform the engagement are also considered by her. The appointment is subsequently accepted by her.

She is also taking into account number and location of branches of the company, requirements of Schedule III of Companies Act, 2013 and expected time by which audit has to be completed keeping in view statutory requirements. Initially, she has thought it proper to inquire key employees of the company in procurement and marketing departments and planned for the same. She has also planned to visit three plants of the company. The purpose of planned inquiry and visit is to identify and assess risk of material misstatements.

A detailed set of instructions has been prepared by her office and it has been handed over to assistants in engagement team. These set of instructions include details of extent of checking and nature of audit procedures to be performed regarding purchases, sales, items of income, items of expenditure etc.

During the course of execution of above set of instructions, it has been brought to her notice that company is also producing substantial quantities of scrap generated during manufacturing process.

However, no instructions have been given to engagement team in this regard.

MULTIPLE CHOICE QUESTIONS (MCQS)

Based on above, answer following questions:

1. Auditor is fact checking about promoters and key managerial persons. She is also considering competence of staff to perform engagement. What is she trying to do?

(a) She is establishing audit strategy.

(b) She is conducting preliminary engagement activities.

(c) She is designing audit plan.

(d) She is checking her compliance of ethical requirements.

Ans: (b)

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2. Consideration of number and location of branches, requirements of financial reporting framework and expected time of completion are relevant factors primarily for which of the following -

(a) Developing audit plan

(b) Establishing overall audit strategy

(c) Designing audit programme

(d) Designing risk assessment procedures

Ans: (b)

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3. Taking into account description of planned inquiry and visit, which of the following statements is TRUE?

(a) Planned inquiry and visit fall in area of audit strategy.

(b) Planned inquiry and visit are planned risk assessment procedures and fall in field of audit plan.

(c) The said description is not related to audit planning.

(d) Planned inquiry and visit fall in scope of audit programme.

Ans: (b)

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4. What is detailed set of instructions given to assistants in engagement team known as?

(a) Audit guidelines

(b) Audit plan

(c) Audit Programme

(d) Audit Procedures

Ans: (c)

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5. The issue of generation of scrap has been overlooked in detailed set of instructions given to engagement team. What should be proper course of action by CA Simran Kaur?

(a) She should ignore this information as audit has already begun.

(b) She should modify earlier set of instructions.

(c) She should leave the matter to wisdom of engagement team.

(d) She should put the ball in court of management as she was not provided with complete information earlier.

Ans: (b)

TEST YOUR KNOWLEDGE

6. Which of the following is not considered in planning an audit generally?

(a) Understanding of legal and regulatory framework of an entity

(b) Need to consider determination of materiality

(c) Evaluating audit evidence

(d) Need to consider involvement of expert

Ans: (c)

7. Which of the following is true about audit plan?

(a) Once an audit plan has been finalized for an engagement, changes cannot be made to it.

(b) Audit plan includes scope, timing and direction of planned risk assessment procedures.

(c) Changes in audit plan cannot lead to change in audit strategy.

(d) Audit plan has to be documented by auditor.

Ans: (d)

8. Which of the following is not included in an audit programme normally?

(a) Extent of checking

(b) Date of checking

(c) Nature or type of procedure

(d) Planning of risk assessment procedures

Ans: (d)

9. Which of the following is not an advantage of an audit programme?

(a) It acts as a guide for audit of coming years.

(b) It fixes responsibility of assistants.

(c) It serves as a shelter for assistants.

(d) It serves a proof of work done by auditor.

Ans: (c)

10. Which of the following is most important principle for formulating an audit plan?

(a) Gaining knowledge of client's workforce

(b) Gaining knowledge of client's business

(c) Gaining knowledge of client's vendors

(d) Gaining knowledge of tax laws applicable to client

Ans: (b)

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

Question 1

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.

Answer 1

Correct: Once the overall audit strategy has been established, an audit plan can be developed 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.

Question 2

Establishing an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan is prerogative of the management.

Answer 2

Incorrect: 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.

Question 3

Planning is a discrete phase of an audit.

Answer 3

Incorrect: Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begin shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures.

Question 4

A detailed Audit Programme once prepared for a business can be used for all business under all circumstances.

Answer 4

Incorrec: 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.

Question 5

The audit plan is more detailed than the overall audit strategy.

Answer 5

Correct: 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.

Theoretical Questions Answer

Question 1

Discuss how performing preliminary engagement activities as part of planning an audit assists auditor.

Answer 1

Performing preliminary engagement activities assists the auditor in identifying and evaluating events or circumstances that may affect auditor's ability to plan and perform audit engagement.

The auditor considers whether relationship with client should be continued and whether ethical requirements including independence continue to be complied with. It includes: -

(A) Performing procedures regarding the continuance of the client relationship

(B) Evaluating compliance with ethical requirements, including independence

(C) Establishing an understanding of terms of engagement

Question 2

Discuss how an engagement partner ensures that firm complies with relevant ethical requirements including independence in relation to client.

Answer 2

The auditor shall continuously evaluate compliance with ethical requirements including independence. "Independence" means that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.

Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. If matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action.

The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner 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.

Besides, consideration for client continuance and compliance with ethical requirements, preliminary engagements activities also include establishing an understanding of terms of engagement.

Question 3

"Purported disadvantages of an audit programme can be overcome". Do you agree?

Answer 3

Purported disadvantages of audit programme may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal.

The disadvantages are: -

(a) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.

(b) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.

(c) Inefficient assistants may take shelter behind the programme i.e., defend deficiencies in their work on the ground that no instruction in the matter is contained therein.

(d) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/ principal.

Question 4

An auditor of a company fails to document audit strategy and audit plan. Briefly outline consequences of such failure.

Answer 4

The auditor shall document: -

(a) the overall audit strategy

(b) the audit plan and

(c) any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Question 5

SA 300 states that auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. Discuss few factors affecting such supervision and review of work of engagement team members.

Answer 5

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.

Question 6 (Illustration)

The auditor T of Hand Fab Ltd is worried as to management of key resources to be employed to conduct audit.

Required

How the audit strategy would be helpful to the auditor?

Answer 6

Refer - Establishing the overall audit strategy- Assistance for the auditor for solution.

(A) Development of Audit plan

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.

Understanding client's business is one of the important principles in developing an audit plan. In fact, without adequate knowledge of client's business, a proper audit is not possible. Gaining knowledge of client's business is, therefore, one of the foremost requirements to develop audit plan.

SA-300 states that auditor shall develop an audit plan that shall include description of-

(i) The nature, timing and extent of planned risk assessment procedures

(ii) The nature, timing and extent of planned further audit procedures at assertion level

(iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

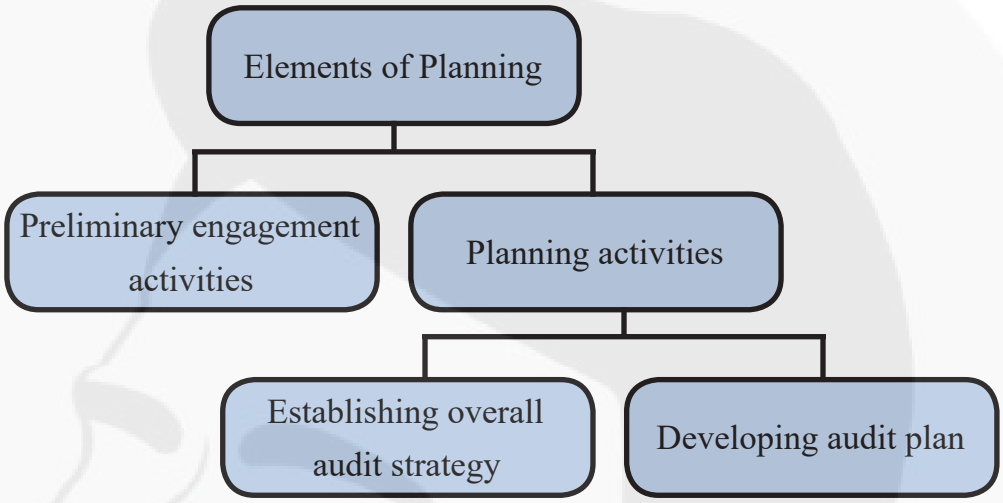
The auditor plans what type of audit procedures are to be performed, their timing and how much work should be done taking into account sample size etc.

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.

For example, planning of the auditor's risk assessment procedures occurs early in the audit process.

However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.



Question 7 Illustration

W, the auditor of SKM Ltd. asks its finance and audit head to prepare audit strategy for conducting audit of SKM Ltd. W also insists him to draw detailed audit procedures. On the request of auditor W completes audit strategy as well as audit procedures as prepared by finance head of the company.

Subsequently, auditor realizes that effectiveness of the audit is compromised and it was his responsibility to prepare the overall audit strategy. Comment.

Answer 7

The overall audit strategy and the audit plan remain the auditor's responsibility. It is the auditor who is responsible for establishing overall audit strategy and developing audit plan. However, as discussed earlier, auditor may discuss elements of planning with entity's management without compromising effectiveness of audit.

Accordingly, approach of W was wrong and he should have prepared overall audit strategy and detailed audit procedures.

Test Your Understanding

Question 1

MG & Co, a firm of auditors, having a standing of 30 years is appointed as a statutory auditor of company engaged in manufacturing of defence equipment. Due to opening of defence sector by government to private players in recent times, many new companies have entered the fray to manufacture sophisticated defence equipment. Considering technical and complex nature of operations, the auditors recognize that involvement of experts in the audit is required. Does consideration for involvement of experts by auditors fall in the domain of planning audit?

Answer 1

Consideration for involvement of experts by auditors falls within domain of planning. While planning an audit, auditor would have to consider whether involvement of experts is necessary. In the stated case, company is involved in technical and complex operations. Therefore, while planning an audit, auditors would have to consider whether involvement of expert is necessary.

Question 2

CA Kartik is planning for audit of a company engaged in manufacturing of cosmetics. Considering nature of operations of the company, he had planned to include testing of controls of the company over purchases, sales and inventories. One fine day, he reaches the corporate office and asks for manuals and required documentation to ensure surprise element in testing. He had never shared with management his intention to carry out above procedures. Is approach of CA Kartik proper?

Answer 2

In the case, CA Kartik has reached office of the company without sharing with management his intention to test the controls. The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement without compromising effectiveness of audit. Sharing details of visit to test controls does not compromise effectiveness of audit. It is for the better facilitation and conduct of audit. Therefore, approach of CA Kartik is not proper.

Question 3

CA Mary, while planning audit of a company, feels that she would inquire from in-house legal counsel of the company status of pending litigation matters against the company to identify and assess risks of material misstatements. Considering above description, are you able to identify said procedures?

Where these identified procedures are included in planning in accordance with SA-300?

Answer 3

These are planned risk assessment procedures to identify and assess risk of material misstatement. The objective of planned inquiry of in-house legal counsel is to identify and assess risk of material misstatement. Such planned risk assessment procedures are included in audit plan in accordance with SA- 300.

Question 4

CA Shubhendu is statutory auditor of a social media company. Due to change in information technology regulations by government, it has become mandatory for such companies to constitute "grievance redressal mechanism" for users of social media platform of the company. Failure to comply with regulations can potentially lead to civil and criminal liabilities against the company. Is above factor to be considered by auditor while framing audit strategy?

Answer 4

Changes in laws and regulations affecting the company is a factor to be considered while establishing overall audit strategy. There has been change in information technology regulations applicable to the company. Non- compliance of the same can have implications in form of civil and criminal liabilities. Such an important matter concerning changes in laws and regulations is to be considered by auditor while establishing overall audit strategy.

Question 5

Rohit, undergoing practical training, is part of an engagement team conducting audit of a company engaged in manufacturing of paints. He has been provided with audit programme pertaining to sales.

It lists out various items to be checked and verified by him including invoices, rate lists, posting in debtors accounts, correlation of invoices with e-way bills on sample basis etc.

During verification, he notices that many e-way bills have been cancelled by the company within 24 hours of their generation in month of March. There is no specific instruction in audit programme in this regard. He keeps mum. Is attitude of Rohit proper?

Answer 5

Attitude of Rohit is not proper. The assistants should observe matters objectively and bring significant matters to the notice of supervisor/principal. Reasons for cancellation of many e-way bills in month of March need to be looked into. Matter should be informed to engagement partner.

CHAPTER 3
RISK ASSESSMENT AND INTERNAL CONTROL

Question 1

Examine with reasons (in short) whether the following statement is correct or incorrect: When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. (MTP 2 Marks March '18, Oct'18, RTP Nov '20)

Answer 1

Correct: When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

Question 2

Examine with reasons (in short) whether the following statement is correct or incorrect:

The assessment of risks is a matter capable of precise measurement. (MTP 2 Marks March '18, Aug 18, Mar'19, RTP Nov'19)

Answer 2

Incorrect: The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

Question 3

Examine with reasons (in short) whether the following statement is correct or incorrect:

Misstatements in the financial statements can arise from fraud only. (MTP 2 Marks Aug '18, Oct'18 & March '18)

Answer 3

Incorrect: Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

Question 4

Examine with reasons (in short) whether the following statement is correct or incorrect: The assessment of risks is a matter of professional judgement. (RTP 2 Marks Oct 18)

Answer 4

Correct: The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

Question 5

The auditor shall identify and assess the risks of material misstatement at both levels to provide a basis for designing and performing further audit procedures. For the purpose of Identifying and assessing the risks of material misstatement the auditor shall Identify risks, assess the identified risks, relate the identified risks and consider the likelihood of misstatement. Explain the above in detail. (MTP 5 Marks Oct 18)

OR

For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall identify risks throughout the process of obtaining an understanding of the entity and its environment. Explain in detail along with other relevant points. (RTP Nov'20).

OR

Discuss the steps to be taken by the auditor for the purpose of Identifying and assessing the risks of material misstatement as per SA 315. (MTP 4 Marks Sep'22)

Answer 5

Identify and assess the risks of material misstatement

(i) The auditor shall **identify and assess** the risks of material misstatement at:

(A) the financial statement level –

(B) the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures

(ii) For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall:

(A) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;

(B) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(C) Relate the identified risks to what can go wrong at the assertion level, tak ing account of relevant controls that the auditor intends to test; and

(D) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Question 6

Examine with reasons (in short) whether the following statement is correct or incorrect:

The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. (MTP 2 Marks April 19)

Answer 6

Correct: The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion.

Question 7

Examine with reasons (in short) whether the following statement is correct or incorrect:

'Test of Control' may be defined as an audit procedure designed to detect material misstatements at the assertion level (MTP 2 Marks Oct 19)

Answer 7

Incorrect: 'Substantive procedure' may be defined as an audit procedure designed to detect material misstatements at the assertion level whereas 'tests of controls' is an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Question 8

In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment". (MTP 4 Marks Oct 19)

Answer 8

Obtaining Knowledge of the Business: The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information among other things.

As per SA 315 – "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework

(b) The nature of the entity, including:

(i) its operations;

(ii) its ownership and governance structures;

(iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

(iv) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(e) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

Question 9

Examine with reasons (in short) whether the following statement is correct or incorrect: Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur. (MTP 2 Marks Oct 20 & March '23)

Answer 9

Incorrect: Assertions refer to representations by management that are embodied in the financial statements as used by the auditor to consider the different types of the potential misstatements that may occur.

Question 10

The division of internal control into five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. Mention those components of internal control. (MTP 4 Marks Oct '20, Oct '21, MTP 3 Marks Mar'23, RTP May 23)

Answer 10

Division of Internal Control into Components: The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

(i) The control environment;

(ii) The entity's risk assessment process;

(iii) Monitoring of controls.

(iv) Control activities; and

(v) The information system, including the related business processes, relevant to financial reporting, and communication;

Question 11

Control environment can prevent, detect and correct a material misstatement. (MTP 2 Marks April 22, RTP Nov '23 & May '23)

Answer 11

Incorrect: The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

Question 12

There is an inverse relationship between detection risks and the combined level of inherent and control risks. (MTP 2 Marks April 22, RTP Nov '22 & Nov '23)

Answer 12

Correct: There is an inverse relationship between detection risks and the combined level of inherent and control risks. For example, when inherent and control risks are high. acceptable detection risks need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risks and still reduce audit risks to an acceptably low level.

Question 13

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the classes of transactions in the entity's operations that are significant to the financial statements, controls surrounding journal entries etc. Explain the other considerations in this regard. (MTP 4 Marks April 22 & Sep '23, RTP May '21)

Answer 13

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following are as under:

(a) The classes of transactions in the entity's operations that are significant to the financial statements;

(b) The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

(c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions;

(d) How the information system captures events and conditions that are significant to the financial statements;

(e) The financial reporting process used to prepare the entity's financial statements;

(f) Controls surrounding journal entries.

Question 14

Examine with reasons (in short) whether the following statements are correct or incorrect: (MTP 2

Marks Sep'22, Aug '18, Oct'18 & March '18, PYP 2 Marks July '21)

Misstatements in the financial statements can arise from either fraud or error.

Answer 14

Correct: Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. Hence misstatement can arise from error or fraud.

Alternative solution: Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting frame work. Hence misstatement can arise from error or fraud.

Question 15

Explain what understanding should an auditor obtain regarding an entity's risk assessment process (one of the components of the internal control of the entity). (MTP 3 Marks Oct'22)

Answer 15

The Entity's Risk Assessment Process– Component of Control Environment

The auditor shall obtain an understanding of whether the entity has a process for:

(a) Identifying business risks relevant to financial reporting objectives;

(b) Estimating the significance of the risks;

(c) Assessing the likelihood of their occurrence; and (d) Deciding about actions to address those risks. The entity's risk assessment process forms the basis for the risks to be managed. If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

Question 16

Explain stating clearly what is not included in Audit Risk? (MTP 5 Marks Aug '18)

Answer 16

Assessment of Risks - Matter of Professional Judgement

The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

What is not included in Audit Risk?

(i) Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.

(ii) Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Question 17

The auditor of MARUT Ltd, engaged in manufacturing of Smart Motor Bikes, obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:

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

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

Advise what is included in control environment. Also explain the elements of control environment.

(MTP 4 Marks May 20, March '19, Aug. '18, Mar'18)

OR

The auditor of FAST CARS Ltd obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether management has created and maintained a culture of honesty and ethical behavior and the strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

Advise what is included in control environment. Also explain the elements of control environment. (RTP Nov '19)

OR

Advise what is included in control environment. Also explain the elements of control environment. (RTP May '18)

Answer 17

Control Environment – Component of Internal Control: 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 behavior; 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? 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.

(iv) **Elements of the Control Environment:** Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

(1) Communication and enforcement of integrity and ethical values – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.

(2) Commitment to competence – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(3) Participation by those charged with governance –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.
- The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(4) Management's philosophy and operating style – Characteristics such as management's:

- Approach to taking and managing business risks.
- Attitudes and actions toward financial reporting.
- Attitudes toward information processing and accounting functions and personnel.

(5) **Organizational structure** – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

(6) **Assignment of authority and responsibility** - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.

(7) **Human resource policies and practices** – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Question 18

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. Explain giving examples. (MTP 4 Marks Sep '23)

OR

Knowledge of the Client's business is one of the important principles in developing an overall audit plan. In fact, without adequate knowledge of client's business, a proper audit is not possible. As per

SA-315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment", the auditor shall obtain an understanding of the relevant industry, regulatory and other external factors including the applicable financial reporting framework.

Substantiate with the help of examples. (RTP May '20)

Answer 18

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. For

Example

- The competitive environment, including demand, capacity, product and price competition as well as cyclical or seasonal activity.
- Supplier and customer relationships, such as types of suppliers and customers (e.g., related parties, unified buying groups) and the related contracts with those entities.
- Technological developments, such as those related to the entity's products
- Energy supply and cost.
- The effect of regulation on entity operations.

Question 19

What is tolerable misstatement and total rate of deviation? (MTP 3 Marks Sep '23)

Answer 19

Tolerable misstatement is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.

Total rate of deviation / Tolerable rate of deviation - A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Question 20

While obtaining audit evidence about the effective operation of internal control s, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognizes that some deviations may have occurred. Analyse and Explain. (RTP Nov '18, MTP 3 Marks Oct'23)

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. Analyse and Explain. (RTP Nov '19)

Answer 20

While obtaining audit evidence about the effective operation of internal controls, the auditor considers how they were applied, the consistency with which they were applied during the period an by whom they were applied. The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised.

In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed. In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures. It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorization, recording and documentation of transaction at each stage through which it flows.

Question 21

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as complex calculations. Also, risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as accounting principles for accounting estimates may be subject to differing interpretation etc. Explain in detail. (MTP 3 Marks Oct'23, RTP Nov '21)

OR

Examine with reasons whether the following statements are correct or incorrect.

Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates. (PYP 2 Marks, Nov'20)

Answer 21

Risks of Material Misstatement– Greater for Significant Non-Routine Transactions

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment.
- Greater manual intervention for data collection and processing.
- Complex calculations or accounting principles.
- The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

Risks of material misstatement– Greater for Significant Judgmental Matters

Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

Question 22

Materiality for the financial statements as a whole may need to be revised as a result of a change in circumstances that occurred during the audit. Explain with the help of example. (MTP 3 Marks Oct 19)

Answer 22

Revision in Materiality level as the Audit Progresses: Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.

Example

If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

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

Question 23

Examine with reasons (in short) whether the following statements are correct or incorrect: (MTP 2 Marks Sep'22, Oct'21)

The concept of materiality is an important and relevant consideration for the auditor in financial statement.

Answer 23

Correct: The concept of materiality is fundamental to the process of accounting. It covers all the stages from recording to classification and presentation. It is very important for the auditor who has constantly to judge whether a particular item is material or not and ensure that a material item is disclosed separately and distinctly.

Question 24

Examine with reasons (in short) whether the following statements are correct or incorrect

If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality. (MTP 2 Marks Oct'22)

Answer 24

Correct: Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit, new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.

Question 25

Examine with reasons (in short) whether the following statements are correct or incorrect:

Materiality is not a matter of size. (MTP 2 Marks April '23 PYP May '22)

Answer 25

Incorrect: Financial statements should disclose all 'material items', i.e., the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. For example -a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future. In certain cases, quantitative limits of materiality are specified.

Question 26

Briefly discuss the limitations of Internal Control. (MTP 4 Marks April 19, PYP 6 Marks May '18, RTP May '23)

Answer 26

Limitations of Internal Control:

(i) Internal control can provide only reasonable assurance: Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity' s financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.

(ii) Human judgment in decision-making: Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.

(iii) Lack of understanding the purpose: Equally, the operation of a control may not be effective, such

as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

(iv) Collusion among People: Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

(v) Judgements by Management: Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

(vi) Limitations in case of Small Entities: Smaller entities often have fewer employees due to which segregation of duties is not practicable. However, in a small owner-managed entity, the owner manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Question 27

Examine with reasons (in short) whether the following statement is correct or incorrect: There is no relation between Inherent risk, Control risk and Detection risk. (MTP 2 Marks Oct 19)

Answer 27

Incorrect: There is an inverse relationship between detection risks and the combined level of inherent and control risks. When inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. When inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risks to an acceptably low level.

Question 28

XYZ & Associates, Chartered Accountants, while evaluating the operating effectiveness of internal controls, detects deviation from controls. In such a situation, state the specific inquiries to be made by an auditor to understand these matters and their potential consequences. (MTP 4 Marks March '21, PYP 5 Marks, May'18)

Answer 28

Evaluating the Operating Effectiveness of Controls: When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

(i) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;

(ii) Additional tests of controls are necessary; or

(iii) The potential risks of misstatement need to be addressed using substantive procedures.

A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

Question 29

Examine with reasons (in short) whether the following statement is correct or incorrect: The SAs do not ordinarily refer to inherent risk and control risk separately. (MTP 2 Marks Nov '21, Mar'22)

Answer 29

Correct: The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non- quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

Question 30

Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as materiality, size of the entity etc.

Explain the other relevant considerations in the above context. (MTP 3 Marks March 22, RTP May 21, RTP Nov'22)

Answer 30

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.

Question 31

In exercising judgment as to which risks are significant risks, the auditor shall consider various factors.

Explain. (MTP 4 Marks Oct'22, RTP May '18)

OR

As a part of Risk assessment, the auditor shall determine whether any of the risks identified are in the auditor's judgement a significant risk. Mention any three guiding factors to judge as to which risks are significant risks? (PYP 3 Marks May '23)

OR

Significant risks often relate to significant non- routine transactions or judgmental matters. Nonroutine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.

In context of significant risk, explain the factors to be considered by the auditor in exercising judgment as to which risks are significant risks. (MTP 4 Marks Sep '23, RTP Nov 21)

Answer 31

Identification of Significant Risks: SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment" defines 'significant risk' as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

(a) Whether the risk is a risk of fraud;

(b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;

(c) The complexity of transactions;

(d) Whether the risk involves significant transactions with related parties;

(e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

(f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

Question 32

When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements. Explain.

(MTP 4 Marks March '23, RTP May 20, Old SM)

Answer 32

Control risk assessment when control deficiencies are identified: When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements.

When control deficiencies are identified and auditor identifies and tests more than one control for each relevant assertion, he evaluates control risk considering all of the controls he has tested. If auditor determines that they support a 'rely on controls' risk assessment, or if compensating controls are identified, tested and evaluated to be effective, he may conclude that the 'rely on controls' is still appropriate. Otherwise we change our control risk assessment to 'not rely on controls.'

When a deficiency relates to an ineffective control that is the only control identified for an assertion, he revises risk assessment to 'not rely on controls' for associated assertions, as no other controls have been identified that mitigate the risk related to the assertion. If the deficiency relates to one WCGW (what can go wrong) out of several WCGW's, he can 'rely on controls' but performs additional substantive procedures to adequately address the risks related to the deficiency.

Question 33

Examine with reasons (in short) whether the following statements are correct or incorrect:

Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. (MTP 2 Marks Oct'23, RTP May'18, Old & New SM)

Answer 33

Incorrect: Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. Control risk, on the other hand is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Question 34

Examine with reasons (in short) whether the following statement is correct or incorrect:

The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. (MTP 2 Marks March '18, Oct'18, Mar'19)

Answer 34

Correct: The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.

Question 35

Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should consider the risks that arise from the use of IT systems. Explain. (MTP 5 Marks Aug '18, RTP Nov '19, PYP 5 Marks, May '18, Old SM)

Answer 35

Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems. Given below are some such risks that should be considered,

• To make necessary changes to systems or programs

• Loss of inaccurate processing of data, processing inaccurate data, or both

- Unauthorized access to data
- Direct data changes (backend changes)
- Excessive access / privileged access (super users)
- Lack of adequate segregation of duties
- Unauthorized changes to systems or programs
- Failure data

Question 36

Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement. Discuss stating the different ways testing is performed in an automated environment. (MTP 5 Marks Oct 18 & March 18)

Answer 36

The following are different ways testing is performed in an automated environment:

There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and reperformance. As shown in the illustration below, Inquiry is the most efficient audit test but it is also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.

Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed, etc. The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file as required by SA 230.

When testing in an automated environment, some of the more common methods are as follows:

- Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
- Observe how a user processes transactions under different scenarios.
- Inspect the configuration defined in an application

Question 37

Examine with reasons (in short) whether the following statement is correct or incorrect:

The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. (MTP 2 Marks March '18, Oct'18, Mar'19)

Answer 37

Correct: The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.

Question 38

Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should consider the risks that arise from the use of IT systems. Explain. (MTP 5 Marks Aug '18, RTP Nov '19, PYP 5 Marks, May '18, Old SM)

Answer 38

Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems. Given below are some such risks that should be considered,

- To make necessary changes to systems or programs
- Loss of inaccurate processing of data, processing inaccurate data, or both
- Unauthorized access to data
- Direct data changes (backend changes)
- Excessive access / privileged access (super users)
- Lack of adequate segregation of duties
- Unauthorized changes to systems or programs
- Failure data

Question 39

Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement. Discuss stating the different ways testing is performed in an automated environment. (MTP 5 Marks Oct 18 & March 18)

Answer 39

The following are different ways testing is performed in an automated environment:

There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and reperformance. As shown in the illustration below, Inquiry is the most efficient audit test but it is also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.

Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.

Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed, etc. The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file as required by SA 230.

When testing in an automated environment, some of the more common methods are as follows:

- Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
- Observe how a user processes transactions under different scenarios.
- Inspect the configuration defined in an application

Question 40

The fundamental principle of an automated environment is the ability to carry out business with less manual intervention. Explain. (MTP 3 Marks March '19)

Answer 40

The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.

For example, if a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-theshelf accounting software, then it is likely to be less automated and hence less complex environment.

Similarly, there are several other aspects that an auditor should consider to determine the level of automation and complexity of a business environment which we will look at in the following sections.

Question 41

In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. Explain stating uses of Data analytics. (MTP 4 Marks April 19)

OR

Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform Fraud investigation. Explain the other relevant points in the above context i.e. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit

tools viz., IDEA and

ACL to perform. (MTP 4 Marks Oct 20)

OR

While auditing in an automated environment, how data analytics can be used in testing electronic records and data residing in IT systems using spread sheets and specialised audit tools? (PYP 3 Marks May '23)

OR

While it is true that companies can benefit immensely from the use of data analysis in terms of increased profitability, better customer service, etc., analyse various functions that can be performed even by the auditor also using Data Analytics tools and techniques in the audit process to obtain good results. (MTP 3 Marks Sep '23, RTP Nov '18, May '21 & May 20, PYP 4 Marks Nov '20)

OR

A company functions in an automated environment. Discuss in what areas data analytics can be useful for auditor of the company. (New SM)

Answer 41

In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. A famous businessman recently said, "Data is the new Oil". The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics.

While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results. The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short.

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 as required by SA 240
- fraud investigation
- evaluating impact of control deficiencies

Question 42

Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls. Explain stating the points that an auditor should consider to obtain an understanding of the company's automated environment.

(MTP 4 Marks Oct 19, MTP 3 Marks Sep '23, RTP May '18)

OR

List any five points that an auditor should consider to obtain an understanding of the Company's automated environment. (MTP 4 Marks Oct '21, Mar'22, Old SM)

Answer 42

Understanding and Documenting Automated Environment: Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls. Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment

- Information systems being used (one or more application systems and what they are)
- their purpose (financial and non-financial)
- Location of IT systems - local vs global
- Architecture (desktop based, client-server, web application, cloud based)
- Version (functions and risks could vary in different versions of same application)
- Interfaces within systems (in case multiple systems exist)
- In-house vs Packaged
- Outsourced activities (IT maintenance and support)
- Key persons (CIO, CISO, Administrators)

Question 43

With respect to audit in an automated environment, explain the following: (any four)

(i) CAATs

(ii) Data Analytics

(iii) Database

(iv) Information Systems

(v) Privileged access (MTP 4 Marks May 20, RTP May'23, PYP 5 Marks Nov'18, Old SM)

OR

With respect to audit in an automated environment, explain the following:

(i) CAATs

(ii) Data Analytics

(iii) Database (MTP 3 Marks Oct'22)

Answer 43

(i) **CAATs:** Short form for Computer Assisted Audit Techniques, are a collection of computer based tools and techniques that are used in an audit for analysing data in electronic form to obtain audit evidence.

(ii) **Data Analytics:** A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information

(iii) **Database:** A logical subsystem within a larger information system where electronic data is stored in a predefined form and retrieved for use.

(iv) **Information Systems:** Refers to a collection of electronic hardware, software, networks and processes that are used in a business to carry out operations and transactions.

(v) **Privileged access:** A type of super user access to information systems that enforces less or no limits on using that system.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Concept of various terms asked in question pertaining to audit in automated environments is clear to the examinees except the term Privileged access where the Examinees wrote about the usage of passwords for privileged access.

Question 44

With respect to audit in an automated environment, explain the following: (any four)

(i) Data Processing

(ii) ERP (Enterprise Resource Planning)

(iii) General IT control

(iv) Automated

(v) Direct Data change (MTP 4 Marks March '21)

Answer 44

(i) **Data Processing:** Refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.

(ii) **ERP (Enterprise Resource Planning):**
A type of business application software that provides an integrated platform to automate multiple interrelated business processes and operations.

(iii) **General IT Control:** Are a type of internal controls that help in mitigating risks that arise due

to use of information technology and information systems in a business.

(iv) **Automated:** A task or activity that is routinely performed by a computer system and does not require manual effort.

(v) **Direct Data Change:** A backend modification that is made directly to data that is stored in a database bypassing business rules built-in to a business application software.

Question 45

With respect to audit in an automated environment, explain the following: (any four)

(i) Applications

(ii) Control Deficiency

(iii) Data Processing

(iv) Enterprise Resource Planning

(v) Software (MTP 4 Marks April '21)

Answer 45

(i) **Applications:** These are computer software programs that provide a medium for recording, storage and retrieval of business operations or transactions in electronic format.

(ii) **Control Deficiency:** It Exists when an internal control is either missing or not operating effectively to prevent or detect a misstatement in a timely manner by management.

(iii) **Data Processing:** It Refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.

(iv) **Enterprise Resource Planning:** A type of business application software that provides an integrated platform to automate multiple interrelated business processes and operations.

(v) **Software:** A computer program or a collection of computer programs that provides an interface to a user for performing a specific activity, task, operation or transaction in electronic form through a computer or information system.

Question 46

When auditing in an automated environment, inquiry is often the most efficient and effective audit testing method. (MTP 2 Marks Oct '21, Nov'21, PYP 2 Marks Nov'18, Old SM)

Answer 46

Incorrect: There are basically four types of audit tests that should be used in an automated environment. They are inquiry, observation, inspection and re-performance. Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient. Applying inquiry in combination with inspection gives the most effective and efficient audit evidence.

Question 47

Examine with reasons (in short) whether the following statement is correct or incorrect: All automated environments are not complex. (MTP 2 Marks Nov '21, Mar'22, Old SM)

Answer 47

Correct: The complexity of an automated environment depends on various factors including the nature of business, level of automation, volume of transactions, use of ERP and so on. There could be environment where dependence on IT and automation is relatively less or minimal and hence, considered less complex or even non-complex.

Question 48

Examine with reasons (in short) whether the following statement is correct or incorrect : A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is known as meaningful data. (MTP 2 Marks Nov '21, Mar'22, Old SM)

Answer 48

Incorrect: A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is known as Data Analytics.

Question 49

When a business operates in a more automated environment it is likely that we, as auditors, will see several business functions and activities happening within the systems. Explain which of the aspect you will consider relevant as an auditor. (MTP 3 Marks April 22, RTP Nov '20 & Nov '18, PYP 3 Marks Dec'21)

OR

When a business operates in a more automated environment, we are likely to see several business functions and activities happening within the systems. List down the business functions and activities happening within the systems. (RTP Nov '23)

OR

When a business operates in a more automated environment, we are likely to see several business functions and activities happening within the systems. List down the business functions and activities happening within the systems. (PYP 3 Marks Dec '21)

Answer 49

When a business operates in a more automated environment it is likely that we, as auditors, will see several business functions and activities happening within the systems. As an auditor, there is a need to consider the following aspects:

- Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).
- Accounting entries are posted automatically (for example, sub-ledger to GL postings are automatic).
- Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).
- Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).
- User access and security are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively).

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Relevance of Information Technology in an Audit: Most of the examinees correctly explained the list of business functions and activities happening within the system. Also, many examinees wrote about importance of IT itself rather than explaining relevance of IT in an audit.

Question 50

The auditor should consider relevance of IT in an audit of financial statements. Explain giving reasons.

(MTP 3 Marks Sep'22, RTP Nov 21, Old SM)

Answer 50

The auditor should consider relevance of IT in an audit of financial statements for the following reasons:

(i) Since auditors rely on the reports and information generated by IT systems, there could be risk in the IT systems that could have an impact on audit.

(ii) Standards on auditing SA 315 and SA 330 require auditors to understand, assess and respond to risks that arise from the use of IT systems.

(iii) By relying on automated controls and using data analytics in an audit, it is possible to increase the effectiveness and efficiency of the audit process.

Question 51

Explain the objective and enlist the activities involved in the General IT Controls over "Program Change".

(MTP 3 Marks Oct'22, Old SM)

Answer 51

General IT Controls are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as "pervasive" controls or "indirect" controls.

Program Change

Objective: To ensure that modified systems continue to meet financial reporting objectives.

Activities:

- Change Management Process – definition, roles & responsibilities
- Change Requests – record, manage, track
- Making Changes – analyze, design, develop
- Test Changes – test plan, test cases, UAT
- Apply Changes in Production
- Emergency & Minor Changes
- Documentation – user/technical manuals
- User Training

Question 52

Examine with reasons (in short) whether the following statement is correct or incorrect:

Application controls include manual controls only that operate at a business process level. (MTP 2 Marks Oct 18, Mar'18, Aug'18)

Answer 52

Incorrect. Application controls include both automated or manual controls that operate at a business process level. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems.

Question 53

With respect to audit in an automated environment, explain the following:

(i) General (IT) Controls

(ii) Material Weakness

(iii) Data Processing (MTP 3 Marks March '23)

Answer 53

(i) **General (IT) Controls:** Are a type of internal controls that help in mitigating risks that arise due to use of information technology and information systems in a business.

(ii) **Material Weakness:** A control deficiency or a combination of deficiencies in internal controls that is important enough to merit the attention of those charged with governance since there is a

reasonable possibility that a material misstatement will not be prevented or detected in a timely manner by management.

(iii) **Data processing:** Refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.

Question 54

Describe how risks in IT systems, if not mitigated, could have an impact on audit. (MTP 3 Marks March '23 & Nov '21, RTP Nov'21, Old SM)

OR

Analyse how risks in the IT system if not mitigated could have an impact on the audit. (MTP 3 Marks

Sep'22, PYP 3 Marks Nov '20)

Answer 54

When risks in IT systems are not mitigated the audit impact could be as follows:

(i) First, auditors may not be able to rely on the data obtained from systems where such risks exist. This means, all forms of data, information or reports that they obtain from systems for the purpose of audit has to be thoroughly tested and corroborated for completeness and accuracy.

(ii) Second, auditors will not be able to rely on automated controls, calculations, accounting procedures that are built into the applications. Additional audit work may be required in this case.

(iii) Third, due to the regulatory requirement of auditors to report on internal financial controls of a company, the audit report also may have to be modified in some instances.

Question 55

Examine with reasons (in short) whether the following statements are correct or incorrect:

The Complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be less complex. (MTP 2 Marks April '23, PYP 2 Marks Jan '21)

Answer 55

Incorrect: The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex. If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an offthe- shelf accounting software, then it is likely to be less automated and hence less complex environment.

Question 56

Magical Limited is a company dealing in mobile spare parts and having its showrooms in almost all the states in the country. For FY 2021-22, the company transferred its accounts from manual to computerized system (SAP). PJ & Co., Chartered Accountants have specialization in the system audit and have been appointed as the system auditor. PJ & Co., at the end of the audit concludes that there are certain findings or exceptions in IT environment and IT controls of the company which needs to be assessed and reported. Mention those points of consideration. (MTP 3 Marks April '23) (PYP 3 Marks July '21 & May '22)

Answer 56

At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee.

Some points to consider are as follows:

- Are there any weaknesses in IT controls?
- What is the impact of these weaknesses on overall audit?
- Report deficiencies to management – Internal Controls Memo or Management Letter.
  Communicate in writing any significant deficiencies to Those Charged With Governance. The auditor needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Points of Consideration for IT environment and IT control: A large number of examinees did not have fair idea about the topic and have answered it generally. Their answer were not relevant and to the point.

Question 57

Examine with reasons (in short) whether the following statements are correct or incorrect:

With reference to General IT control, the objective of Data Center and Network Operations is to ensure that systems are developed, configured and implemented to meet financial reporting objectives. (MTP

2 Marks Sep '23, PYP 2 Marks July '21)

Answer 57

Incorrect: Objective of Data Center and Network Operations is to ensure that production systems are processed to meet financial reporting objectives.

Objective of Application system acquisition, development, and maintenance is to ensure that systems are developed, configured and implemented to meet financial reporting objectives.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Objective of Data Centre and Network Operations: A large number of examinees were not aware of the objective of Data Canter and Network Operations and therefore, could not answer correctly.

Question 58

With respect to audit in an automated environment, explain the following:

(i) Applications

(ii) Automated

(iii) CAATs

(iv) Data Processing

(v) General (IT) Controls] (RTP May '22, MTP 4 Marks Oct '23)

Answer 58

(i) **Applications:** These are computer software programs that provide a medium for recording, storage and retrieval of business operations or transactions in electronic format.

(ii) **Automated:** A task or activity that is routinely performed by a computer system and does not require manual effort

(iii) **CAATs:** Short form for Computer Assisted Audit Techniques, are a collection of computer-based tools and techniques that are used in an audit for analysing data in electronic form to obtain audit evidence.

(iv) **Data Processing:** Refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.

(v) **General (IT) Controls:** Are a type of internal controls that help in mitigating risks that arise due to use of information technology and information systems in a business.

Question 59

Discuss the various points which auditor needs to consider in determining whether it is appropriate to use audit evidence about operating effectiveness of controls obtained in previous audit, and if so, the length of the time period that may elapse before retesting a control. (MTP 4 Marks April '23, PYP 4 Marks Nov '19)

Answer 59

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

i. The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;

ii. The risks arising from the characteristics of the control, including whether it is manual or automated;

iii. The effectiveness of general IT-controls;

iv. The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affects the application of the control;

v. Whether the lack of a change in a particular control poses a risk due to changing circumstances; and

vi. The risks of material misstatement and the extent of reliance on the control.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Many examinees were not aware about the penal consequences to the Company.

Question 60

The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". Explain. (RTP Nov '19 Nov '18, May'19, Old & New SM)

Answer 60

The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

It can be concluded from the above that- Risk of Material Misstatement= Inherent Risk X Control Risk

Question 61

State with reason (in short) whether the following statements are true or false:

Risk assessment procedures are not performed to obtain an understanding of the entity and its environment. (RTP May '20)

Answer 61

Incorrect: Risk assessment procedures refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

Question 62

Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. Explain with the help of examples. (RTP Nov'20)

OR

The risk assessment procedures shall include the Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. Explain giving at least three examples.(MTP 3 Marks Sep'22)

Answer 62

Inquiries of Management and Others Within the Entity: Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority.

Examples

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post- sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system- related risks.

Question 63

The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement. Explain in detail stating clearly the meaning of control activities and also discuss control activities that are relevant to the audit. (RTP May '21)

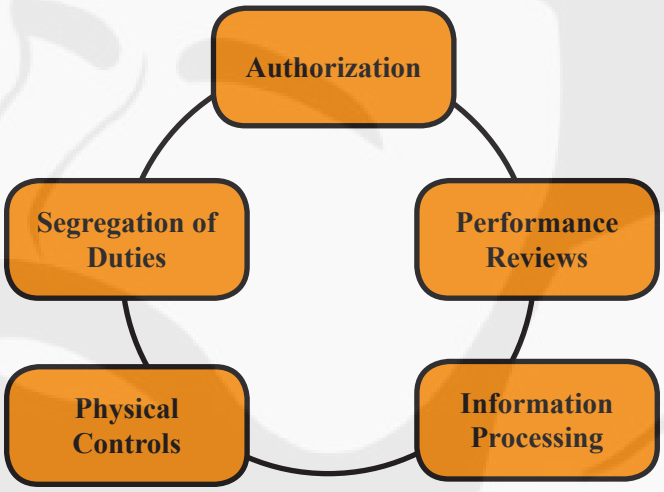
Answer 63

The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement. An audit requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process.

Control activities are the policies and procedures that help ensure that management directives are carried out.

Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.

Examples of specific control activities include those relating to the following:



Control activities that are relevant to the audit are:

- Control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; or
- Those that are considered to be relevant in the judgment of the auditor;
- As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk.

Question 64

State with reason (in short) whether the following statements are true or false:

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, the auditor need not seek direct communication with the entity's external legal counsel.

(RTP Nov '21)

Answer 64

Incorrect: 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.

Question 65

Discuss what is included in risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls. (RTP May '18)

Answer 65

Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

Question 66

"A satisfactory control environment is not an absolute deterrent to fraud although it may help reduce the risk of fraud." Explain. (RTP May '18)

OR

The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. Analyse and explain. (RTP May '19)

Answer 66

a. Satisfactory Control Environment – not an absolute deterrent to fraud: The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For

example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures.

The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

b. The auditor of XYZ Ltd, engaged in FMCG (Fast Moving Consumable Goods) obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:

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

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

Question 67

State with reason (in short) whether the following statements are true or false:

When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall not perform substantive procedures that are specifically responsive to that risk. (RTP May '19 & Nov '18)

Answer 67

Incorrect: When the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

Question 68

State with reason (in short) whether the following statements are true or false:

According to SA 315, the objective of the auditor is to identify and assess the risk of material misstatement, whether due to fraud or error, only at assertion level. (RTP May '23)

Answer 68

Incorrect: According to SA 315, the objective of the auditor is to identify and assess the risk of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control.

Question 69

State with reason (in short) whether the following statements are true or false:

Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur. (RTP May '23, PYP 2 Marks July '21)

Answer 69

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

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Assertions refer to the representations by the auditor: In general most of the examinees wrote the definition of assertions correctly. However, some examinees wrote about the names of various assertions which was not required of the question.

Question 70

Obtaining an understanding of the entity and its environment establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit.

Explain by giving examples. (RTP Nov '23 & May 20, Old & New SM)

Answer 70

Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. This understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the financial statements;
- Determining materiality in accordance with SA 320;
- Considering the appropriateness of the selection and application of accounting policies;
- Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

Question 71

Risk of material misstatement refers to the risk that the financial statements are materially misstated prior to audit. Discuss the levels at which this risk exists. (RTP Nov '23 & Nov 20)

Answer 71

The risks of material misstatement may exist at two levels:

(i) The overall financial statement level - Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

(ii) The assertion level for classes of transactions, account balances, and disclosures - Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

Question 72

While conducting the audit of Smart TV Ltd, engagement team of HTR& Co, has considered materiality and audit risk throughout the audit. Discuss explaining the meaning of audit risk. (RTP May '22)

Answer 72

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

(a) Identifying and assessing the risks of material misstatement;

(b) Determining the nature, timing and extent of further audit procedures; and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Question 73

The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, explain the auditor's assumptions about users of the financial statements. (RTP May '21)

Answer 73

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

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

Question 74

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Explain (RTP May '21)

Answer 74

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

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

Question 75

State with reason (in short) whether the following statements are true or false:

There is direct relationship between materiality and the degree of audit risk. (RTP May '18, Old & New SM)

Answer 75

Incorrect: There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

Question 76

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Discuss stating the factors that may affect the identification of an appropriate benchmark. (RTP May '18, PYP 2 Marks Jan '21)

OR

An auditor has to exercise professional judgement in determining materiality. Explain the factors that may affect the identification of an appropriate benchmark in determining materiality for the financial statements as whole. (PYP 3 Marks May '23)

OR

With Ref. to SA 320 "Materiality in planning and performing an audit" Indicate the factors which may effect the identification of an appropriate benchmark while determining materiality for the financial statements as a whole. (PYP 4 Marks, Nov'20)

Answer 76

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

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

Question 77

What could be considered material for all situations cannot be defined precisely and an amount or transaction material in one situation may not be material in other situation. Explain. (RTP Nov '21)

Answer 77

Materiality is an important consideration for an auditor to evaluate whether the financial statements reflect a true and fair view or not. SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor should consider materiality and I its relationship with audit risk while conducting an audit. When planning the audit, the auditor considers what would make the financial information materially misstated. The auditor's preliminary assessment of materiality related to specific account balances and classes of transactions helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk. It may be noted that the auditor's assessment of materiality and audit risk may be different at the time of initially planning of the audit as against at the time of evaluating the results of audit procedures. At the planning stage, the auditor needs to consider the materiality for the financial statements as a whole. The auditor has to carry out a preliminary identification of significant components and material classes of transactions, account balances and disclosure which he plans to examine. What could be considered material for all situations cannot be defined precisely and an amount or transaction material in one situation may not be material in other situation. For example, ₹ 5,000 may be material for a small entity, but even ₹ 100,000 may not be material for a large entity.

Question 78

You are being appointed as the auditor of Track Ltd. for the first time. You want to determine the materiality level and for that you have applied percentage to choose benchmark as a starting point in determining materiality for the financial statements as a whole. What are the factors that may affect the identification of an appropriate benchmark? (RTP May '22)

Answer 78

SA 320 "Materiality in Planning and Performing an Audit" prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole.

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:

i. The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);

ii. 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);

iii. 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.

iv. The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and

v. The relative volatility of the bench.

Question 79

The extent and the nature of the audit program me is substantially influenced by the internal control system in operation. Analyse and explain. (RTP Nov '19)

OR

The auditor can formulate his entire audit programmer only after he has had a satisfactory understanding of the internal control systems and their actual operation. Analyse and explain. (RTP Nov 18)

Answer 79

The auditor can formulate his entire audit program me only after he has had a satisfactory understanding of the internal control systems and their actual operation. If he does not care to study this aspect, it is very likely that his audit program me may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers. It is also important for him to know whether the system is actually in operation. Often, after installation of a system, no proper follow up is there by the management to ensure compliance. The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially. This state of affairs is probably the worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.

It would be better if the auditor can undertake the review of the internal control system of client. This will give him enough time to assimilate the controls and implications and will enable him to be more objective in the framing of the audit programmer. He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed.

From the foregoing, it can be concluded that the extent and the nature of the audit programmer is substantially influenced by the internal control system in operation. In deciding upon a plan of test checking, the existence and operation of internal control system is of great significance.

A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programmer.

In a situation where the internal controls are considered weak in some areas, the auditor might choose

an auditing procedure or test that required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction.

Question 80

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control. (RTP May '20)

OR

"The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting" Explain. (Old & New SM)

OR

Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control. (Old & New SM)

Answer 80

Objectives of Internal Control

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

Objectives of Internal Control are:

(i) transactions are executed in accordance with managements general or specific authorization;

(ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;

(iii) assets are safeguarded from unauthorized access, use or disposition; and

(iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate

to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

An understanding of internal control assists the auditor in:

(i) identifying types of potential misstatements;

(ii) identifying factors that affect the risks of material misstatement, and

(iii) designing the nature, timing, and extent of further audit procedures

Question 81

It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Explain with the help of example in respect of the procedure for sales. (RTP May '20, May'23, Old SM)

Answer 81

It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorization, recording and documentation of transaction at each stage through which it flows.

For example, the procedure for sales requires the following:

1. Before acceptance of any order the position of inventory of the relevant article should be known to ascertain whether the order can be executed in time.
2. An advice under the authorisation of the sales manager should be sent to the party placing the order, internal reference number, and the acceptance of the order. This advice should be prepared on a standardized form and copy thereof should be forwarded to inventory section to enable it to prepare for the execution of the order in time.
3. The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.
4. The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.
5. Before deciding upon the credit period, a reference should be made to the credit section to know the creditworthiness of the party and particularly whether the party has honored its commitments in the past.

Question 82

Auditor GR and Associates have been appointed to conduct audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditors do not think that it would be necessary to understand internal controls. Advise the auditor in this regard explaining clearly the benefits of understanding the internal control. (RTP May '21)

Answer 82

The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

Benefits of Understanding the Internal Control

An understanding of internal control assists the auditor in:

(i) identifying types of potential misstatements;

(ii) identifying factors that affect the risks of material misstatement, and

(iii) designing the nature, timing, and extent of further audit procedures.

Question 83

Auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143. Explain in detail quoting specifically the Law in the above context covering each and every aspect. (RTP Nov '21, RTP Nov'18)

Answer 83

Auditors' Responsibility for Reporting on Internal Financial Controls over Financial Reporting in India Clause (I) of Sub-section 3 of Section 143 of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

It may be noted that auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.

Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

Objectives of an auditor in an audit of internal financial controls over financial reporting: The auditor's objective in an audit of internal financial controls over financial reporting is, "to express an opinion on the effectiveness of the company's internal financial controls over financial reporting." It is carried out along with an audit of the financial statements.

Reporting under Section 143(3)(I) is dependent on the underlying criteria for internal financial controls over financial reporting adopted by the management. However, any system of internal controls provides only a reasonable assurance on achievement of the objectives for which it has been established. Also, the auditor shall use the concept of materiality in determining the extent of testing such controls.

Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

The inclusion of the matters relating to internal financial controls in the director's responsibility statement is in addition to the requirement of the directors stating that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

Question 84

A Flow Chart is a graphic presentation of each part of the company's system of internal control. Explain elaborating each and every aspect about flow chart. (RTP Nov 18)

Answer 84

A Flow Chart: It is a graphic presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimizes the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form. It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

It is also necessary for the auditor to study the significant features of the business carried on by the concern; the nature of its activities and various channels of goods and materials as well as cash, both inward and outward; and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

Question 85

IT poses specific risks to an entity's internal control. Explain (RTP May '19)

Answer 85

IT also poses specific risks to an entity's internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorised changes to data in master files.

- Unauthorised changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

Question 86

So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programmer. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. Explain stating clearly the benefits of evaluation of internal control to the auditor. (RTP May '19)

OR

The review of internal controls will enable the auditor to know the areas where control is weak. Explain stating clearly the benefits of evaluation of internal control to the auditor. (RTP Nov'22)

Answer 86

So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programmer. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operations of these internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

Benefits of Evaluation of Internal Control to the Auditor

The review of internal controls will enable the auditor to know:

(i) whether errors and frauds are likely to be located in the ordinary course of operations of the business;

(ii) whether an adequate internal control system is in use and operating as planned by the management;

(iii) whether an effective internal auditing department is operating;

(iv) whether any administrative control has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);

(v) whether the controls adequately safeguard the assets;

(vi) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned;

(vii) how reliable the reports, records and the certificates to the management can be;

(viii) the extent and the depth of the examination that he needs to carry out in the different areas of accounting;

(ix) what would be appropriate audit technique and the audit procedure in the given circumstances;

(x) what are the areas where control is weak and where it is excessive; and

(xi) whether some worthwhile suggestions can be given to improve the control system.

Question 87

Generally, IT benefits an entity's internal control by enabling an entity to enhance the timeliness, availability, and accuracy of information. Discuss explaining the other relevant points in the above context. (RTP May '22)

Answer 87

Generally, IT benefits an entity's internal control by enabling an entity to:

(i) Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;

(ii) Enhance the timeliness, availability, and accuracy of information;

(iii) Facilitate the additional analysis of information;

(iv) Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;

(v) Reduce the risk that controls will be circumvented; and

(vi) Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

Question 88

Saburi Textile Ltd is an established player in the textile manufacturing sector. It has developed strong internal controls in almost every area. It has appointed you as an Internal Audit team head. Internal audit has a very strong relation with internal control of the company. Internal Audit analyses the effectiveness with which the internal control of the company is operating and also makes suggestions for improvement in that internal control. Explain stating clearly activities relating to Internal Control.

(RTP May '22)

OR

Internal audit not only analyses the effectiveness with which the internal control of a company is operating but also improves the effectiveness of internal control. Elucidate the statement. (PYP 4 Marks May'22)

OR

Discuss the objectives and scope of internal audit functions with respect to activities relating to internal control. (PYP 3 Marks, Jan'21)

Answer 88

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the activities Relating to Internal Control:

(i) Evaluation of internal control: The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

(ii) Examination of financial and operating information: The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

(iii) Review of operating activities: The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non financial activities of an entity.

(vi) Review of compliance with laws and regulations: The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

Internal audit has a very strong relation with internal control of a company. Internal Audit analyzes the effectiveness with which the internal control of a company is operating and also makes suggestions for improvement in that internal control.

Question 89

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware. Explain (RTP Nov '23)

OR

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Explain in detail. (RTP Nov'20)

OR

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

Answer 89

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Question 90

Explain some of the commonly used methods for testing in an automated environment. (RTP May '20)

Answer 90

When testing in an automated environment, some of the more common methods are as follows:

- Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
- Observe how a user processes transactions under different scenarios.
- Inspect the configuration defined in an application.

Question 91

With the increasing adoption of information technology, business today relies on software systems and applications more than ever. Many of these IT systems generate and process data that is used in the preparation of financial statements of a company. The auditors also often rely on the data and reports that are generated from these systems. Explain stating clearly the meaning of Automated environment with example. (RTP Nov'20)

Answer 91

With the increasing adoption of information technology, business today relies on software systems and applications more than ever. Many of these IT systems generate and process data that is used in the preparation of financial statements of a company. The auditors also often rely on the data and reports that are generated from these systems. In this context, it is critical to understand the IT specific risks that could potentially impact the integrity and reliability of financial transactions and data flowing through a company's systems.

An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems. Nowadays, it is very common to see computer systems being used in almost every type of business.

Example

Think about how banking transactions are carried out using ATMs (Automated Teller Machines), or how tickets can be purchased using "apps" on mobile phones, etc. In these examples, you can see how these computer systems enable us to transact business at any time and any day.

Question 92

Objective of Data Center and Network Operations is to ensure that production systems are processed to meet financial reporting objectives. Discuss the activities performed by Data Center and Network operations. Also explain the meaning of General IT Controls in detail. (RTP May '21)

Answer 92

General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, mainframe, and end-user environments.

General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:"

(i) Data center and network operations

(ii) Program change

(iii) Access security

(iv) Application system acquisition, development, and maintenance (Business Applications)

These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as "pervasive" controls or "indirect" controls. Let us now learn about each of the General IT controls in more detail.

Data Center and Network Operations

Objective: To ensure that production systems are processed to meet financial reporting objectives.

Activities:

1. Overall Management of Computer Operations Activities
2. Batch jobs – preparing, scheduling and executing
3. Backups – monitoring, storage & retention
4. Performance Monitoring – operating system, database and networks
5. Recovery from Failures – BCP, DRP
6. Help Desk Functions – recording, monitoring & tracking
7. Service Level Agreements – monitoring & compliance
8. Documentation – operations manuals, service reports

Question 93

Discuss the impact of IT related risks on Substantive Audit, Controls and Reporting. (RTP May '18)

Answer 93

Impact of IT related risks i.e. on Substantive Audit, Controls and Reporting: The above risks, if not mitigated, could have an impact on audit in different ways. Let us understand how:

Impact on Substantive Audit	Impact on Controls	Impact on Reporting
• Cannot rely on the data obtained from systems. • System data and reports should be tested substantively for completeness and accuracy. • More audit evidence is needed.	• Cannot rely on automated controls, system calculations and accounting procedures built into applications. • Cannot rely on IT dependent manual controls. • System data and reports should be trusted substantively for completeness and accuracy. • More substantive audit work is needed.	• Communication to those charged with governance. • Modified auditors report.

- First, we may not be able to rely on the data obtained from systems where such risks exist. This means, all forms of data, information or reports that we obtain from systems for the purpose of audit has to be thoroughly tested and corroborated for completeness and accuracy.
- Second, we will not be able to rely on automated controls, calculations, accounting procedures

that are built into the applications. Additional audit work may be required in this case.

- Third, due to the regulatory requirement of auditors to report on internal financial controls of a company, the audit report also may have to be modified in some instances.

In all the above scenarios, it is likely that the auditor will be required to obtain more audit evidence and perform additional audit work. The auditor should also be able to demonstrate how the risks were identified and what audit evidence was obtained and validated to address these IT risks.

Here, we should remember that as the complexity, automation and dependence of business operations on IT systems increases, the severity and impact of IT risks too increases accordingly. The auditor should apply professional judgement in determining and assessing such risks and plan the audit response appropriately.

Question 94

Explain the meaning of automated environment. Also discuss the key features of an automated environment. (RTP May '19)

Answer 94

An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology(IT) systems. Nowadays, it is very common to see computer systems being used in almost every type of business.

For example, think about how banking transactions are carried out using ATMs (Automated Teller Machines), or how tickets can be purchased using "apps" on mobile phones, etc. In these examples, you can see how these computer systems enable us to transact business at any time and any day.

Some of the key features of an automated environment are as follows:

Key features of an Automated Environment

- Enables faster business operations
- Accuracy in data processing and computation
- Ability to process large volumes of transactions
- Integration between business operations
- Better security and controls
- Less prone to human errors
- Provides latest information
- Connectivity and Networking capability

The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.

For example, if a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment. Similarly, there are several other aspects that an auditor should consider to determine the level of automation and complexity of a business environment which we will look at in the following sections.

Question 95

Explain the meaning of Internal Financial Controls clearly stating reporting requirement (with reference to audit) on adequacy of internal financial controls. Also discuss about its (reporting requirement on adequacy of internal financial controls) applicability on various types of Companies.

(RTP May '22)

Answer 95

Explanation given in Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as, "the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information."

From the above definition, it is clear that internal financial controls are the policies and procedures adopted by the company for:

1. ensuring the orderly and efficient conduct of its business, including adherence to company's policies,
2. the safeguarding of its assets,
3. the prevention and detection of frauds and errors,
4. the accuracy and completeness of the accounting records, and
5. the timely preparation of reliable financial information."

Section 143(3)(i) of the Act requires an auditor to report whether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls.

However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall not be applicable to a private company which is a–

(i) Oneperson company; or

(ii) Small company; or

(iii) Company having turnover less than ₹ 50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or anybody corporate at any point of time during the financial year less than ₹ 25 crore.

Question 96

List the points that an auditor should consider to obtain an understanding of the Company's automated environment. (RTP Nov'22, Nov'19 & Nov '23, PYP 5 Marks, May '18)

Answer 96

Understanding of the Company's Automated Environment: Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment

- Information systems being used (one or more application systems and what they are)
- their purpose (financial and non-financial)
- Location of IT systems - local vs global
- Architecture (desktop based, client-server, web application, cloud based)
- Version (functions and risks could vary in different versions of same application)
- Interfaces within systems (in case multiple systems exist)
- In-house vs Packaged
- Outsourced activities (IT maintenance and support)
- Key persons (CIO, CISO, Administrators)

Question 97

Which are specific risks to the company's internal control having IT environment? (RTP Nov'22, PYP 4 Marks May '19)

Answer 97

IT poses specific risks to the Company's internal control, which include-

(i) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.

(ii) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or nonexistent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.

(iii) The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.

(iv) Unauthorised changes to data in master files.

(v) Unauthorised changes to systems or programs.

(vi) Failure to make necessary changes to systems or programs. Inappropriate manual intervention.

(vii) Potential loss of data or inability to access data as required.

Question 98

The auditor's responsibility includes reporting on Internal Financial Controls over Financial Reporting which includes an understanding IT environment of the company and relevant risks and controls. Mention the situations where IT will be relevant to an audit. (RTP May '23)

OR

Discuss the situations in which IT will be relevant to an audit. (RTP May '19)

OR

The auditor's responsibility includes reporting on Internal Financial Controls over Financial Reporting which includes an understanding IT environment of the company and relevant risks and controls.

Mention any three situations where IT will be relevant to an audit. (PYP 3 Marks Nov '19)

Answer 98

With the introduction of the Companies Act 2013, there is greater emphasis given to internal financial controls (IFC) from a regulatory point of view. Directors and those charged with governance (including Board of directors, Audit committee) are responsib le for the implementation of internal controls framework within the company. The auditors' responsibilities now include reporting on Internal Financial Controls over Financial Reporting which include and understanding IT environment of the company and relevant risks & controls.

Following are some situations in which IT will be relevant to an audit:

(i) Increased use of Systems and Application software in Business (for example, use of ERPs)

(ii) Complexity of transactions has increased (multiple systems, network of systems)

(iii) Hi-tech nature of business (Telecom, e-Commerce).

(iv) Volume of transactions are high (Insurance, Banking, Railways ticketing).

(v) Company Policy (Compliance).

(vi) Regulatory requirements - Companies Act 2013 IFC, IT Act 2008.

(vii) Required by Indian and International Standards - ISO, PCI-DSS, SA 315, SOC, ISAE

(viii) Increases efficiency and effectiveness of audit.

Question 99

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls. Explain and also state when will the auditor design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls. (RTP Nov'20, Nov'18)

Answer 99

Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

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

(a) 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

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

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.

Question 100

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Discuss the matters the auditor may consider in determining the extent of test of controls.

(RTP Nov'20)

Answer 100

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Matters the auditor may consider in determining the extent of test of controls include the following:

1. The frequency of the performance of the control by the entity during the period.
2. The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
3. The expected rate of deviation from a control.
4. The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
5. The extent to which audit evidence is obtained from tests of other controls related to the assertion.

Question 101

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. Analyse and explain. (RTP Nov '18)

OR

"A multinational co. wants to appoint you to carry the statutory audit." Discuss with reference to SA 330 the substantive procedures to be performed to assess the risk of material misstatement. (PYP Marks ,6 Nov'18)

Answer 101

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

1. **This requirement reflects the facts that:**

(i) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and

(ii) there are inherent limitations to internal control, including management override.

2. **Depending on the circumstances, the auditor may determine that:**

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

3. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.
4. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.
5. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory.
6. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

Question 102

Examine with reasons (in short) whether the following statements are correct or incorrect: Judgmental matters are transactions that are unusual due to either its size or nature and that therefore occur infrequently. (PYP 2 Marks, Nov '2018)

Answer 102

Incorrect: Significant risks often relate to significant non-routine transactions or judgmental matters. Nonroutine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Thus judgmental matters are not always unusual due to their size or nature.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Examinees did not understand judgemental matters and therefore could not write about judgemental matters which was required.

Question 103

Examine with reasons whether the following statements are correct or incorrect.

For an auditor, the Risk assessment procedure provides sufficient appropriate audit evidence to base the audit opinion. (PYP 2 Marks Nov '19, MTP 2 Marks Apr'23)

Answer 103

Incorrect: The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

Question 104

What factors are to be considered by an auditor while making control risk assessments? (PYP 3 Marks Nov'20)

Answer 104

Auditor assesses control risk as Rely or Not rely on Controls. When making control risk assessments, the factors an auditor would consider are:

- The control environment's influence over internal control. A control environment that supports the prevention, detection and correction of material misstatements allows greater confidence in the reliability of internal control and audit evidence generated within the entity.
- Evaluations of the related IT processes that support application and IT-dependent manual controls.
- Our testing approach over SCOTs and disclosure processes (i.e., controls reliance or substantive only strategy). The expectation of the operating effectiveness of controls based on the understanding

Question 105

Auditor or Sunshine Ltd. is of the view that due to greater management intervention to specify accounting treatment, the risk of material misstatement is greater for non-routine transactions. Is the view of the auditor correct? Specify the other matters due to which the risk of material misstatement is greater for significant non-routine transactions. (PYP 3 Marks Dec '21)

OR

What is understood by "non-routine" transactions? Briefly outline why risks of material misstatement is greater for such transactions. (New SM)

Answer 105

Risk of Material Misstatement – Greater for Significant Non-Routine Transactions:

Significant risks often relate to significant non- routine transactions or judgmental matters. Nonroutine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Risks of Material Misstatement– Greater for Significant Non-Routine Transactions Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

(a) Greater management intervention to specify the accounting treatment.

(b) Greater manual intervention for data collection and processing.

(c) Complex calculations or accounting principles.

(d) The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks. Keeping in view above, view of Auditor of Sunshine Ltd is correct.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Risk of Material Misstatement - Greater for Significant Non-Routine Transactions: Many examinees answered the conclusion part correctly, but the "other matters" have not been written appropriately except the matter given in the question itself.

Question 106

State with reasons whether the following statements are correct or incorrect. (Answer any seven).

Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are detected by obtaining sufficient appropriate audit evidence. .(PYP 2 Marks May'22)

Answer 106

Incorrect: Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

Question 107

Z Ltd. is a manufacturer of ready-made garments. During the year 2021-22, they have opened two new branches and there is a substantial increase in their sales. The management has appointed CA R to review the internal control system of the company as they feel that there are lapses in the control environment of the company. What is included in the control environment and what will the auditor evaluate in order obtain an understanding of the control environment? (PYP 4 Marks Nov 22)

Answer 107

Control Environment:

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.

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

(a) Management has created and maintained a culture of honesty and ethical behavior; and

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

Question 108

ABC Ltd. has many divisions and branches across the country. They have an internal control system which is well established maintained by the management on a regular basis. Explain the meaning of internal control as per SA-315 and also state the benefits of understanding the internal controls of a company. (PYP 3 Marks Nov 22)

Answer 108

Meaning and benefits of understanding Internal Control:

Meaning of Internal Control: As per SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the internal control may be defined as "the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control."

Benefits of Understanding of Internal Control: An understanding of internal control assists the auditor in:

i. identifying types of potential misstatements.
ii. identifying factors that affect the risks of material misstatement, and
iii. designing the nature, timing, and extent of further audit procedures.

Question 109

You are appointed as an auditor of Gama Ltd. Your audit assistant wants to understand the meaning of Audit Risk. Explain him the meaning of Audit Risk with example. Also guide him as to what is not included in Audit Risk. (PYP 4 Marks May '23)

Answer 109

Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Thus, it is the risk that the auditor may fail to express an appropriate opinion in an audit assignment.

Example

Gama Limited purchased a Plant and Machinery for ₹ 2 Crores in the financial year 2021-2022. The accountant of Gama limited debited ₹ 2 crores in the repair and maintenance account in the statement of Profit and loss instead of taking it to the balance sheet as PPE and claim depreciation on it. While auditing the accounts of this company the auditor may not notice this and consequently may not report anything regarding the plant and machinery. Therefore, opinion given by the auditor would be inappropriate resulting in audit risk.

What is not included in Audit Risk?

(i) Audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant.

(ii) Further, audit risk is a technical term related to the process of auditing. It does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Question 110

CA D has been appointed as an auditor of LMP Ltd. Before developing an overall audit plan, CA D wants to get an understanding and knowledge of the Client's business including applicable financial reporting framework. Guide CA D in understanding of the same with reference to the relevant Standard on Auditing. (PYP 4 Marks May '23)

Answer 110

Understanding and Knowledge of the Client's Business

It is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of client's business, a proper audit is not possible. As per SA-315, "Identifying and

Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment", the auditor shall obtain an understanding of the following:

(1) Relevant industry, regulatory and other external factors including the applicable financial reporting framework.

(2) The nature of the entity, including:

(i) its operations;

(ii) its ownership and governance structures;

(iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

(iv) the way the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(3) The entity's selection and application of accounting policies including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(4) The entity's objectives and strategies and those related business risks that may result in risks of material misstatement.

The measurement and review of the entity's financial performance.

Question 111

"Professional judgment is essential to the proper conduct of an audit." Discuss. (MTP 3 Marks Oct 20) (PYP 5 Marks Nov '18)

Answer 111

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

(i) Materiality and audit risk.

(ii) The nature, timing, and extent of audit procedures used to meet the requirements of the SAs and gather audit evidence.

(iii) Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the SAs and thereby, the overall objectives of the auditor.

(iv) The evaluation of management's judgments in applying the entity's applicable financial reporting framework.

(v) The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

Question 112

State with reasons whether the following statements are correct or incorrect.

Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur. (PYP 2 Marks, July' 21)

Answer 112

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

Question 113

The auditor shall obtain an understanding of major activities that the entity uses to monitor internal control over financial reporting. Discuss "Monitoring of control" as a component of Internal control. (PYP 4 Marks, Nov'20)

OR

Define Monitoring of Controls and in respect of monitoring of controls, answer the following questions:

(i) How monitoring of controls would be helpful in assessing the effectiveness of controls?

(ii) How can management accomplish monitoring of controls?

(iii) What is included in the Management's monitoring activities? (RTP Nov'22)

Answer 113

Monitoring of Controls: Component of Internal Control

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting.

Monitoring of controls Defined: Monitoring of controls is a process to assess the effective ness of internal control performance over time.

(i) Helps in assessing the effectiveness of controls on a timely basis: It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.

(ii) Management accomplishes through ongoing activities, separate evaluations etc.: Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

(iii) Management's monitoring activities include: Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

(iv) In case of Small Entities: Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

Question 114

Explain how Internal Financial Control and Internal controls over financial reporting differ? (PYP 4 Marks, Jan'21, RTP Nov'21)

Answer 114

Difference between internal financial control and internal control over financial reporting Internal Financial Control as per Section 134(5)(e), "the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information." On the other hand, Internal controls over financial reporting-is required where auditors are required to express an opinion on the effectiveness of an entity's internal controls over financial reporting, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements.

Question 115

Internal control cannot eliminate risk of material misstatements in the financial statements. (PYP 2 Marks Dec '21)

Answer 115

Correct: Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management. However, internal control can only reduce but not eliminate risks of material misstatement in the financial statements. This is because of the inherent limitations of internal control.

There is possibility of human errors or mistakes, or of controls being circumvented by collusion. Accordingly, some control risk will always exist.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Inherent Limitations of Internal Control: Most of the examinees wrote about reduction of material misstatements which was not required but few managed to write about the inherent limitations and their examples. Many examinees did not write about possibility of human errors or mistakes.

Question 116

State with reasons whether the following statements are correct or incorrect Audit findings and control deficiencies can be evaluated or assessed arbitrarily. (PYP 2 Marks May'22)

Answer 116

Incorrect: Evaluation and assessment of audit findings and control deficiencies involves applying professional judgement that include considerations for quantitative and qualitative measures. Each finding should be looked at individually and in the aggregate by combining with other findings/deficiencies.

Question 117

State with reasons whether the following statements are correct or incorrect Inappropriate management can override internal controls of any organization. (PYP 2 Marks May'22)

Answer 117

Correct: Controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

Question 118

Discuss the common methods applied by the auditor when testing in an automated environment is done by him. (PYP 4 Marks, Jan'21)

Answer 118

There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and performance. Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.

When testing in an automated environment, some of the more common methods are as follows:

Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.

- Observe how a user processes transactions under different scenarios.
- Inspect the configuration defined in an application.
- Inspect the system logs to determine any changes made since last audit testing.
- Inspect technical manual / user manual of systems and applications.
- Carry out a test check (negative testing) and observe the error message displayed by the application.
- Conduct performance using raw source data and independently applying formulae, business rules or validations on the source data using CAATs.

Question 119

When the company is working in an automated environment, it is not necessary for its auditor to understand its automated environment and depends upon the professional judgement of the auditor as to whether gaining knowledge of company's IT systems is required or not. Do you agree with this statement? (PYP 3 Marks May'22)

Answer 119

Understanding and Documenting Automated Environment: When a business operates in a more automated environment it is likely that auditor will see several business functions and activities happening within the systems. Consider the following aspects instead of:

(i) Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).

(ii) Accounting entries are posted automatically (for example, sub-ledger to GL postings is automatic).

(iii) Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).

(iv) Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).

(v) User access and security are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively).

Companies derive benefit from the use of IT systems as an enabler to support various business operations and activities. Auditors need to understand the relevance of these IT systems to an audit of financial statements.

While it is true that the use of IT systems and automation benefit the business by making operations more accurate, reliable, effective and efficient, such systems also introduce certain new risks, including IT specific risks, which need to be considered, assessed and addressed by management.

To the extent that it is relevant to an audit of financial statements, even auditors are required to understand, assess and respond to such risks that arise from the use of IT systems.

From the above discussion, it is quite apparent that it is necessary for an auditor to understand the automated environment.

Alternative Solution

Understanding and Documenting Automated Environment: In an audit of financial statements, an auditor is required to understand the entity and its business, including IT as per SA 315. Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.

Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment:

(i) Information systems being used (one or more application systems and what they are).
(ii) Their purpose (financial and non-financial).
(iii) Location of IT systems - local vs global.
(iv) Architecture (desktop based, client-server, web application, cloud based).
(v) Version (functions and risks could vary in different versions of same application).
(vi) Interfaces within systems (in case multiple systems exist).
(vii) In-house vs Packaged.
(viii) Outsourced activities (IT maintenance and support).
(ix) Key persons (CIO, CISO, Administrators).
The understanding of a company's IT environment that is obtained should be documented. From the above discussion, it is quite apparent that it is necessary for an auditor to understand the automated environment.

Question 120

State with reasons whether the following statements are correct or incorrect:

In an automated environment, the relationship between the application controls and the General IT controls over IT systems are not interrelated. (PYP 2 Marks Nov 22, New SM)

Answer 120

Incorrect: The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems. These two categories of control over IT systems are interrelated.

Question 121

In an automated environment, General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. One such area is access security. What is the objective of access security and what are the activities included in it? (PYP 3 Marks Nov 22)

Answer 121

Access Security in Automated Environment:

Objective of access security: The objective of Access Security is to ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

Activities:

(i) Security Organization & Management
(ii) Security Policies & Procedures
(iii) Application Security

(iv) Data Security
(v) Operating System Security
(vi) Network Security – internal network, perimeter network
(vii) Physical Security – access controls, environment controls
(viii) System Administration & Privileged Accounts – Sysadmins, DBAs, Super users

Question 122

If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered less complex and easy to audit compared to using an off the-shelf accounting software.

(PYP 2 Marks May '23)

Answer 122

Incorrect: If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit.

On the other hand, if a company is using off-the-shelf accounting software, then it is likely to be less automated, less complex and easy to audit.

Question 123

CA L is in the process of finalizing his Risk Assessment Procedures of Effluent Limited which include observation and inspection that may support inquiries of management and others. Discuss few examples of audit procedures which include observation or inspection of the entity's operations. (PYP 3 Marks, July'21)

Answer 123

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

Examples of audit procedures which include observation or inspection of the entity's operations are:

(1) Documents (such as business plans and strategies), records, and internal control manuals.
(2) Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of director's meetings)
(3) The entity's premises and plant facilities.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Examples of audit procedure: Many examinees did not understand the requirement of the question and their answer was not relevant to the topic. Some examinees just explained about observation and inspection which was not required.

Question 124

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

Answer 124

The audit documentation shall include the following amounts and the factors considered in their determination:

(a) Materiality for the financial statements as a whole

(b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures

(c) Performance materiality and

(d) Any revision of (a)-(c) as the audit progressed

MULTIPLE CHOICE QUESTIONS (MCQS)

1. SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement -

(a) at the financial statement levels only.

(b) at the assertion levels only.

(c) at the financial statement and assertion levels.

(d) at the financial statement or assertion levels. (MTP 1 Mark March '19, Oct'19)

Ans: (c)

2. The risks of material misstatement at the assertion level consist of two components:

(a) Inherent risk and detection risk

(b) control risk and detection risk

(c) audit risk and detection risk

(d) Inherent risk and control risk (MTP 1 Mark March '19)

Ans: (d)

3. Which of the following is correct:

(a) When the projected misstatement exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.

(b) When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.

(c) When the anomalous misstatement exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.

(d) When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample provides a reasonable basis for conclusions about the population that has been tested. (MTP 1 Mark March '19)

Ans: (b)

4. Which of the following is correct:

(a) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.

(b) The auditor is expected to and can reduce audit risk to zero and can therefore obtain absolute assurance.

(c) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain reasonable assurance that the financial statements are free from material misstatement due to fraud or error.

(d) The auditor is expected to and can reduce audit risk to zero and can therefore obtain reasonable assurance that the financial statements are free from material misstatement due to fraud or error. (MTP 1 Mark April'19)

Ans: (a)

5. Audit risk is a function of the

(a) risks of material misstatement and detection risk.

(b) audit risk and detection risk.

(c) control risk and detection risk.

(d) inherent risk and detection risk. (MTP 1 Mark April'19, MTP 2 Marks Apr'21)

Ans: (a)

6. _____refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

(a) Misstatement

(b) Error

(c) Fraud

(d) Any of the above (MTP 1 Mark April'19, MTP 1 Mark Oct'19)

Ans: (a)

7. One of your junior audit team members is confused with the term 'material misstatement'. You explain him that a material misstatement is untrue information in a financial statement that could affect the financial decisions of one who relies on the statement. Which of the following would constitute material misstatement?(MTP 2 Marks April 19)

(1) An error of Rs.5,000 in relation to assets of Rs.20 lakhs.

(2) A payroll fraud of Rs.100 in a company where profit before tax is Rs.11,000.

(3) Non-disclosure of a material uncertainty.

(4) Financial statements have been prepared on a going concern basis when the company is in the process of being liquidated.

(a) 1 and 2

(b) 3 and 4

(c) 2 and 3

(d) 1 and 4

Ans: (b)

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8. The assessment of the risks of material misstatement may be expressed in

(a) quantitative terms, such as in percentages, or in non-quantitative terms.

(b) quantitative terms, such as in percentages,

(c) non-quantitative terms.

(d) None of the above (MTP 1 Mark Oct 19)

Ans: (a)

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9. The risk that the financial statements are materially misstated prior to audit is called-

(a) Risk of material misstatement

(b) detection risk

(c) audit risk

(d) significant risk (MTP 2 Marks March '21)

Ans: (a)

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10. Risk of material misstatement may be defined as the risk

(a) that the financial statements are materially misstated after audit.

(b) that the financial statements are materially misstated during audit.

(c) that the financial statements are materially misstated prior to audit.

(d) All of the above (MTP 2 Marks April '21 , Nov '21, MTP 1 Mark April'19, MTP 1 Mark Oct'19)

Ans: (c)

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11. Owing to the _____ limitations of an audit, there is risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

(a) Inherent, unavoidable

(b) Inherit, complete

(c) Management, unavoidable

(d) Regulatory, control (MTP 1 Marks March 22)

Ans: (a)

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12. A company is engaged in manufacturing of wooden furniture. The auditor of company notes that company has identified emerging risks pertaining to probable reduction in demand of company's products due to procurement of imported furniture from South East Asian nations. It has also estimated how significant are those risks and their possibility of happening. Besides, it has also formulated an action plan to deal with the situation, in case these risks materialize.

Which of the following options would be most appropriate to describe above situation?

(a) An example of audit risk for auditor

(b) An example of component of internal control of company

(c) An example of control risk of company

(d) An example of inherent risk for auditor (MTP 1 Marks Oct'22)

Ans: (b)

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13. Which of the following is incorrect-

For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall :

(a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;

(b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and

(d) Not consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement. (MTP 1 Mark March '23)

Ans: (d)

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14. To evaluate the Internal Control of Kingsway Limited, a team member of the auditors used a method according to which, number of questions relating to internal control of the company were required to be answered by the employees of the company. After obtaining the answers there was a discussion relating to those answers between team member of the auditor and employees of the company for a clear picture. State the method of evaluation of internal control as discussed above.

(a) Narrative record

(b) Check List

(c) Internal Control questionnaire

(d) Flow chart (MTP 1 Mark Sep '23)

Ans: (c)

15. The term Internal Financial Controls (IFC) basically refers to the policies and procedures put in place by companies for ensuring:

(i) Reliability of financial reporting

(ii) Compliance with applicable laws and regulations

(iii) Safeguarding of assets.

(iv) Effectiveness and efficiency of operations

(v) Prevention and detection of frauds

Which statement is correct?

(a) (i),(ii)and (iv)

(b) (i),(iii) (v) and(ii)

(c) (i),(ii),(iii) and (iv)

(d) (i), (ii),(iii),(iv)and (v) (MTP 1 Mark Sep '23)

Ans: (d)

16. In designing and performing test of controls, the auditor shall perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:

(i) How the controls were applied at relevant times during the period under audit.

(ii) The consistency with which they were applied.

(iii) By whom or by what means they were applied. Which of the following is correct?

(a) (i) and (ii)

(b) (ii) and (iii)

(c) (i),(ii) and (iii)

(d) (i) and (iii) (MTP 1 Marks March 22)

Ans: (c)

17. Consider the following statements pertaining to nature and meaning of "assertions":-

Statement I—-Assertions are representations by the management which are present in financial statements.

Statement II —-The assertions have to be necessarily explicit.

Which of the following is correct?

(a) Only Statement I is true.

(b) Only Statement II is true.

(c) Both statements I and II are true.

(d) Both statements I and II are false. (MTP 1 Marks March 22)

Ans: (a)

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18. SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor

(a) should not consider materiality and its relationship with audit risk while conducting an audit.

(b) should consider materiality and its relationship with audit risk while conducting an audit.

(c) should not consider materiality but should consider its relationship with audit risk while conducting an audit.

(d) should consider materiality but need not consider its relationship with audit risk while conducting an audit. (MTP 1 Mark March '19, MTP 2 Marks Mar'21)

Ans: (b)

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19. The concept of materiality is applied by the auditor:

(a) in planning and performing the audit

(b) in evaluating the effect of identified misstatements on the audit

(c) both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit

(d) none of the above is correct (MTP 2 Marks Oct '20, Sep'22, RTP May'21)

Ans: (c)

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20. _____ are needed to support the functioning of _____

(a) General IT Controls; Application Controls

(b) Application Controls; General IT Controls

(c) IT Dependent Controls; General IT Controls

(d) Application Controls; IT Dependent Controls (MTP 1 Marks April '23)

Ans: (a)

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21. _____refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

(a) Audit assessment procedures

(b) substantive procedures

(c) test of control

(d) Risk assessment procedures (RTP Nov '19)

Ans: (d)

22. When more persuasive audit evidence is needed regarding the effectiveness of a control,

(a) it may be appropriate to increase the extent of testing of the control and reduce the extent of the degree of reliance on controls.

(b) it may be appropriate to decrease the extent of testing of the control as well as the degree of reliance on controls.

(c) it may be appropriate to decrease the extent of testing of the control and increase the extent of the degree of reliance on controls.

(d) it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. (RTP Nov '19)

Ans: (d)

23. When deviations from controls upon which the auditor intends to rely are detected,

(a) the auditor shall not make any inquiries to understand these matters and their potential consequences

(b) the auditor shall make specific inquiries to understand these matters and their potential consequences

(c) the auditor shall make general inquiries to understand these matters and their potential consequences

(e) the auditor shall make both general as well as specific inquiries to understand these matters and their potential consequences (RTP Nov '19)

Ans: (b)

24. _____refer to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.(RTP May '22)

(a) Internal control assessment procedures

(b) Risk assessment procedures

(c) substantive procedures

(d) analytical procedures

Ans: (b)

25. The Guidance Note on Audit of Internal Financial Controls over Financial Reporting has been issued by?

(a) ICAI

(b) SEBI

(c) MCA

(d) RBI (MTP 1 Mark March '19)

Ans: (a)

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26. The management of Magog Ltd. has developed a strong internal control in its accounting system in such a way that the work of one person is reviewed by another. Since no individual employee is allowed to handle a task alone from the beginning to the end, the chances of early detection of frauds and errors are high. CA. Olive has been appointed as an auditor of the company for current Financial Year 2017-18.

Before starting the audit, she wants to evaluate the internal control system of Magog Ltd. To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls,

CA. Olive decided to use internal control questionnaire to know and assimilate the system and evaluate the same. Which of the following questions need not be framed under internal control questionnaire relating to purchases?

(a) Are authorized signatories for purchases limited to elected officials?

(b) Are payments approved only on original invoices?

(c) Does authorized officials thoroughly review the documents before signing cheese?

(d) Are monthly bank reconciliations implemented for each and every bank accounts of the company? (RTP May '19)

Ans: (d)

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27. A type of super user access to information systems that enforces less or no limits on using that system is known as: (RTP May '22)

(a) Super access.

(b) Super user access.

(c) Unlimited access.

(d) Privileged access.

Ans: (d)

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28. Tools and techniques that auditors use in applying the principles of data analytics are known as -

(a) Computer Aided Audit Technique

(b) Computer Aided Audit Tools

(c) Computer Accounting and Auditing Technique

(d) Computer Assisted Audit Technique (RTP May '23)

Ans: (d)

29. Which of the following is a risk that arises from the use of IT systems?

(a) Direct data changes (backend changes).

(b) Limited/Monitored access.

(c) Adequate segregation of duties.

(d) Authorized access to data. (RTP Nov '23)

Ans: (a)

CASE STUDY - 1

CA Paritosh is auditor of a company. The financial statements of the company have just been received for audit. Following issues have been flagged pertaining to the financial statements of the company for purpose of risk assessment: -

(i) The revenue of company has fallen from ₹ 50 crore in last year to ₹ 5 crore in current year (for which financial statements have been received for audit) due to lack of demand in the market for company's products.

(ii) Due to advent of new products in the market, company's products are fast becoming outdated.

(iii) A large customer having an outstanding balance of ₹ 5 crore has failed to pay to the company despite efforts made by the company.

(iv) Inventory holding period has increased from 30 days in last year to 90 days.

(v) The company also gets carried out job operations from third parties. Therefore, parts of inventories are lying with third parties.

MULTIPLE CHOICE QUESTIONS (MCQS)

Based on above, answer the following questions: -

1. Regarding drastic fall in revenue of the company, which of the following is an audit risk?

(a) Fall in revenue would result in fall of profits for the company.

(b) Drastic fall in revenue may imply that company is not able to carry out its operations in foreseeable future due to lack of demand in the market for company's products. There is a risk that going concern disclosure is omitted to be made in financial statements.

(c) The company can explore some new line of activity, if demand of its products is falling.

(d) Fall in revenue would mean lower tax liabilities for the company.

Ans: (b)

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2. The company's products are getting outdated in the market. Which of the following is an audit risk?

(a) The company should devise strategies to sell products in the market.

(b) Inventories may be understated in such a scenario.

(c) Inventories may be overstated in such a scenario.

(d) The company should launch a 1+1 free offer for its customers.

Ans: (c)

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3. A large customer has failed to pay to the company. Identify audit risk from below:

(a) Receivables may be misstated if irrecoverable debt is not written off.

(b) Receivables may be overstated if irrecoverable debt is not written off.

(c) Writing off irrecoverable debt would impact profits of company adversely.

(d) Failure to recover outstanding debt would impact cash flows of company adversely.

Ans: (b)

4. Identify audit risk involved when inventory holding period has increased from 30 days to 90 days.

(a) There is a risk of overstatement of inventories.

(b) There is a risk relating to existence of inventories.

(c) There is a risk that slow movement of stocks would increase tax liability when GST rates are increased.

(d) There is a risk relating to holding and storage cost of inventories.

Ans: (a)

5. Part of inventories are lying with third parties. Identify audit risk involved.

(a) There is a risk that third parties do not manufacture according to specifications of the company.

(b) There is a risk that by getting job work done from third parties, company is increasing its costs.

(c) There is a risk that sufficient and appropriate evidence would not be available in respect of quantity and condition of inventories lying with third parties.

(d) There is a risk that sufficient and appropriate evidence would not be available for quality control in respect of inventories lying with third parties.

Ans: (c)

CASE STUDY - 2

CA Piyush is understanding internal controls as part of audit exercise of a company. It is a new client.

He has studied controls in place in various operational areas of the company. After studying and gaining an understanding of such controls, he has decided to test few controls to actually see whether these are operating as intended by the management.

Till now, he has studied controls over inventories and bank. Few of such controls are listed below: -

Nature of Control	Control description
Control over inventories	Inventories of the company lying at each location should be insured.
Control over inventories	There should be inventory counts on a regular basis for each location of the company.
Control over Bank operations	Bank reconciliations are to be performed at regular intervals.

1. Which of the following most appropriately describes test of control regarding insurance of inventories?

(a) Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. The sum insured and period of validity of policy are not relevant.

(b) Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure adequacy of sum insured by comparing it with value of inventories. Also ensure policy period has not expired.

(c) Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure policy period has not expired.

(d) Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. Ensure policy period has not expired.

Ans: (b)

2. Which of the following most appropriately describes test of control regarding inventory counts?

(a) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure.

(b) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count.

(c) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count and perform test count.

(d) Attend inventory count and perform test count.

Ans: (c)

3. While testing control over bank reconciliations, it has been noticed that bank reconciliations are not being performed at regular intervals. Identify the most appropriate description of "control deficiency" in this regard: -

(a) Bank reconciliations are not being performed regularly as concerned staff is overburdened.

(b) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors.

(c) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors. It may result in misstatement of cash and bank balance in financial statements.

(d) Bank reconciliations are not being performed regularly as concerned staff is overburdened.

These should be performed monthly and reviewed by senior accountant.

Ans: (c)

4. Since the company is a new client, which of the following statements is most appropriate?

(a) There is reduced detection risk.

(b) There is increased detection risk.

(c) There is no effect on detection risk.

(d) Detection risk should be increased to lower audit risk.

Ans: (b)

5. Which of the following statements is most appropriate regarding auditor's response to assessed risk of a new client?

(a) More substantive procedures would require to be performed.

(b) Less substantive procedures would require to be performed.

(c) There is no effect on substantive procedures.

(d) There is no effect on substantive procedures as audit risk is low.

Ans: (a)

TEST YOUR KNOWLEDGE

6. Which of the following is true regarding materiality?

(a) It is unaffected by nature of an item.

(b) It is unaffected by requirements of law or regulations.

(c) It is not a matter of professional judgment.

(d) It is not always a matter of relative size.

Ans: (d)

7. The operations of a company are automated substantially. Which of the following statements is most appropriate in this respect?

(a) It results in complex business environment.

(b) It results in simple business environment and easier audit.

(c) Automation has no relationship with complexity of business environment.

(d) It results in simple business environment. However, it increases complexity of audit.

Ans: (a)

8. Who is responsible for maintaining effective internal financial controls?

(a) Statutory auditor

(b) Audit Committee

(c) Management

(d) Shareholders

Ans: (c)

9. Which of the following is not a risk to a company's internal control due to its IT environment?

(a) Potential loss of data

(b) Inability to access data when required

(c) Unauthorized access to data

(d) Processing of large volumes of data

Ans: (d)

10. Which of the following is not an example of "General IT controls"?

(a) Controls pertaining to Disaster recovery plan

(b) Controls pertaining to batch preparation

(c) Controls pertaining to data security

(d) Controls pertaining to validation of input data in an application

Ans: (d)

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

Question 1

There is direct relationship between materiality and the degree of audit risk.

Answer 1

Incorrect: There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular

account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

Question 2

Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

Answer 2

Incorrect: Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. Control risk, on the other hand is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Question 3

Tests of control are performed to obtain audit evidence about the effectiveness of Internal Controls Systems.

Answer 3

(i) Correct: Tests of Control are performed to obtain audit evidence about the effectiveness of:

(a) the design of the accounting and internal control systems that is whether, they are suitably designed to prevent or detect or correct material misstatements and

(b) the operation of the internal controls throughout the period.

Question 4

Maintenance of Internal Control System is the responsibility of the Statutory Auditor.

Answer 4

Incorrect: The management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. Maintenance of Internal Control System is responsibility of management because the internal control is the process designed, implemented and maintained by those charged with governance/management to provide reasonable assurance about the achievement of entity's objectives.

THEORETICAL QUESTIONS ANSWER

Question 1

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

Answer 1

Analytical Procedures: Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.

Analytical procedures performed as risk assessment procedures may include both financial and non financial information, for example, relationship between sales and square footage of selling space or volume of goods sold.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Question 2

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

Answer 2

The audit documentation shall include the following amounts and the factors considered in their determination:

(a) Materiality for the financial statements as a whole

(b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures

(c) Performance materiality and

(d) Any revision of (a)-(c) as the audit progressed

Question 3

Discuss relationship between "General IT controls" and "application controls" in an automated environment.

Answer 3

These two categories of control over IT systems are interrelated.

The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems.

Question 4

A company functions in an automated environment. Discuss in what areas data analytics can be useful for auditor of the company.

Answer 4

The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialized audit tools viz., IDEA and ACL to perform the following:

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

Question 5

What is understood by "non-routine" transactions? Briefly outline why risks of material misstatement is greater for such transactions.

Answer 5

Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement. The auditor assesses assertions affected by a significant risk as higher inherent risk. The following are always significant risks:

- Risks of material misstatement due to fraud
- Significant transactions with related parties that are outside the normal course of business for the entity

Question 6

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting" Explain.

Answer 6

The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It helps in assessing the effectiveness of controls on a timely basis.

It involves 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.

Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Question 7

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

Answer 7

The risk of material misstatement at assertion level comprises of two components i.e., inherent risk and control risk. Both inherent risk and control risk are the entity's risks and they exist independently of the audit of financial statements. Inherent risk and control risk are influenced by the client. These are entity's risks and are not influenced by the auditor.

Inherent risk

Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements before consideration of any related controls as described in SA-200.

There is always a risk that before considering any existence of internal control in an entity, a particular

transaction, balance of an account or a disclosure required to be made in the financial statements of an entity have a chance of being misstated and such misstatement can be material. This risk is known as inherent risk.

Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations.

Inherent risk factors are considered while designing tests of controls and substantive procedures.

Category of auditor's assessment lower or higher, each category covers a range of degrees of inherent risk. Auditor may assess the inherent risk of two different assertions as lower while recognizing that one assertion has less inherent risk than the other, although both have been assessed as lower.

It is important to consider the reason for each identified inherent risk even if the risk is lower, when auditor designs tests of controls and substantive procedures.

External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete. Factors in the entity and its environment may also influence the inherent risk related to a specific assertion.

Control Risk

In accordance with SA-200, control risk is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Control risk is a risk that internal control existing and operating in an entity would not be efficient enough to stop from happening, or find and then rectify in an appropriate time, any material misstatement relating to a transaction, balance of an account or disclosure required to be made in the financial statements of that entity. Therefore, in a way, it can be said that there exists an inverse relation between control risk and efficiency of internal control of an entity. When efficiency of internal control of an entity is high, the control risk is low and when efficiency of internal control of that entity is low, the control risk is high.

Question 8

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

Answer 8

Standards on auditing do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case,

the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

Audit risk = Risks of material misstatement X Detection risk

It can be concluded from the above that: -

Since risks of material misstatement is a function of inherent risk and control risk, it can also be shown as: -

Audit risk = Inherent risk X Control risk X Detection risk

Question 9

"The auditor shall obtain an understanding of the control environment" Explain stating what is included in control environment.

Answer 9

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.

Question 10

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control.

Answer 10

Objectives of Internal Control

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

Objectives of Internal Control are:

(i) transactions are executed in accordance with managements general or specific authorization;

(ii) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;

(iii) assets are safeguarded from unauthorised access, use or disposition; and

(iv) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

Question 11 Illustration

XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as ready made garments for all seasons, shoes, gift items, watches etc. There are security tags on each and every item. Moreover, inventory records are physically verified on monthly basis.

Discuss the types of inherent, control and detection risks as perceived by the auditor.

Answer 11

Inherent Risk: Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate.

Control Risk: There is a security tag on each item displayed. Moreover, inventory records are physically verified on monthly basis. Despite various controls being implemented at the stores, still collusion among employees may be there and risk to auditor would again be that inventory records would be inaccurate.

Detection Risk: Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, enquiry, etc. In addition to these, the auditor would also employ sampling techniques to check few sales transactions from beginning to end. However, despite all these procedures, the auditor may not detect the items which have been stolen or misappropriated.

Question 12 Illustration

A Partnership Firm of Chartered Accountants HT and Associates was appointed to audit the books of accounts of Wind and Ice Limited for the financial year 2020 -21. There was a risk that HT and Associates would give an inappropriate audit opinion if the financial statements of Wind and Ice Limited are materially misstated. State the Risk mentioned in the question.

Answer 12

The risk mentioned in the question is known as Audit Risk, because risk that auditor of a company will give an inappropriate audit opinion if the financial statements of that company are materially misstated is known as Audit Risk.

Question 13 Illustration

One of the team members of auditors of Highly Capable Limited was of the view that Materiality and Audit Risk are only considered at planning stage of an audit. Comment as an auditor

Answer 13

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

Question 14 Illustration

The auditor of ABC Textiles Ltd chalks out an audit plan without understanding the entity's business. Since he has carried out many audits of textile companies, there is no need to understand the nature of business of ABC Ltd. Advise the auditor how he should proceed.

Answer 14

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The auditor should proceed accordingly.

Question 15 Illustration

While auditing the books of accounts of Heavy Material Limited for the financial year 2022-23, a team member of the auditor of Heavy Material Limited showed no inclination towards understanding the business and the business environment of the above mentioned company. Is the approach of team member of the auditor of Heavy Material Limited correct or incorrect? Also give reason for your answer.

Answer 15

The approach of team member of the auditor of Heavy Material Limited is incorrect because understanding the business and the business environment of company whose audit is to be conducted is very important, as it helps in planning the audit and identifying areas requiring special attention during the course of audit of that company.

Question 16 Illustration

Prince Blankets is engaged in business of blankets. Its major portion of sales is taking place through internet. Advise the auditor how he would proceed in this regard as to understanding the entity and its environment.

Answer 16

While understanding entity and its environment, internet sales is being perceived as risky area by the auditor and thereby would be spending substantial time and extensive audit procedures on this particular area.

Question 17 Illustration

Auditor GR and Associates, appointed for audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditor does not think that it would be necessary to understand internal controls. Advise the auditor in this regard.

Answer 17

The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

Question 18 Illustration

The team member of the auditor of Simple and Easy Limited was of the view that understanding the internal control of the company would not help them in any manner in relation to audit procedures to be applied while conducting the audit.

Answer 18

The view of the team member of the auditor is incorrect because understanding the internal control of the company would help the auditor and his team members in designing the nature, timing and extent of audit procedures to be applied while conducting the audit of the company.

Question 19 Illustration

Mr. Y, one of the team member of the auditors of What and Where Limited was very keen in knowing whether the internal control of the company would safeguard the company's assets. Advise Mr. Y.

Answer 19

The review of internal controls will enable the auditors to know whether the controls adequately safeguard the assets.

Question 20 Illustration

Mr. H, a team member of the auditor of There and Here Limited was of the view that evaluation of internal control of the company would help in identifying the areas where internal control is weak. Advise

Answer 20

The review of internal controls will enable the auditor to know what are the areas where control is weak and where it is excessive.

Question 21 Illustration

In order to evaluate the Internal Control of Your and My Limited, a team member of the auditors used a method according to which, number of questions relating to internal control of the company were required to be answered by the employees of the company. After obtaining the answers there was a discussion relating to those answers between team member of the auditor and employees of the company for a clear picture. State the method of evaluation of internal control as discussed above.

Answer 21

The method of evaluation of internal control used in the above question is known as Internal Control Questionnaire because in questionnaire method, a number of questions relating to internal control of a company are required to be answered by employees of that company and when answers to the questions are obtained, there is a discussion relating to those answers between team members of the auditors and employees of that company for a clear picture.

Question 22 Illustration

Healthy and Useful Limited is into small manufacturing as well as trading business. For the purpose of evaluating the internal control of Healthy and Useful Limited, a team member of the auditors of the company used a method according to which the whole description of internal control that was operating in the said company was to be recorded. Identify the method of evaluation of internal control as mentioned above.

Answer 22

The method of evaluation of internal control referred above is known as Narrative Record because in Narrative Record method, a whole description of internal control operating in an entity is recorded. Narrative Record method is also appropriate for small manufacturing as well as trading business as is mentioned in the question above case.

Test Your Understanding

Question 1

Wear & Tear Private Limited is a "start-up" engaged in providing holistic solutions to problem of paddy stubble burning mainly catering to needs of farmers of North western India. Due to importance given by governments to this issue, companies have entered in the market in past few years. Many of these companies have not been successful and have gone bust. As an auditor of the company, can you spot the component of risks of material misstatement involved in above?

Answer 1

It has been stated that many companies engaged in providing holistic solutions to problem of stubble burning have not been successful. It shows that line of activity is inherently risky. Therefore, there is a greater possibility of misstatements. The component of risks of material misstatement involved is "inherent risk."

Question 2

A company has devised a control that its inventory of perishable goods is stored in appropriate conditions- in a controlled environment to prevent any damages to inventory. Responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. Identify the component of risks of material misstatement involved as an auditor of the company.

Answer 2

The company has devised a control that its inventory of perishable goods is stored in appropriate conditions and responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. There is a possibility that persons given responsibility do not perform their work and report deviations. The component of risks of material misstatement is "control risk".

Question 3

Shree Foods Private Limited is engaged in manufacturing of garlic bread. The auditors of company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that misstatements in revenue recognition are not identified by planned audit procedures. Which risk is being alluded to?

Answer 3

There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. The risk alluded to it is "detection risk".

Question 4

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

Answer 4

Jo Jo Limited is planning to list on Bombay Stock Exchange next year. There is a greater chance of misstatements in the financial statements due to planned listing next year. There could be a possibility of intentional manipulation of financial statements so that good response is received to proposed issue. Therefore, there is increased audit risk i.e., risk of expressing inappropriate opinion by the auditor when financial statements are materially misstated.

Question 5

On perusing financial statements of Jo Jo Limited put up for audit, it is observed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). Identify what kind of risk assessment procedures are being performed by auditor? Has it any relation with listing of the company next year on Bombay Stock Exchange?

Answer 5

It is noticed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). The auditor is using "analytical procedures" as risk assessment procedures. Current ratio has improved from previous year. There could be a possibility of misstatement in current assets and current liabilities. It is possible that improvement in current ratio is artificial due to misstatements and has been done to secure good response to the proposed issue of company next year.

Question 6

CA A. Raja is auditor of Build Well Forgings Private Limited having a revenue of ₹ 25 crore. The company has been sanctioned a term loan of ₹ 50 lacs from a bank. However, as at end of the year, only ₹ 1 lac was availed due to delay in procurement of asset. The financial statements of the company do not disclose nature of security against which loan has been taken. Schedule III of Companies Act,2013 requires disclosure in this respect. Discuss, whether, non-disclosure of nature of security is material for auditor.

Answer 6

If there is any statutory requirement of disclosure, it is to be considered material. Schedule III mandates disclosure of nature of security in relation to loan. The amount involved is irrelevant.

Question 7

CA Smriti is auditor of a company. As part of audit, she is going through company policies and practices regarding employee recruitment, training, orientation and related matters. She seems to be very much interested in finding out whether company hires best candidates from applicant pool. Identify what she is trying to do? How gaining knowledge about this aspect is useful to her as an auditor?

Answer 7

The study of company policies and practices regarding employee recruitment, training, orientation and related matters including hiring of best candidates is part of understanding HR function of the company.

It, in turn, helps in understanding control environment of the company. By gaining such a knowledge, she can better understand internal control of the company.

Question 8

During the audit of same company, CA Smriti is keen to find out whether there exists a proper system of segregation of duties in the company. She wants to be sure that a person responsible for recording a transaction is different from the person authorising it. Discuss what she is trying to do and how its understanding is significant to her as an auditor.

Answer 8

She is keen to find out whether there exists a proper system of segregation of duties in the company. She is gaining an understanding of internal control of the company. In particular, she is understanding "control activities". When a person recording a transaction is different from one authorizing it, she gains confidence that there exists a system for preventing misstatements. It helps her in gaining insight into the internal control system of the company.

Question 9

Zomba Products Private limited is a small company. The control systems in the company are rudimentary. How, you as an auditor of the company, would proceed to evaluate internal control of the company?

Answer 9

In a small company, control systems are basic and not formalized. Therefore, auditor should proceed to evaluate internal control using narrative record.

Question 10

A Chartered accountant during course of audit of a company finds that cash is not deposited into bank frequently although concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. Discuss what does it represent from auditor's perspective.

Answer 10

Cash is not deposited into bank frequently, although, concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. It means that control is not working as planned. It would not be able to prevent misstatement and very purpose of control is defeated. It represents a "control deficiency".

CHAPTER 4
AUDIT EVIDENCE

SA 500- Audit Evidence

Question 1

Examine with reasons (in short) whether the following statements are correct or incorrect :

When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. (MTP 2 Marks March '19, MTP 2 Marks March '18, Oct'18, RTP Nov '20)

Answer 1

Correct. — When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

Question 2

Discuss the following:

Name the assertions for the following audit procedures:

(i) Year end inventory verification.

(ii) Depreciation has been properly charged on all assets.

(iii) The title deeds of the lands disclosed in the Balance Sheet are held in the name of the company.

(iv) All liabilities are properly recorded in the financial statements.

(v) Related party transactions are shown properly. (MTP 5 Marks April '21) (PYP 5 Marks, May '18)

Answer 2

(i) Year end inventory verification: Existence Assertion.

(ii) Depreciation has been properly charged on all assets: Valuation Asser tion.

(iii) Title deeds of the lands disclosed in the Balance Sheet are held in the name of the Company: Rights & Obligations Assertion.

(iv) All liabilities are properly recorded in the financial statements: Completeness.

(v) Related party transactions are shown properly: Presentation & Disclosure.

Question 3

Examine with reasons (in short) whether the following statements are correct or incorrect: Inquiry alone ordinarily does not provide sufficient audit evidence. (MTP 2 Marks Nov '21 & March 22)

Answer 3

Correct: Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

Question 4

State with reason (in short) whether the following statements are true or false Inquiry alone provides sufficient audit evidence of the absence of a material misstatement at the assertion level and of the operating effectiveness of controls:(RTP Nov'19, PYP 2 Marks May'18, Old & New SM)

Answer 4

Incorrect: Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

Question 5

In the course of audit of SMP Limited for the financial year ended 31st March, 2020 you have observed as an auditor that the company has provided a sum of ₹ 20 Lakhs in the books of account as Gratuity payable to employees based on certificate obtained from an actuary. Give your comments with reference to the Standard on Auditing. (MTP 3 Marks Nov '21)

Answer 5

Certificate from a Management's Expert: In the given case, SMP Limited has provided a sum of 20 lakh in the books of accounts as gratuity payable on the basis of certificate obtained from an actuary. The liability towards gratuity payable to the employees at the time of cessation of service should be ascertained and provided for in the accounts when the employees are in service, it is an ascertained present liability accruing over the period of service but payable upon cessation of service. The auditor

should check the quantification of the gratuity liability. He should ascertain whether the same had been actuarially determined. The auditor should treat the actuary as managements' expert and conduct procedures relevant to checking the opinion of an expert in accordance with SA 500.

As per SA 500, "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

1. Evaluate the competence, capabilities and objectivity of that expert;
2. Obtain an understanding of the work of that expert; and
3. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Question 6

The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source, its nature and the circumstances under which it is obtained. Explain and elucidate the guiding principles which are useful in assessing the reliability of audit evidence. (MTP 3 Marks March 22, RTP May 18)

Answer 6

Reliability of Audit Evidence: As per SA 500 on "Audit Evidence", the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions.

While recognising that exceptions may exist, the following guiding principles about the reliability of audit evidence may be useful:

(i) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

(ii) 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.

(iii) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

(iv) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

(v) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

Question 7

Examine with reasons (in short) whether the following statements are correct or incorrect Audit evidence obtained through observation of the application of a control is less reliable than audit evidence obtained by inquiry about the application of a control. (MTP 2 Marks Oct'22)

Answer 7

Incorrect: Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

Question 8

CA Amar is the statutory auditor of XYZ Ltd. for the FY 2021-22. During the course of audit, CA Amar found that a litigation is going against the company for which the company has hired an external legal team (management expert). CA Amar wanted to use the information as audit evidence which is prepared using the work of the management expert. What should CA Amar consider before using the work of such management expert? (MTP 3 Marks Oct'22)

Answer 8

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

1. Evaluate the competence, capabilities and objectivity of that expert;
2. Obtain an understanding of the work of that expert; and
3. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.
4. CA Amar should consider the above before using the work of the management's expert.

Question 9

What is meant by sufficiency of Audit Evidence? Explain the factors affecting the auditor's judgement as to the sufficiency of audit evidence. (MTP 3 Marks April '23, RTP Nov 20 & May 23, Old & New SM)

OR

The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. Analyse and Explain stating clearly the factors affecting the auditor's judgement as to sufficiency of audit evidence. (RTP May '18 & May '19)

OR

There was a Partnership Firm of Chartered Accountants WT and Associates. Mr. W, one of the partners of WT and Associates, while explaining to his audit team members about importance of audit evidence informed them about sufficiency and appropriateness of audit evidence. Mr. H, one of the members of audit team of WT and Associates was of the view that sufficiency of audit evidence means simplicity of audit evidence and appropriateness of audit evidence means ease of obtaining audit evidence. Explain whether sufficiency and appropriateness of audit evidence mean simplicity and ease of obtaining audit evidence. (Old & New SM)

Answer 9

Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

Following are the factors affecting the auditor's judgment as to the sufficiency of audit evidence:

(i) **Materiality:** It may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand, if assertions are more material to the users of the financial statements, more evidence would be required.

(ii) **Risk of material misstatement:** It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level:

• **Inherent risk**—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.

• **Control risk**—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control.

Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand, if assertions have a higher risk of material misstatement, more evidence would be required.

(iii) **Size of a population:** It refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

Question 10

Examine with reasons (in short) whether the following statements are correct or incorrect:

While audition the books of accounts of XYZ Ltd., the auditor of the company was involved in examining records and documents in paper form, electronic form etc. and was also conducing physical examination of assets. In the present case, audit procedure used by the auditor is known as "Observation". (MTP 2 Marks Sep '23 & Oct '23)

Answer 10

Incorrect: The audit procedure used by the auditor of XYZ Ltd. is known as "Inspection". Whereas Observation consists of looking at a process or procedure being performed by others.

Question 11

Examine with reasons (in short) whether the following statements are correct or incorrect:

Negative assertions, encountered in the financial statements, may be expressed or implied. (MTP 2 Marks Oct '23, RTP Nov '22)

Answer 11

Correct: Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is no contingent liability, it would be an expressed negative assertion. On the other hand, if in the balance sheet there is no item as "building", it would be an implied negative assertion that the entity did not own any building on the balance sheet date.

Question 12

Discuss the following:

An audit does not provide absolute assurance. Discuss how nature of audit procedures itself is one of the reasons due to which audit cannot provide absolute assurance. (MTP 3 Marks Oct'23)

OR

There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain with the help of examples. (MTP 3 Marks Oct 20)

Answer 12

The Nature of Audit Procedures: The auditor carries out his work by obtaining audit evidence through performance of audit procedures. There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

1. There is possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.

2. Fraud may involve sophisticated and carefully organised schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Question 13

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts.

This he cannot do unless he has examined the financial statements objectively. He needs evidence to obtain information for arriving at his judgment. Discuss explaining clearly the meaning of audit evidence in detail. (MTP 4 Marks Oct'23, RTP Nov '19)

Answer 13

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs.

An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgment.

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

(1) Information contained in the accounting records: Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocation, computations, reconciliations and disclosures.

(2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements: Other information which the auditor may use as audit evidence includes, for example minutes of the meeting, writhe confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

Question 14

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

Explain (RTP Nov '19 & Nov '18, Old & New SM)

Answer 14

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated

Question 15

Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and Analyse and explain with the help of example of evidence in respect of Sales. (RTP May '20)

Answer 15

Evidence is the very basis for formulation of opinion and an audit program me is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit program me. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.

Example Sales are evidenced by:

(i) invoices raised by the client;
(ii) price list;
(iii) forwarding notes to client;
(iv) inventory-issue records;
(v) sales managers' advice to the inventory section;
(vi) acknowledgment of the receipt of goods by the customers; and collection of money against sales by the client. explain with the help of example of evidence in respect of Sales.

Question 16

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. An auditor picks up evidence from a variety of fields. Analyse and explain with the help of examples. (RTP Nov'20)

Answer 16

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.

An auditor picks up evidence from a variety of fields and it is generally of the following broad types:

(a) Documentary examination,
(b) Physical examination,
(c) Statements and explanation of management, officials and employees,
(d) Statements and explanations of third parties,
(e) Arithmetical calculations by the auditor,
(f) State of internal controls and internal checks,

(g) Inter-relationship of the various accounting data,

(h) Subsidiary and memorandum records,

(i) Minutes,

(j) Subsequent action by the client and by others.

Example

1. For cash in hand, the best evidence is 'count'

2. For investment pledged with a bank, the banker's certificate.

3. For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion.

The auditor, however, has to place appropriate weight on each piece of evidence and accordingly should prescribe the priority of verification. It is true that in al l cases one procedure may not bring the highest satisfaction and it may be dangerous for the auditor to ignore any evidence that is available. By the word "available" we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.

Question 17

When information to be used as audit evidence has been prepared using the work of a management's expert and having regard to the significance of expert's work for the auditor's purposes, explain the considerations auditor would consider for the purposes of his audit. (RTP May '21)

Answer 17

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

(i) Evaluate the competence, capabilities and objectivity of that expert;

(ii) Obtain an understanding of the work of that expert; and

(iii) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Question 18

Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. Discuss. (RTP May '18)

Answer 18

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes: -

(1) **Information contained in the accounting records:** Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

(2) **Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements:** Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

Question 19

While conducting the audit of Pummy Limited, the statutory auditors collected written representations from the Management. The audit was finalized in addition to other audit procedures but, without making any inquiries, as the statutory auditors were short of time. In the light of this information, state the importance of inquiry as one of the methods of collecting Audit Evidence. (RTP May '22)

OR

Evaluating responses to inquiries is an integral part of the inquiry process. Explain. (RTP May '18)

Answer 19

Inquiry: As per SA 500 Audit Evidence: -

(i) Inquiry consists of seeking information of knowledgeable persons, financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

(ii) Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

(iii) Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out

its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

(iv) In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries

Question 20

An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively. Explain. (RTP Nov'22)

Answer 20

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgement.

SA 500 – "Audit Evidence", explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

Question 21

Manya Textiles is manufacturer of bed sheets, curtain cloths, other handloom items etc. having its plant at Panipat. Auditors SJ & Co. is having doubts over the reliability of information given to him as audit evidence. Also, auditors observed inconsistent information while conducting audit. Guide the auditor as to how they should proceed in the given situation. (RTP Nov'22)

Answer 21

If:

(a) audit evidence obtained from one source is inconsistent with that obtained from another; or

(b) the auditor has doubts over the reliability of information to be used as audit evidence, the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit.

Question 22

If an entity has a known number of employees at fixed rates of pay throughout the period, there would be more need to perform tests of details on the payroll. (RTP Nov'20)

Answer 22

Incorrect: If an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.

Question 23

State with reason (in short) whether the following statements are true or false: Subjective examination connotes critical examination and scrutiny of the accounting statements. (RTP Nov'19)

Answer 23

Incorrect: Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs.

Question 24

State with reason (in short) whether the following statements are true or false:

The matter of difficulty, time, or cost involved is in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative. (RTP May '19)

Answer 24

Incorrect: The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the 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.

Question 25

State with reason (in short) whether the following statements are true or false:

While auditing the books of accounts of XYZ Ltd., the auditor of the company looked at the inventory counting process to obtain audit evidence. In the present case, audit procedure used by the auditor is known as "Inspection". (RTP May '23, PYP 2 Marks Dec '21)

Answer 25

Incorrect: The audit procedure used by the auditor of XYZ Ltd. is known as "observation". Whereas inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

Question 26

T Ltd has used the services of an expert for the purpose of physical verification of its inventory which is appearing in the financial statements of the company at ₹ 75 Crores. Discuss the broad parameters auditor would take into consideration while deciding about using the work performed by the Management's Expert in physical verification of company's inventory. (RTP Nov '23)

Answer 26

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

- Evaluate the competence, capabilities and objectivity of that expert;
- Obtain an understanding of the work of that expert; and
- Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Question 27

SA 500 – "Audit Evidence", explains what constitutes audit evidence in an audit of financial statements. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements. Explain and discuss the meaning of Audit Evidence in detail. (RTP Nov '23)

OR

The auditor of Fresh and Well Limited explained to the audit team members about the relationship between Audit Evidence and Opinion of Auditor. Explain what relationship exists between Audit Evidence and Opinion of Auditor. (Old & New SM)

Answer 27

SA 500 – "Audit Evidence", explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:

(1) Information contained in the accounting records: Accounting records include

- the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers;
- invoices;
- contracts;
- the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and
- records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

(2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements: Other information which the auditor may use as audit evidence includes, for example

- minutes of the meetings,
- written confirmations from trade receivables and trade payables,
- manuals containing details of internal control etc.

A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

Question 28

Examine with reasons whether the following statements are correct or incorrect.

The auditor's substantive procedure at the assertion level means substantive analytical procedures only (PYP 2 Marks, Nov'19)

Answer 28

Incorrect: The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedure, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

Question 29

CA K audited the books of accounts of E Ltd. for the financial year 2020 -2021. The auditor used an audit procedure according to which all the documents and records maintained by the company were checked in detail to obtain audit evidence. Explain the audit procedure used by the auditor and its reliability. (PYP 3 Marks, Dec'21)

Answer 29

Audit Procedure:

Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

Example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a inventory or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets.

Inspection of individual inventory items may accompany the observation of inventory counting.

In view of above, it can be concluded that CA K used Inspection as an audit procedure.

Question 30

SPR Ltd has been into the media business since 1990. During the F.Y 2021-2022 many notices were received by the company for hurting public sentiments and financial claims were filed against the company. As an auditor of the company, you requested the management for arranging the meeting with company's external legal counsel. Management is of the view that such meetings are necessary in some certain circumstances only. Can you list down those certain circumstances? (PYP 3 Marks May'22)

Answer 30

Circumstances when becoming necessary to meet with external legal counsel: In the given case of SPR Ltd., Auditor requested the management for meeting with SPR's external legal counsel.

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.

This may be the case, for example, where:

(i) The auditor determines that the matter is a significant risk.

(ii) The matter is complex.

(iii) There is disagreement between management and the entity's external legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

Question 31

Examine with reasons (in short) whether the following statements are correct or incorrect:

During the audit process, the Auditor can easily identify all mistakes or manipulations that may exist in the accounts through routine checking processes. (PYP 2 Marks May '2018)

Answer 31

Incorrect: Routine checking cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts. Certain other procedures also have to be applied like trend and ratio analysis including review of internal control.

Question 32

The objective of auditing is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. This can be obtained by performing which procedures? Name the types of audit procedures the auditor can perform to obtain audit evidence? (PYP 4 Marks Nov 22)

Answer 32

Audit Procedures to Obtain Audit Evidence: Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(I) Risk assessment procedures; and

(II) Further audit procedures, which comprise:

i. Test of controls, when required by the SAs or when the auditor has chosen to do so; and

ii. Substantive procedures, including tests of details and substantive analytical procedures.

Audit procedures to obtain audit evidence can include

(a) Inspection

(b) Observation

(c) External Confirmation

(d) Recalculation

(e) Reperformance

(f) Analytical Procedures

(g) Inquiry

Question 33

Appropriateness is the measure of the quantity of audit evidence. (PYP 2 Marks May '23)

Answer 33

Incorrect: Appropriateness is the measure of the quality of audit evidence, that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Question 34

Sufficiency is the measure of the quantity of audit evidence. (PYP 2 Marks Jan'21)

Answer 34

Correct: Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence is affected by the auditors assessment of the risks of misstatement. (Higher the assessed risks the more audit evidence is likely to be required.

Question 35

Management is often in the best position to perpetrate fraud. As an auditor you are suspecting existence or suspicion of fraud from management. Give any three examples of "others within the entity" to whom direct inquiries can be made. (PYP 3 Marks May '23)

Answer 35

Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

1. Operating personnel not directly involved in the financial reporting process.
2. Employees with different levels of authority.
3. Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
4. In-house legal counsel.
5. Chief ethics officer or equivalent person.
6. The person or persons charged with dealing with allegations of fraud.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. Which of the following is incorrect :

(a) Inquiry consists of seeking information of unknown persons, both financial and non- financial, within the entity or outside the entity.

(b) Inquiry is used extensively throughout the audit in addition to other audit procedures.

(c) Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

(d) Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. (MTP 1 Marks March '19)

Ans: (a)

2. Audit evidence includes

(a) information contained in the accounting records underlying the financial statements

(b) both information contained in the accounting records underlying the financial statements and other information.

(c) other information.

(d) information contained in the accounting records underlying the financial statements or other information. (MTP 2 Marks MTP-Oct'19-MTP-APRIL-2019 , April '21 , Nov '21 & April '23)

Ans: (b)

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3. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

(a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel.

(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel.

(c) Reviewing legal expense accounts.

(d) All of the above (MTP1 Mark April'19)

Ans: (d)

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4. Audit evidence is necessary to support the auditor's opinion and report. It is_____in nature and is primarily obtained from audit procedures performed during the course of the audit.

(a) cumulative

(b) regressive

(c) selective

(d) objective (MTP 1 Mark Oct 19, Apr'22, RTP Nov'19)

Ans: (a)

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5. Which of the following is not a Specific Evaluations by the Auditor:

(a) The financial statements adequately disclose the significant accounting policies selected and applied;

(b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(c) The accounting estimates made by management are reasonable;

(d) The sufficient appropriate audit evidence has been obtained; (MTP 2 Marks Oct 19)

Ans: (d)

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6. In relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures is known as:

(a) Monitoring

(b) Inspection

(a) Subsequent Audit procedures

(b) Compliance procedures (MTP 1Mark Sep'22)

Ans: (b)

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7. Mr. H and his team members in detail checked and evaluated the books of accounts and relevant documents of WT Limited. This is an example of which audit procedure:

(a) Inspection.

(b) Re-performance.

(c) Recalculation.

(d) Observation. (MTP 1Mark Sep'22)

Ans: (a)

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8. Statement 1: Audit procedures consist of Risk Assessments Procedures and other procedures.
Statement 2: Substantive procedures consist of test of details and analytical procedures.

(a) Only Statement 1 is correct

(b) Only Statement 2 is correct

(c) Both 1 & 2 are correct

(d) Both 1 & 2 are incorrect (MTP 1Marks Sep'22, RTP May'20)

Ans: (c)

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9. CA X, auditor of Green Shoots Private Ltd. is going through financial statements of the company. On perusing notes to accounts, he finds ageing of trade payables reflecting in accordance with requirements of Schedule III of Companies Act, 2013. He wants to be sure that ageing of trade payables forming part of notes of accounts is proper and carries out ageing independently to confirm its veracity.

Identify audit procedure(s) being performed by CA X.

(a) Analytical procedures

(b) Recalculation

(c) Re-performance

(d) Observation (MTP 1 Marks Oct'22)

Ans: (c)

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10. may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. It includes both information contained in the accounting records underlying the financial statements and other information.

(a) Audit procedure

(b) Audit evidence

(c) Audit plan

(d) Audit programme (MTP 1 Mark Sep '23)

Ans: (b)

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11. While auditing the books of accounts of Mehra Limited for the financial year 2022-23, the auditor of the company used an audit procedure according to which complete documents and records of the company were checked in detail in order to obtain audit evidence. Explain the audit procedure used by the auditor of company.

(a) Recalculation

(b) Analytical Procedures

(c) Inquiry

(d) Inspection (MTP 1 Mark Sep '23)

Ans: (d)

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12. CA Tarini is in process of formulating audit plan for conducting audit of a company engaged in business of dealing in commodity futures. Which of the following is not likely to be an appropriate audit procedure to be included in audit plan for the abovesaid company?

(a) Verification of turnover of company

(b) Verification of cost of raw material consumed

(c) Examination of company's accounting policy for revenue recognition

(d) Verification of contract notes with brokers (MTP 1 Mark Oct '23)

Ans: (b)

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13. While conducting the audit of Saraswati Ltd, a packaged water making company, it was found that a purchase of motor car was made in the name of the company. Your Article Assistant has performed the following audit procedures. Identify which of the following procedure is incorrect.

(a) Ascertain whether the purchase of car has been properly authenticated.

(b) Check invoice of the car dealer to confirm the purchase price

(c) Examine registration with Transport Authorities to verify the ownership

(d) Ensure that the motor car has been included in the Closing inventory of goods. (RTP Nov'20)

Ans: (d)

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14. In July, 2018, M/s Tom & Co. entered into an agreement with M/s Jerry & Co. under which a machinery would be let on hire and M/s Jerry & Co. would have the option to purchase the machinery in accordance with the terms of the agreement. Thus, M/s Jerry & Co. agreed to pay M/s Tom & Co. a settled amount in periodical installments. The property in the goods shall be passed to M/s Jerry & Co. on the payment of last of such installments. While checking such hire-purchase transaction, what would the auditor examine?

(a) That the periodical installments paid are charged as an expenditure by M/s Jerry & Co.

(b) That the hire purchase agreement specifies clearly the hire-purchase price of the machinery to which the agreement relates.

(c) That M/s Tom & Co. charges depreciation throughout the life of the machinery.

(d) All of the above. (RTP May '19)

Ans: (b)

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15. While auditing the accounts of Thoughts Ltd., CA. Bliss, the auditor of the company came across certain accounts payable balances for which direct confirmation procedure needs to be applied. Thus, for the year ending 31set March, 2018, he sent positive confirmation requests wherein the trade payables are requested to respond whether or not they are in agreement with the balance shown. The auditor received all the confirmation replies from the trade payables on time as correct except from five of them. What other option the auditor is left with regard to trade payables from which no reply for confirmation requests received?

(a) Perform additional testing which may include agreeing the balance to subsequent cash paid.

(b) Accept the balances as it is assuming other replies against received confirmation requests being correct.

(c) Accept the balances as it is assuming that the trade payables must have replied in case of any discrepancies.

(d) None of the above. (RTP May '19)

Ans: (a)

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16. Mr. H and his team members carefully watched the whole process of counting of finished wooden doors by employees of Bottom Limited. This is an example of which audit procedure:

(a) External Confirmation.

(b) Observation.

(c) Inquiry.

(d) Inspection. (RTP Nov '21)

Ans: (b)

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17. _____refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

(a) Assertions

(b) Positive Confirmation

(c) Written representation

(d) Audit Evidence. (MTP 2 Marks March '21)

Ans: (a)

SA 610- Using the Work of Internal Auditors

Question 1

Explain the meaning, objectives and scope of internal audit functions as per SA 610.

Also discuss who can be appointed as Internal Auditor? (RTP May '19)

Answer 1

Who can be appointed as Internal Auditor? As per section 138, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in practice or not), or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies. The internal auditor may or may not be an employee of the company.

Internal audit function: A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity' s governance, risk management and internal control processes.

The objectives and scope of internal audit functions: As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity' s governance processes, risk management and internal control such as the following:

1. **Activities Relating to Governance:** The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.
2. **Activities Relating to Risk Management:** The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process). The internal audit function may perform procedures to assist the entity in the detection of fraud.
3. **Activities Relating to Internal Control**

(i) Evaluation of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

(ii) Examination of financial and operating information. The internal audit function may be assigned

to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

(iii) Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity.

(iv) Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

Question 2

Explain whether the following statements are correct or incorrect, with reasons/ explanations/ examples The objectives and scope of internal audit functions are restricted to activities relating to evaluation of internal control only. (PYP 2 Marks Jan '21)

Answer 2

Incorrect: As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control.

From the above, it can be concluded that the objective and scope of internal audit function are not restricted to activities relating to evaluation of control only.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. CA M is internal auditor of Crayon Products Limited. Which of the following is not TRUE about scope of internal audit?

(a) Internal audit is an independent assurance activity.

(b) Internal audit helps in improving internal control of the company.

(c) Internal audit cannot review non-financial activities of company.

(d) Internal audit can review compliance of company with various laws and regulations. (MTP 1 Marks Oct'22)

Ans: (c)

Audit Sampling

Question 1

Examine with reasons (in short) whether the following statement is correct or incorrect:

According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to 100% of items within a population of audit relevance. (MTP 2 Marks March '18, Mar'19)

Answer 1

Incorrect: According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable bas is on which to draw conclusions about the entire population.

Question 2

Examine with reasons (in short) whether the following statement is correct or incorrect:

Stratified Sampling involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. (MTP 2 Marks Oct 18)

Answer 2

Correct: Stratified Sampling 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 if 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.

Question 3

Discuss the following:

The sample size can be determined by the application of a statistically -based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.

Explain Stating the examples of factors that the auditor may consider when determining the sample size for tests of controls. (MTP 5 Marks Oct 18 , MTP 4 Marks March'19 , MTP 3 Marks May '20)

OR

The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be. Explain Stating the examples of factors that the auditor may consider when determining the sample size for tests of controls.(MTP 5 Marks March '18)

Answer 3

The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.

Examples of Factors Influencing Sample Size for Tests of Controls: The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

- When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased). Thus, sample size will increase.
- If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be.
- When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as higher the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
- An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.
- In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.

Question 4

Examine with reasons (in short) whether the following statement is correct or incorrect:

Sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

(MTP 2 Marks April 19)

Answer 4

Correct: The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non statistical approaches. Whatever maybe the approach non-statisticalor statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

Question 5

While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind? (MTP 3 Marks April 19, RTP Nov 18, Old & New SM)

OR

While designing an audit sample, the auditor shall determine a sample size sufficient to reduce the sampling risk to an acceptably low level. In this context, explain sampling risk and non-sampling risk.

(PYP 4 Marks May '23)

OR

"Sampling risk can lead to erroneous conclusions". Justify. (MTP 4 Marks April '21, PYP 4 Marks May '19, RTP May '23, RTP May'22)

OR

Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk leads to erroneous conclusions. Explain in detail distinguishing it from non- sampling risk with examples. (RTP Nov'20)

OR

In the context of SA 530 'Audit Sampling', explain the terms 'Sampling Risk' and 'Non- Sampling risk'. (PYP 4 Marks, Jan'21)

Answer 5

Risk Factors while applying Sampling Techniques: As per SA 530 "Audit Sampling" Sampling Risk. The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Non-Sampling Risk. The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Example

Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.

Sources of Non-Sampling risk are

(i) Human Mistakes

(ii) Applying audit procedures not appropriate to the objectives of audit

(iii) Relying on erroneous information e.g. erroneous confirmation

(iv) Misinterpreting the sample results

(v) Non sampling risk can never be mathematically measured

Question 6

Examine with reasons (in short) whether the following statement is correct or incorrect:

The method which involves dividing the population into groups of items is knows as block sampling.

(MTP 2 Marks Oct 19, Old & New SM)

Answer 6

Incorrect: The method which involves dividing the population into groups of items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.

Question 7

XYZ Ltd is engaged in trading of electronic goods and having huge accounts receivables. For analysing the whole accounts receivables, auditor wanted to use sampling technique. In considering the characteristics of the population from which the sample will be drawn, the auditor determines that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques. Advise the auditor in accordance with SA 530. (MTP 4 Marks Oct 19, RTP May 18)

OR

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. Guide the auditor on the use of stratification and value-weighted sampling techniques. (RTP Nov '21)

Answer 7

Stratification and Value-Weighted Selection: In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value weighted sampling techniques.

Stratification: Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population.

For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.
Value-Weighted Selection: When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.
One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.
This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

Question 8

Audit testing done through Statistical sampling 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. Explain and also state advantages of Statistical sampling. (MTP 4 Marks Oct 20)

OR

What are the advantages of statistical sampling techniques in Auditing? (RTP May'22, Old & New SM)

Answer 8

(1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
(2) The sample selection is more objective and thereby more defensible.
(3) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
(4) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
(5) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.
(6) It is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way

Question 9

State the requirements relating to audit sampling, sample design, sample size and selection of items for testing. (MTP 4 Marks Oct '21, RTP Nov 22, Old & New SM)

Answer 9

Audit Sampling: As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is – the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The requirements relating to sample design, sample size and selection of items for testing are explained below-

Sample design - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

Sample Size- The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Selection of Items for Testing- The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

Question 10

CA X is not sure about the kind of Sampling method to be used for audit of a company. Advise him about the choice of methods (name of methods only) of Sampling to be used in various circumstances. Also explain briefly the advantages of the Sampling to be used by him in auditing. (MTP 3 Marks Nov '21)

Answer 10

Sample Selection:

CA. X should obtain the knowledge before using the sampling methods. The principal methods are as follows:

(1) Random selection.

(2) Systematic selection.

(3) Monetary Unit sampling.

(4) Haphazard selection.

(5) Block selection.

Advantages of Statistical Sampling in Auditing:

(i) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.

(ii) The sample selection is more objective and thereby more defensible.

(iii) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.

(iv) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.

(v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

Question 11

ABC Ltd is a Large Company with huge purchase and sales transactions. Which sampling approach is recommended in such a company? Explain giving features of such sampling approach along with example (MTP 3 Marks March 22)

Answer 11

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

Features/Characteristics of Statistical Sampling:

(1) 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.

(2) 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.

(3) There Is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of sample can be evaluated and projected on the whole population in a more reliable manner.

For Example: An auditor while verifying the Purchases during the year realised that the purchase transactions in that year are more than 45000 in number, then in such case, statistical sampling will be highly recommended in the audit program. Random Sampling (discussed ahead in this topic) is the method you decide to choose sample in such a situation.

Question 12

The level of sampling risk that the auditor is willing to accept will not affect the sample size. (MTP 2 Marks April 22, RTP Nov '22)

Answer 12

Incorrect: As per SA 530, "Audit Sampling" the level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Question 13

Examine with reasons (in short) whether the following statements are correct or incorrect: (MTP 2 Marks Sep'22, PYP 2 Marks July'21)

In case of stratified sampling, the conclusions are drawn on the stratum.

Answer 13

Correct: In case of stratified sampling, the conclusions are drawn on the stratum. The combination of all the conclusions on stratum together will be used to determine the possible effect of misstatement or deviation. Hence the samples are used to derive conclusion only on the respective stratum from where they are drawn and not the whole population

Question 14

Examine with reasons (in short) whether the following statements are correct or incorrect Systematic sampling means dividing heterogeneous population into homogeneous sub population, where samples are drawn from each sub population. (MTP 2 Marks Oct'22)

Answer 14

Incorrect: Stratification means dividing heterogeneous population into homogeneous sub population, where samples are drawn from each sub population. Systematic sampling is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

Question 15

There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. Explain. (MTP 4 Marks April 22, RTP Nov 19)

Answer 15

No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved.

With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished and auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non-consequential routine checking. By routine checking we traditionally think of extensive checking and vouching of all entries.

Question 16

Examine with reasons (in short) whether the following statements are correct or incorrect

The higher the auditor's assessment of the risk of material misstatement, the smaller the sample size needs to be. (MTP 2 Marks Oct'22)

Answer 16

Incorrect: The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.

Question 17

Examine with reasons (in short) whether the following statements are correct or incorrect.

Low acceptable sampling risk requires larger sample size. (MTP 2 Marks March '23, Old & New SM)

Answer 17

Correct: Sampling risk arises from possibility that the auditor's conclusion based upon sample may be different from conclusion that would have been reached if same audit procedures were applied on the entire population. If acceptable sampling risk is low, large sample size is needed.

Question 18

Examine with reasons (in short) whether the following statements are correct or incorrect:

Statistical sampling being more scientific and without personal bias will always be appropriate to use under all circumstances. (MTP 2 Marks April '23 & Oct '23, PYP 2 Marks Dec '21)

Answer 18

Incorrect: Statistical sampling is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort. For instance, when exact accuracy is required or in case of legal requirements etc.

Question 19

It is imperative for the auditor to project misstatements for the population while performing audit procedures through sampling. Comment. (MTP 3 Marks Oct'23, PYP 3 Marks, Nov '20, RTP May 20 ,May '19 & Nov 23)

Answer 19

(i) The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

(ii) When a misstatement has been established as an anomaly, it may be excluded when projection misstatements to the population. However, the effect of any such misstatement, if uncorrected, sFll needs to be considered in Addison to the projection of the non-anomalous misstatements.

(iii For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviation is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

Question 20

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor.

It is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed Explain (RTP Nov '19)

Answer 20

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor, there is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do is to express his opinion and become bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On a consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed and which have a recognized basis. Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability.

Question 21

State with reason (in short) whether the following statements are true or false:

Statistical sampling has narrower application where a population to be tested consists of a large number of similar items. (RTP May '20)

Answer 21

Incorrect: 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.

Question 22

Explain the sampling method which involves selection of a block(s) of contiguous items from within the population. Also give example (RTP May '20)

Answer 22

Block Sampling: This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

Example

Take the first 200 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.

Question 23

Explain the factors that should be considered for deciding upon the extent of checking on a sampling plan. (RTP Nov'20 & May 19, PYP 5 Marks Nov '18, Old & New SM)

Answer 23

The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

(i) Size of the organization under audit.

(ii) State of the internal control.

(iii) Adequacy and reliability of books and records.

(iv) Tolerable error range.

(v) Degree of the desired confidence.

Question 24

Explain the following terms with reference to Audit Sampling:

(i) Stratification

(ii) Tolerable misstatement

(iii) Tolerable rate of deviation (RTP May '21)

Answer 24

Stratification – The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

(i) Tolerable misstatement – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

(ii) Tolerable rate of deviation – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an

(iii) appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Question 25

In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries. Explain in detail. (RTP May '21)

Answer 25

In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries.

Auditors realized that they can derive good satisfaction by undertaking a much lesser checking by adoption of this technique in the auditing process. It is a mathematical truth that the sample, if picked purely on a random basis would reveal the features and characteristics of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the client's organization because they provide the reliability of the records. Sampling is used as a part of Test

of controls. Auditor will check few internal controls and their operating effectiveness. Based on the conclusion derived, he can then design the sample size for test of details (i.e. checking of transactions and balances)

If the internal control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains.

On the other hand, if in certain areas controls are slack or not properly implemented, the auditor may have to take a much larger sample for getting satisfactory result.

Another truth about the sampling technique should be noted. It can never bring complete reliability; it cannot give precisely accurate results. It is a process of estimation. It may have some error. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular case.

Question 26

When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. Explain in detail. (RTP Nov '21)

Answer 26

Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose.

Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirement of relevant portion (paragraph 8) of SA 500, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

The auditor's consideration of the purpose of the audit procedure includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements. For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a disposing between customer accounts does not affect the total accounts receivable balance. Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even

though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size. For example, if the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Question 27

Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. Discuss explaining Statistical and Non-Statistical sampling approaches. (RTP May '18)

Answer 27

Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics. A sampling approach that does not have above characteristics is considered non-statistical sampling.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Sample must be representative.

Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

Question 28

The auditor shall evaluate the results of the sample and whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. Explain. (RTP Nov 18, MTP 5 Marks Aug'18)

Answer 28

The auditor shall evaluate-

(a) The results of the sample; and

(b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also, if the projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

In case the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Question 29

This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e. it is suitable for a homogeneous population having a similar range. Explain about that method. (RTP Nov'22)

Answer 29

Simple Random Sampling: Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection. Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum). Today random numbers are also generated using various applications on the cell phones like the random number generator.

This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e. it is suitable for a homogeneous population having a similar range.

Question 30

Chintamani Ltd appoints Chintan & Mani as statutory auditors for the financial year 2022-2023. Chintan & Mani seem to have different opinion on audit approach to be adopted for audit of Chintamani Ltd. Mani is of the opinion that 100% checking is not required and they can rely on Audit Sampling techniques in order to provide them a reasonable basis on which they can draw conclusions about the entire population.

Chintan is concerned whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

You are required to guide Chintan about his role if audit sampling has not provided a reasonable basis for conclusions about the population that has been tested in accordance with SA 530. (RTP Nov '23)

Answer 30

As per SA 530, "Audit Sampling", the auditor shall evaluate:

(a) The results of the sample; and

(b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

(I) Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or

(II) Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Question 31

Examine with reasons (in short) whether the following statements are correct or incorrect:

When statistical sampling is used to select a sample, sample need not be representative because the statistical sampling takes care of the representation. (PYP 2 Marks, May '18, Old & New SM)

OR

Sample need not be representative (Old & New SM)

Answer 31

Incorrect: Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

Question 32

Examine with reasons whether the following statements are correct or incorrect.

The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific. (PYP 2 Marks, Nov'19)

Answer 32

Correct: The non-statistical sampling is criticized on the grounds that it is neither objective nor scientific.

The expected degree of objectivity cannot be assured in non-statistical sampling because the risk of personal bias in selection of sample items cannot be eliminated. The closeness of the qualities projected by the sample results with that of the whole population cannot be measured because the sample has not been selected in accordance with the mathematically based statistical techniques.

Question 33

With reference to SA 530 "Audit Sampling", explain briefly the following factors that the auditor may consider when determining the sample size for the Test of Details –

(i) The desired level of assurance

(ii) Stratification of the population. (PYP 3 Marks Dec '21)

Answer 33

Examples of factors influencing Sample Size for Test of Details:

(i) Desired Level of Assurance: An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will increase the sample size. Hence, greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.

(ii) Stratification of population: When stratification of the population is appropriate then sample size will decrease as when there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

Question 34

CA B is appointed as an auditor of M/s. Divine Pharmacy, a wholesale medicine supplier. While auditing for the financial year 2020-21, CA B wants to use test checking technique. Advise CA B, what kind of precautions should be taken by him in this regard. (PYP 4 Marks, July'21)

OR

What precautions should be taken by the auditor while applying test check techniques? (Old & New SM)

Answer 34

While auditing the accounts of Divine Pharmacy, CA B wanted to use Test Checking technique. The following Precautions should to be taken by CA B while applying test check techniques:

- Thorough study of accounting system should be done before adopting sampling
- Proper study of internal control systems.
- Areas which are not suitable for sampling should be carefully considered. eg: compliance with statutory provisions, transactions of unusual nature etc.
- Proper planning for Sampling methods to be used and explaining the staff,
- Transactions and balances have to be properly classified (stratified)
- Sample size should be appropriately determined.
- Sample should be chosen in unbiased way,
- Errors located in the sample should be analyzed properly.

Question 35

The approach to audit and extent of checking are undergoing a progressive change in favour of more attention towards the questions of principle and controls with a curtailment of non-consequential routine checking. Discuss the given statement. (PYP 3 Marks May'22)

Answer 35

Sampling: An Audit Procedure: No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all the efforts are directed to check all transactions without any exception. This invariably leads to more emphasis on routine checking, which often is not

necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished i.e., the internal controls as designed by the management are for the very purpose of Prevention, Detection and Correction of Frauds and Errors. Thus, the auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non-consequential routine checking. By routine checking, we traditionally think of extensive checking and vouching of all the entries, disregarding the concept of materiality.

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor. There is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent it has to be done. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do as an auditor is to express his opinion on the financial statements and become bound by that. To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking (i.e., sampling), he should adopt standards and techniques which are widely followed and which have a recognised basis.

Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability. This enables the auditor to make conclusions and express fair opinion without having to check all of the items within the financial statements.

Question 36

What are the matters that the auditor shall consider while designing an audit sample? (PYP 3 Marks Nov 22)

Answer 36

Matters to be considered while designing an Audit Sample:

As per SA 530, "Audit Sampling",

(i) When designing an audit sample, the auditor shall consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn.

(ii) When designing an audit sample, the auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

(iii) When designing an audit sample, the auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

(iv) When designing an audit sample, the auditor shall determine that sample selected must be representative of the population.

(v) When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose.

(vi) When designing an audit sample, Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.

(vii) In fulfilling the requirement of SA 500 "Audit Evidence", when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. The relationship between tolerable error and sample size is

(a) Inverse

(b) Direct

(c) Close

(d) There is no relationship. (MTP 1 Marks April '23)

Ans: (a)

2. In the case of tests of details

(a) the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population.

(b) the projected misstatement is the auditor's best estimate of misstatement in the population.

(c) the anomalous misstatement is the auditor's best estimate of misstatement in the population.

(d) the projected misstatement plus anomalous misstatement, if any, cannot be the auditor's best estimate of misstatement in the population. (MTP 1 Mark March '19)

Ans: (a)

3. _____ in which the auditor selects the sample without following a structured technique

(a) Haphazard selection,

(b) Monetary Unit Sampling

(c) Block Sampling

(d) Structured Sampling (RTP May '21, MTP April'19 1 Mark)

Ans:(a)

SA 501- Audit Evidence-Specific Considerations for Selected Items

Question 1

Krishna Cycles Ltd is engaged in manufacturing of different type of Bicycles. Ongoing through its financial statements for the past years, it is observed that inventory is material to the financial statements. You as an auditor of the company wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss, how would you proceed as an auditor. (MTP 5 Marks Aug '18 & Oct 18, March 19, May 20)

OR

ABC Ltd is engaged in manufacturing of different type of yarns. Ongoing through its financial statements for the past years, it is observed that inventory is material to the financial statements. You as an auditor of the company wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss, how would you proceed as an auditor. (MTP-March'18,5 Marks)

Answer 1

When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(a) Attendance at physical inventory counting, unless impracticable, to:

(i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;

(ii) Observe the performance of management's count procedures;

(iii) Inspect the inventory; and

(iv) Perform test counts; and

(b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

Question 2

Depending on how the business operates, the management may value inventory using weighted average basis. (MTP 2 Marks May 20)

Answer 2

Incorrect: Depending on how the business operates, the management may value inventory using First-in first-out (FIFO) or weighted average basis

Question 3

While conducting audit of Vee Ltd, CA Aman, auditor of the company, found that some goods are lying with third party for a long period. Advise Aman how will he verify them. (MTP 4 Marks Oct '21)

Answer 3

Goods Lying with Third Party: The auditor should check that the materiality of the item under this caption included in inventories.

(i) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.

(ii) He should inquire into the necessity of sub contractor retaining the inventory. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.

(iii) The goods lying with them for the very long period would merit auditors' special attention for making provision.

(iv) The records, voucher/slips for the regulating the movement of inventory into and out of entity for sub-contracting work be reviewed by vouching for few transaction for ensuring existence and working of internal control system for them.

(v) The excise gate pass, entry in such records, information in returns, be also cross-verified.

(vi) The valuation of inventories should be correctly made for including material cost on appropriate inventory valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.

(vii) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.

(viii) Evaluate condition of goods and see whether adequate provision has been made.

(ix) Check whether subsequently the goods lying with third party were sold or received back after the expiry of stipulated time period.

(x) Ensure that the goods have been included in the closing inventory though lying with third party.

Question 4

TRM Ltd. is a company engaged in manufacture of beauty products. It has hair care segment, skin care segment and kids' beauty products. The auditor wants to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework. Suggest the audit procedures in the given case. (MTP 4 Marks March '21)

Answer 4

The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:

(1) Obtaining an understanding of the methods used by management in determining segment information. Further,

(i) Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and

(ii) Where appropriate, testing the application of such methods; and

(2) Performing analytical procedures or other audit procedures appropriate in the circumstances.

Question 5

Examine with reasons (in short) whether the following statements are correct or incorrect:

When inventory under the custody and control of a third party is material to the financial statements, the auditor cannot obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by taking written representation from management. (MTP 2 Marks Sep '23, RTP May '23, Old & New SM)

Answer 5

Correct: 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 inspec3on or other audit procedures appropriate in the circumstances.

Question 6

Explain clearly the examples of matters relevant in planning attendance at physical inventory counting. (RTP May '20, PYP 5 Marks Nov '18, Old & New SM)

Answer 6

Matters relevant in planning attendance at physical inventory counting include, for example:

(a) Nature of inventory.

(b) Stages of completion of work in progress.

(c) The risks of material misstatement related to inventory.

(d) The nature of the internal control related to inventory.

(e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.

(f) The timing of physical inventory counting.

(g) Whether the entity maintains a perpetual inventory system.

(h) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate

(i) Whether the assistance of an auditor's expert is needed.

Question 7

GPS & Co, Chartered Accountants, conducting the audit of Pratibha Ltd., a listed company for the year ended 31.03.2022 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GPS & Co wanted to ensure that methods adopted by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework. Guide GPS & Co with 'Examples of Matters' that may be relevant when obtaining an understanding of the methods used by the management with reference to the relevant Standards on Auditing. (RTP May '22)

Answer 7

The auditors, GPS & Co wanted to ensure and obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by obtaining an understanding of the methods used by management in determining segment information. SA 501 guides in this regard. As per SA 501- "Audit Evidence—

Specific Considerations for Selected Items", example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

(i) Sales, transfers and charges between segments, and elimination of inter - segment amounts.

(ii) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.

(iii) The allocation of assets and costs among segments.

(iv) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

Question 8

Pachranga International Ltd is manufacturer of pickles, ginger garlic paste, jams etc having its plant at Jaipur. Being in food industry, the company is facing many litigations in various courts across India. Auditors SPV & Co. wants to identify such litigations and claims involving the company which may give rise to risk of material misstatement. Guide the auditor as to how they should proceed for the purpose. (RTP May '22, Old & New SM)

Answer 8

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

(a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(c) Reviewing legal expense accounts.

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. Further if:

(a) 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

(b) the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. Coyote Ltd. is dealing in trading of electronic goods. Huge inventory (60% approximately) of the company is lying on consignment (i.e. under the custody of third party). CA. Star, the auditor of the company, wants to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory lying on consignment. Thus, he requested & obtained confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity, however, it raised doubts about the integrity and objectivity of the third party. Which of the following other audit procedures may be performed by CA. Star to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory under the custody of third party?

(a) Attend third party's physical counting of inventory.

(b) Arrange for another auditor to attend third party's physical counting of inventory.

(c) Inspect warehouse receipts regarding inventory held by third parties.

(d) All of the above. (RTP May '19)

Ans: (c)

SA 505- External Confirmations

Question 1

Audit evidence obtained from external confirmation is always reliable. (MTP 2 Marks Oct '21) (PYP 2 Marks Nov '18)

Answer 1

Incorrect: The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability.

Question 2

R Ltd. has asked for email responses for the purpose of external confirmation. The auditor, however, feels that external confirmation received electronically involves the risk of its reliability. (MTP 2 Marks April 22)

Answer 2

Correct: SA 505, "External Confirmations", responses received electronically, for example by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect. Hence R Ltd. Should avoid using email responses as evidence for external confirmation.

Question 3

External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements but need not be restricted to these items. Apart from confirmations for bank balances and accounts receivables, what are the other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement? (MTP 3 Marks April 22, RTP Nov'22)

Answer 3

Other examples of situations where external confirmations may be used include the following:

- Inventories held by third parties at bonded warehouses for processing or on consignment
- Property title deeds held by lawyers or financiers for safe custody or as security
- Investments held for safekeeping by third parties, or purchases from stockbrokers but not delivered at the balance sheet date
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms
- Long outstanding share application money.

Question 4

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow -up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests. (RTP May '20, Old & New SM)

Answer 4

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

(a) Determining the information to be confirmed or requested;

(b) Selecting the appropriate confirming party;

(c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and

(d) Sending the requests, including follow-up requests when applicable, to the confirming party.

Question 5

Define the following:

(i) Positive confirmation request

(ii) Negative confirmation request

(iii) Non-response

(iv) Exception (RTP May '20)

Answer 5

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.

Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

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.

Question 6

External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. Analyze and Explain. (RTP Nov '18)

Answer 6

External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no "side agreement" exists that may be relevant to an entity's revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- Bank balances and other information relevant to banking relationships.
- Accounts receivable balances and terms.
- Inventories held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms.

Question 7

Examine with reasons whether the following statements are correct or incorrect.

Positive Confirmation request is a request where the confirming party respond only if it disagrees with the information provided in the request. (PYP 2 Marks, May'19)

Answer 7

Incorrect –In Positive confirmation request 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 whereas Negative confirmation request is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Question 8

Examine with reasons whether the following statements are correct or incorrect.

External confirmation procedures are restricted to the items of addressing assertions associated with account balances & their elements only. (PYP 2Marks, Nov'20)

Answer 8

Incorrect: External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmation need not be restricted to account balances only.

Question 9

CA Rohit is appointed as an auditor of Grace Ltd., he wants to design a suitable confirmation request letter for a few debtors of Grace Ltd. As a senior auditor of the firm, explain to him with reference to SA 505 "External Confirmation" all the conditions that should be present to use Negative Confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level. (PYP 4 Marks, july'21)

Answer 9

Negative confirmations are a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative information provides less persuasive audit evidence than positive confirmations. Accordingly, CA Rohit, Auditor of Grace Ltd, shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

(a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;

(b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;

(c) A very low exception rate is expected; and

(d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

Question 10

CA P is the auditor of MN Ltd. While scrutinising the accounts of MN Ltd., he observed that the company had large volume of Trade payable outstanding in the Balance sheet as on 31st March, 2023 for which external confirmations are not available, CA P wants to send external confirmation request to selected Trade payables but management of MN Ltd. refused for the same. Discuss how CA P should deal in this regard as per relevant Standard on Auditing. (PYP 4 Marks May '23, PYP 4 Marks, Nov'20)

Answer 10

If management refuses to allow the auditor to send a confirmation request, CA P should deal in this regard in the manner prescribed in SA 505 explained hereunder:

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

(b) 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

(c) 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.

The auditor shall also determine the implications for the audit and the auditor's opinion in accordance with SA 705.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request is-

(a) Positive confirmation request

(b) Non-response

(c) Exception

(d) Negative confirmation request (MTP 2 Marks May 20 & April'19)

Ans: (d)

2. A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered is called-

(a) Negative confirmation request

(b) Non-response

(c) Exception

(d) Positive confirmation request (RTP Nov 19)

Ans: (b)

SA 510- Initial Audit Engagements – Opening Balances

Question 1

Auditors of M/s Tender India (P) Ltd. were changed for the accounting year 2016-17. The closing inventory of the company as on 31.3.2016 amounting to Rs. 100 lacs continued as it is and became closing inventory as on 31.3.2017. The auditors of the company propose to exclude from their audit programme the audit of closing inventory of Rs. 100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor. (MTP 4 Marks Oct 19)

Answer 1

Verification of Inventory: As per SA 510 "Initial Audit Engagements – Opening Balances", in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether-

(i) Opening balances contain misstatements that materially affect the current period's financial statements; and

(ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

When the financial statements for the preceding period were audited by predecessor auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the Balance Sheet date. The contention of the management that the inventory has not undergone any change cannot be accepted, it forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the inventory lying as it is might have deteriorated and the same need to be examined. The auditor is advised not to exclude the audit of closing inventory from his audit programme.

Question 2

What is the objective of the auditor with respect to the opening balances when conducting an initial audit engagement as per the relevant SA? (RTP May '23, Old & New SM)

OR

M/s PQR and associates are the statutory auditors of TUV Ltd. for the FY 2020- 21-. They have been appointed as statutory auditors of TUV Ltd. for the first time. What is the objective of the engagement partner in terms of SA 510? (Old & New SM)

Answer 2

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

(a) Opening balances contain misstatements that materially affect the current period's financial statements; and

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Question 3

Examine with reasons (in short) whether the following statements are correct or incorrect:

An auditor is not concerned with consistency of accounting policies relating to opening balances (PYP 2 Marks, Nov'2018)

Answer 3

Incorrect: In conducting an initial audit engagement, one of the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Question 4

M/s Pankaj & Associates, Chartered Accountants, have been appointed as an auditor of ABC Limited. CA Pankaj did not apply any audit procedures regarding opening balances. He argued that since financial statements were audited by the predecessor auditor therefore he is not required to verify them. Is CA Pankaj correct in his approach? (PYP 5 Marks, Nov '18, Old & New SM)

OR

The newly appointed auditor of BTN Limited wants to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. What audit procedures should he perform for this purpose?(PYP 3 Marks May'22, MTP 3 Marks April '23)

Answer 4

Initial audit engagement is an engagement in which either

(i) The financial statements for the prior period were not audited; or

(ii) The financial statements for the prior period were audited by a predecessor auditor.

From the above, it is quite clear that CA Pankaj is not correct in his approach and therefore would be required to follow the initial audit engagement and also apply audit procedures regarding opening balances.

Audit Procedures regarding Opening Balances; The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures. The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following:

(i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;

(ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

(iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

SA 550- Related Parties

Question 1

There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements.

Explain in detail stating clearly the auditor's responsibility in the above context. (RTP Nov'20, May'19)

Answer 1

There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements.

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances.

The auditor needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

(a) Achieve a true and fair presentation; or

(b) Are not misleading (for compliance frameworks).

In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether fraud risk factors are present as required by SA 240. This is because fraud may be more easily committed through related parties.

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- Management may be unaware of the existence of all related party relationships.
- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.
- Planning and performing the audit with professional skepticism as required by SA 200 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

Question 2

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances.

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the records or documents that may provide information about related party relationships and transactions. Explain in detail with examples. (RTP Nov '21, MTP Oct'23)

Answer 2

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the following records or documents that may provide information about related party relationships and transactions, for example:

1. Entity income tax returns.
2. Information supplied by the entity to regulatory authorities.
3. Shareholder registers to identify the entity's principal shareholders.
4. Statements of conflicts of interest from management and those charged with governance.
5. Records of the entity's investments and those of its pension plans.
6. Contracts and agreements with key management or those charged with governance.
7. Significant contracts and agreements not in the entity's ordinary course of business.
8. Specific invoices and correspondence from the entity's professional advisors.
9. Life insurance policies acquired by the entity.
10. Significant contracts re-negotiated by the entity during the period.
11. Internal auditors' reports.
12. Documents associated with the entity's filings with a securities regulator e.g., prospectuses)

Question 4

The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Explain with the help of at least three examples. (RTP May'20, Old & New SM)

Answer 4

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

Example

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Question 1

State with reasons whether the following statements are correct or incorrect.

In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater. (PYP 2 Marks, July'21)

Answer 1

Correct: In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- Management may be unaware of the existence of all related party relationships.
- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

Question 2

P Ltd. is a company from a business group "ABCD" and is engaged in trading of garments. The promoters of the company are promoters and directors of some other group companies also. You have been appointed as an auditor of P Ltd. P Ltd has entered into various intercompany transactions (within group companies) during the year which are outside its normal course of business. What will be your duties as an auditor in relation to those transactions? (PYP 4 Marks May'22)

Answer 2

Duties of Auditor in identifying Significant Related Party Transactions: For identified significant related party transactions outside the P Ltd.'s normal course of business, the auditor shall:

1. Inspect the underlying contracts or agreements, if any, and evaluate whether:

(i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;

(ii) The terms of the transactions are consistent with management's explanations; and

(iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework; and

2. Obtain audit evidence that the transactions have been appropriately authorised and approved.

Analytical Procedures

Question 1

Examine with reasons (in short) whether the following statement is correct or incorrect:

A modelling tool constructs a statistical model from financial data only of prior accounting periods to predict current account balances.(MTP 2 Marks March '18, March'19)

Answer 1

Incorrect: A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

Question 2

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, explain the factors that are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures. (MTP 5 Marks March '18,Oct '18, PYP 3 Marks May 23)

Answer 2

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

(i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products;

(iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures.

The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices.

Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 (Revised) establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

Question 3

Examine with reasons (in short) whether the following statement is correct or incorrect:

Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time. (MTP 2 Marks Aug '18, Old & New SM)

Answer 3

Incorrect: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.

Question 4

Examine with reasons (in short) whether the following statement is correct or incorrect: Ratio analysis is a commonly used technique in the comparison of current data with the prior period balance or with a trend in two or more prior period balances. (MTP 2 Marks Oct 18)

Answer 4

Incorrect: Trend analysis is a commonly used technique in the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Question 6

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Explain. (MTP 4 Marks April 19 & April '22, RTP Nov 18)

Answer 6

Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total

payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Question 9

CA Amar wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2020-21. The rent amounts to Rs.50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of Rs. 10,000/- per month for a similar location. How will applying the analytical procedures impact the verification process of such rental payments by XYZ Ltd.? (MTP 3 Marks April '21, Old & New SM)

Answer 9

If CA Amar checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e. XYZ Ltd. paid Rs. 50,000/- per month as rent and the same is getting reflected in the rent agreement. Here, CA Amar may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location.

If CA Amar applies analytical procedure i.e. compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.

However, if CA Amar does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.

Question 10

Mention the Analytical Review procedures that may be useful as a means of obtaining audit evidence regarding various assertions relating to Trade receivables, loans and advances. (MTP 4 Marks Oct '21)

OR

Mention the Analytical Review procedures that may be useful as a means of obtaining audit evidence regarding various assertions relating to Trade receivables, loans and advances. (RTP May '21)

Answer 10

Analytical Review Procedures: The following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to trade receivables, loans and advances-

(i) comparison of closing balances of trade receivables, loans and advances with the corresponding figures for the previous year;

(ii) comparison of the relationship between current year trade receivable balances and the current year sales with the corresponding budgeted figures, if available;

(iii) comparison of actual closing balances of trade receivables, loans and advances with the corresponding budgeted figures, if available;

(iv) comparison of current year's ageing schedule with the corresponding figures for the previous year;

(v) comparison of significant ratios relating to trade receivables, loans and advances with similar ratios for other firms in the same industry, if available;

(vi) comparison of significant ratios relating to trade receivables, loans and advances with the industry norms, if available.

Question 11

Explain how a statutory auditor of a company can apply analytical procedures at the planning phase of audit. (MTP 3 Marks Nov '21, Old & New SM)

OR

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk. Explain. (RTP Nov'20)

Answer 11

Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.

Analytical Procedures in Planning the Audit

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

For example, analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

Question 13

While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence? (MTP 4 Marks March 22, RTP May'23, Old & New SM)

OR

The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Explain clearly stating the techniques available as substantive analytical procedures. (MTP 5 Marks Aug '18)

OR

Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Explain stating the techniques available as substantive analytical procedures. (MTP 3 Marks Oct 19)

The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. In this context, discuss the techniques available as Substantive Analytical Procedures. (RTP May '21)

OR

Ratio analysis is useful for analyzing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Explain stating the techniques available as substantive analytical procedures. (RTP May '18)

OR

Explain techniques available as substantive analytical procedures.(RTP May '19, PYP 3 Marks Jan '21, PYP 5 Marks May '18)

Answer 13

While applying the Substantive Analytical Procedures the statutory auditor of a company may use the following techniques to obtain sufficient and appropriate audit evidence

Trend analysis – Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Ratio analysis – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its

relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Reasonableness tests – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

Examples include:

- Interest expense against interest bearing obligations.
- Raw Material Consumption to Production (quantity)
- Wastage & Scrap % against production & raw material consumption (quantity)
- Work-in-Progress based on issued of materials & Sales (quantity)
- Sales discounts and commissions against sales volume
- Rental revenues based on occupancy of premises.

(Examples included in May 21)

Structural modelling – A modelling tool constructs a statistical model from financial and/or non financial data of prior accounting periods to predict current account balances (e.g., linear regression).

The statutory auditor may use any of the above mentioned techniques while applying substantive analytical procedures depensing upon the availability of data and requirements of the case.

Question 1

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, how would the auditor investigate such differences. (MTP 3 Marks Oct'23, RTP May '23, May'22, May'19)

Answer 1

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluation those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation,

or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

Question 2

Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis.

Analyze and Explain stating clearly the meaning of analytical procedures. (RTP Nov '19)

Answer 2

Since routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests. These collectively are known as overall tests. With the passage of tests, analytical procedures have acquired lot of significance as substantive audit procedure. SA-520 on Analytical Procedures discusses the application of analytical procedures during an audit.

Meaning of Analytical Procedures. As per the Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Question 3

Give examples of Analytical Procedures having consideration of comparisons of the entity's financial information (RTP Nov '19)

Answer 3

Examples of Analytical Procedures having consideration of comparisons of the entity's financial information with are:

- Comparable information for prior periods.
- Antic pated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Question 6

Explain the commonly used technique in the comparison of current data with the prior period balance or with a trend in two or more prior period balances. (RTP May '20)

Answer 6

Trend analysis – A commonly used technique is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Question 7

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions. Explain the other relevant points in this context.(RTP May '20)

Answer 7

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall:

(i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;

(ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

(iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

(iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

Question 10

The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment. Explain. (RTP Nov'20)

Answer 10

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about

the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

Question 13

For the purposes of the SAs, the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Explain giving examples of both. (RTP Nov '21)

Answer 13

Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entity is of comparable size in the same industry.

Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Question 14

Analysis by computation of ratios includes the study of relationships between financial statement amounts. State Commonly used ratios (RTP Nov '21)

Answer 14

Analysis by computation of ratios includes the study of relationships between financial statement amounts. Commonly used ratios include:

- Elements of income or loss as a percentage of sales
- Gross profit turnover
- Accounts receivable turnover
- Inventory turnover
- Profitability, leverage, and liquidity

Question 15

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Explain stating the purpose of analytical procedures with examples. (RTP May '18)

Answer 15

Purpose of Analytical Procedures

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical procedures are used for the following purposes:

(i) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

For instance, establishing the relationship that exists between certain balances included in the Balance Sheet and the Statement of Profit and Loss and comparing them with those that existed between the same set of balances in the previous year's reconciling the physical balances of assets with the relevant financial record; obtaining of account from the bankers, account receivables and account payables and reconciling with relevant balances in books of account; confirming amounts of outstanding income and expenses by preparing reconciliation statements, etc. These are helpful in the detection of unusual state of affairs and mistakes in accounts.

Example:

In XYZ Ltd., after applying analytical procedures as comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio. Therefore, it became necessary for the auditor to make further enquiries as it may be due to pilferage of inventories/ misappropriation of a part of the sale proceeds/ a change in the cost of sales without a corresponding increase in the sales price.

Likewise, on verifying the balances of sundry account receivables and account payables by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of an account receivable is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him. Also whether in the case of account payable, the discrepancy is due to failure to afford him credit for one or more consignments of goods supplied by him or failure to debit him with an amount of remittance.

Similarly, by taking inventories of raw materials and stores at the end of the year any excesses or shortages therein shall be detected. The investigation of their causes might disclose that the shortages were the result of a misappropriation of inventory or that the excess were due to requisitions having been entered before the inventories were issued.

In the same way, by reconciling the amounts of interest and dividends collected with the amounts which had accrued due and that which are outstanding for payment, the mistake, if any, in the adjustment of such an income would be detected.

The overall tests can be extended for making inter-firm and intra-firm comparison of trading results. For example, if balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss for the same period of another entity engaged in the same trade and working under similar circumstances, it would be possible to find out the cause of the variation in the rate of profitability that exists.

Similarly, it would also be possible to compare the balances on the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years. By setting up certain expenses ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales. If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

An abnormal fall in the cost of manufacture or that in the administrative cost, apart from economy in expenses, there could be no provision or less provision for expenses incurred in the year. When it is suspected, the auditor should compare the entries in the outstanding book with those in the previous year. He must also check the vouchers for one month immediately before the close of the following years. To verify that none of the expenses in the accounts under audit have been charged to the accounts of the following years.

Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss. For instance, the cost of importing goods which are subjected to an ad valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of excise duty paid. Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, e.g., commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

Thus, it is important to note that 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 rig skis of material misstatement due to fraud.

Question 17

The relationships between individual financial statements items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other nonbusiness public sector entities. Analyze and Explain. (RTP Nov '18)

Answer 17

The relationships between individual financial statements items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities; for example, in many public sector entities there may be little direct relationship between revenue and expenditure. In addition, because expenditure on the acquisition of assets may not be capitalized, there may be no relationship between expenditures on, for example, inventories and fixed assets and the amount of those assets reported in the financial statements. Also, industry data or statistics for comparative purposes may not be available in the public sector. However, other relationships may be relevant, for example, variations in the cost per kilometer of road construction or the number of vehicles acquired compared with vehicles retired.

Question 20

Discuss the matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated. (RTP May '22)

Answer 20

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

(i) The accuracy with which the expected results of substantive analytical procedures can be predicted.

For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

(ii) The degree to which information can be disaggregated.

For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

(iii) The availability of the information, both financial and non-financial.

For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

Question 21

Explain the aspects to be considered by an auditor when designing and performing substantive analytical procedures, either alone or in combination with test of details, as substantive procedures in accordance with SA 330. (RTP Nov'22)

Answer 21

Analytical procedures used as substantive tests: When designing and performing substantive analytical procedures, either alone or in combination with test of details as, substantive procedures in accordance with SA 330, the auditor shall:

(i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and test of details, if any, for these assertions.

(ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation.

(iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation

Question 22

Discuss with examples the factors that are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures. (RTP Nov'22)

OR

CA A, auditor of ABC Ltd. wants to design substantive analytical procedure and for that he wants to check whether the data is reliable or not. Mention the relevant points which he has to consider whether data is reliable for purpose of designing the substantive analytical procedures. (PYP 3 Marks, Nov'19)

OR

What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures". (Old & New SM)

Answer 22

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

(i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls.

For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

Question 25

State with reason (in short) whether the following statements are true or false:

Sample size is not a valid criterion to distinguish between statistical and non- statistical approaches. (RTP Nov '23)

Answer 26

Correct: The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

Question 26

Flower Limited presented its financial statements for the F.Y. 2022-2023 to its auditor for expressing an opinion thereon. The auditor while carrying out the audit started comparing various items of profit and loss account of the year under audit with previous financial years. What is auditor trying to achieve by carrying out those comparisons? (RTP Nov '23, PYP 4 Marks May '22)

Answer 26

Purpose of Applying Analytical Procedure: Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

The auditor of Flower Ltd. would achieve the following by carrying out the comparison stated in the question:

(i) If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years.

(ii) By setting up certain expenses' ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.

(iii) If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

(iv) It would be possible to identify the existence of unusual transactions, amounts, ratios and trends that might indicate matters that have audit implications.

Question 27

When designing and performing substantive analytical procedures, either alone or in combination with tests of details as substantive procedures in accordance with SA 330, the auditor shall determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions. Discuss. (RTP Nov '23)

Answer 27

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

- The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.
- However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

- In some cases, even an unsophisticated predictive model may be effective as an analytical procedure.

Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

The determination of the suitability of particular substantive analytical procedure is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.

Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

Question 7

State with reason (in short) whether the following statements are true or false:

In the planning stage, analytical procedures would not in any way assist the auditor. (RTP May '20)

Answer 7

Incorrect: In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

Question 1

Discuss the audit procedure to be considered by an auditor while performing analytical procedure to obtain audit evidence as to overall reasonableness of purchase quantity and price. (PYP 3 Marks, Nov'19, PYP 4 Marks May'19)

Answer 1

Auditor needs to 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 management if any significant variations 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 compare the same with previous years and ask for the reasons from management if any significant variations found.

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

(iv) Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.

Question 3

With respect to SA 520 "Analytical procedures", explain the following factors to be considered by the auditor for substantive audit procedures.

(i) Account type (ii) Predictability (iii) Nature of Assertion. (PYP 3 Marks, Nov'20)

Answer 3

The auditor should consider the following factors for Substantive Audit Procedures:

Account Type – Substantive analytical procedures are more useful for certain types of accounts than for others. Income statement accounts tend to be more predictable because they reflect accumulated transactions over a period, whereas balance sheet accounts represent the net effect of transactions at a point in time or are subject to greater management judgment.

Predictability – Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable (e.g., between sales and cost of sales or between trade receivables and cash receipts). A predictable relationship is one that may reasonably be expected to exist and continue over time.

Nature of Assertion – Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). Predictive analytical procedures using data analytics can be used to address completeness, valuation/ measurement and occurrence.

Question 5

The statutory auditor of ABC Ltd., CA Raj identifies certain inconsistencies while applying analytical procedures to the financial and non-financial data of ABC Ltd. With reference to SA 520 on "Analytical Procedures", how CA Raj shall investigate such differences? (PYP 3 Marks, July'21, Old & New SM)

Answer 5

If analytical procedures perform med in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) **Inquiring of management and obtaining appropriate audit evidence relevant to management's responses:** Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) **Performing other audit procedures as necessary in the circumstances:** The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

Conclusion: In the present case CA Raj identifies certain inconsistencies while applying analytical procedure to financial or nonfinancial data of ABC Ltd. CA Raj should inquire the management of ABC Ltd, and obtain sufficient and appropriate audit evidences relevant to the management response. Further CA Raj should also perform other audit procedures, if required in the circumstances of the case to obtain further sufficient and appropriate evidence.

(iii) with the audit evidence obtained relevant to management's response, is not considered adequate.

Conclusion: In the present case CA Raj identifies certain inconsistencies while applying analytical procedure to financial or nonfinancial data of ABC Ltd. CA Raj should inquire the management of ABC Ltd, and obtain sufficient and appropriate audit evidences relevant to the management response. Further CA Raj should also perform other audit procedures, if required in the circumstances of the case to obtain further sufficient and appropriate evidence.

Question 6

State with reasons whether the following statements are correct or incorrect

SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit, that assist the auditor in preparation of the financial statements. .(PYP 2 Marks May'22)

Answer 6

Incorrect: SA 520 deals with the auditor's use of analytical procedures as substantive procedures

("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

Question 7

State with reasons whether the following statements are correct or incorrect:

The term "Analytical Procedures" means evaluation of financial information through analysis of plausible relationships among financial data and non-financial data. (PYP 2 Marks Nov 22)

Answer 7

Correct: As per Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Question 8

As per the Standard on Auditing (SA) 520 "Analytical Procedures", what are the examples of analytical procedures having consideration of relationships? (PYP 3 Marks Nov 22)

Answer 8

Examples of Analytical Procedure having consideration of relationship:

As per the Standard on Auditing (SA) 520 "Analytical Procedures", examples of Analytical Procedures having consideration of relationships are:

i. Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
ii. Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Question 9

Analytical procedures are used in all stages of audit by experienced auditors. (PYP 2 Marks May '23)

Answer 9

Correct: Experienced auditors use analytical procedures in all stages of the audit. Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition, these are also required during the completion phase.

Alternative solution

Incorrect: Every auditor shall use analytical procedures in all stages of the audit. Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition, these are also required during the completion phase.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. Which of the following is correct:

(a) As per the Standard on Auditing (SA) 520 "Analytical Procedure" 'the term "analytical procedures" means evaluations of financial information through analysis of financial data.

(b) As per the Standard on Auditing (SA) 520 "Analytical Procedure" 'the term "analytical procedures" means evaluations of financial information through analysis of non-financial data.

(c) As per the Standard on Auditing (SA) 520 "Analytical Procedure" 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

(d) As per the Standard on Auditing (SA) 520 "Analytical Procedure" 'the term "analytical procedures" means evaluations of financial information through ratio analysis. (MTP 1 Mark March '19)

Ans: (c)

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2. Which of the following is not an analytical procedure?

(a) Tracing of purchases recurred in the purchase book to purchase invoices.

(b) Comparing aggregate wages paid to number of employees

(c) Comparing the actual costs with standard costs

(d) All of them are analytical procedures (MTP 1 Mark Oct 19)

Ans: (a)

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3. Which of the following is correct:

(a) Different types of analytical procedures provide different levels of assurance.

(b) Different types of analytical procedures provide similar levels of assurance.

(c) Similar type of analytical procedures provide different levels of assurance.

(d) All are correct (MTP 2 Marks Oct 19)

Ans: (a)

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4. _____ implies analysing account fluctuations by comparing current year to prior year information and, also, to information derived over several years.

(a) Trend analysis

(b) Ratio analysis

(c) Structural modelling

(d) Account fluctuations analysis (MTP 1 Marks March 22)

Ans: (a)

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5. Statement I: As per the Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among financial data.

Statement II: Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

(a) Only Statement I is correct

(b) Only Statement II is correct

(c) Both statements are correct

(d) Both Statements are incorrect (MTP 1 Mark April 22, Sept 22)

Ans: (b)

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6. Auditor Compares Gross Profit Ratio with that of Previous year and it is discovered that there has been a fall in the ratio. This is an example of:

(a) Analytical Procedure

(b) Test of Controls

(c) Walk Through Test

(d) Audit Sampling (MTP 1 Mark April 22 & April '23)

Ans: (a)

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7. The auditor of Vishwas Ltd wants to know from you which of the following methods are analytical procedures

I. Comparison of client and industry data

II. Comparison of client data with similar prior period data

III. Comparison of client data with client-determined expected results

IV. Comparison of client data with auditor-determined expected results

(a) I, II and III only

(b) I &, II only

(c) III &, IV only

(d) I, II, III and IV (MTP 1 Marks, Sep'22)

Ans: (d)

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8. Which of the following statement is correct?

(a) Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time

(b) Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time

(c) Substantive analytical procedures are generally more applicable to small volumes of transactions that tend to be predictable over time

(d) None of the above (RTP Nov '19)

Ans: (a)

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9. Statement I as per the Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among financial data.

Statement II Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

(a) Only Statement I is correct

(b) Only Statement II is correct

(c) Both statements are correct

(d) Both Statements are incorrect (RTP May '20)

Ans:(b)

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10. Which of the following is not an example of Analytical Procedures having consideration of comparisons of the entity's financial information:

(a) Comparable information for prior periods.

(b) Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.

(c) Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

(d) Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages. (RTP May '20)

Ans:(d)

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11. Auditor Compares Gross Profit Ratio with that of Previous year and it is discovered that there has been a fall in the ratio. This is an example of:

(a) Analytical Procedure

(b) Test of Controls

(c) Walk Through Test

(d) Audit Sampling. (RTP Nov'20)

Ans:(a)

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12. Marvin Ltd. is a renowned food chain supplier in a posh area providing restaurant facility along with food delivering. CA. Felix was appointed as an auditor of the company for the Financial Year 2017-18.

While examining the books of account of the company, CA. Felix came to know about one of the major expenses of the company i.e. rent expense of ` 1,20,000 per month, for which he applied substantive analytical procedure for verification purpose. Explain, how would CA. Felix perform substantive analytical procedure in the given scenario?

(a) CA. Felix would inspect every single rent invoice per month of ` 1,20,000 and verify other elements appropriately.

(b) CA. Felix would compare the rental expense of the company with that of another nearby company having corresponding dimensions, for high degree of accuracy.

(c) CA. Felix would select the first month rent invoice of ` 1,20,000 and appropriately verifying other elements would predict that the rent for the whole year would be` 14,40,000 (i.e. ` 1,20,000 * 12). Thereafter, he would compare the actuals with his prediction and follow-up for any fluctuation.

(d) (a) and (b), both. (RTP May '19)

Ans:(c)

CASE STUDY 1

CA Drishti Khandelwal is conducting audit of a company engaged in manufacturing of towels and bedspreads. The company is having its own manufacturing set-up. However, it also gets some manufacturing processes outsourced from third parties. The company has three locations having substantial quantities of inventories in the same city. Besides, due to outsourcing of some processes, inventories are also held in premises of third parties in the same city. As part of audit procedures, she is performing many audit procedures required by different Standards on Auditing.

In particular, she is attending physical inventory count process of the company at year end in accordance with requirements of SA 501.The inventory of the company includes raw materials consisting mainly of natural and dyed yarns, work in process in different stages of manufacturing and finished stocks of towels and bedspreads.

She is also planning sending confirmations to parties to whom the company has sold goods. On reviewing trade receivables list, she finds that the list also contains large number of parties having small balances. She further finds that these receivables have arisen due to sale of bedspreads to small time retailers and possibility of difference in balances as per company's records and as per records of these small-time retailers is low. Risk of misstatements in relation to trade receivables has been assessed as low. Besides, there is nothing to suggest that small-time retailers would disregard such requests.

While conducting audit, she is testing controls operating in the company. She is also conducting tests of various items of income and expenditure as well as balances appearing in balance sheet. She intends to rely upon sampling extensively.

MULTIPLE CHOICE QUESTIONS (MCQS)

Based on above, answer the following questions: -

1. Which of the following statements is most appropriate regarding inventory count by auditor in accordance with SA 501?

(a) She should inspect the inventory to ascertain its existence and condition at all locations, observe how company personnel are carrying out count procedures and perform test counting.

(b) She should inspect the inventory to ascertain its existence at all locations, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.

(c) She should inspect the inventory to ascertain its existence at selected location, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.

(d) She should inspect the inventory to ascertain its existence and condition at all locations and perform counting of each and every item.

Ans: (a)

2. As regards inventories lying with third parties, which of following statements meets requirements of SA 501?

(a) She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company as well as request third parties to allow her to inspect inventories held by them. Both requirements are necessary to be complied with.

(b) She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these or both is required for purposes of SA 501.

(c) There is no obligation cast upon an auditor in respect of inventories lying with third parties.

(d) She should request confirmation from third parties regarding quantity, condition and value of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these is sufficient for purposes of SA 501.

Ans: (b)

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3. Keeping in view description regarding trade receivables, identify the most appropriate statement in context of SA 505?

(a) She should not plan and design confirmation requests for large number of parties having small balances.

(b) She should plan and design positive confirmation requests for large number of parties having small balances.

(c) She should plan and design positive confirmation requests for large number of parties having small balances and meticulously analyse exception rate

(d) She should plan and design negative confirmation requests for large number of parties having small balances.

Ans: (d)

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4. As regards sampling, which of the following statements is most appropriate in terms of requirements of SA 530?

(a) Sampling is used in tests of transactions as well as tests of controls.

(b) Sampling is used in tests of balances as well as tests of controls.

(c) Sampling is used in tests of details.

(d) Sampling is used in tests of details as well as tests of controls.

Ans: (d)

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5. Since she intends to rely upon sampling extensively, which of the following statements is true about sampling risk?

(a) Sampling risk can be eliminated.

(b) Increase in sampling risk would lead to decrease in detection risk.

(c) Decrease in sampling risk would lead to increase in detection risk.

(d) Sampling risk will always be in existence.

Ans: (d)

CASE STUDY 2

Financial statements of a firm have been put up for audit before CA Manushi. Ongoing through financial statements, she wants to verify assertions contained in financial statements and has planned certain procedures for carrying out detailed checking.

(A) She plans to verify some major bills debited in "Machinery repair" account. The purpose of it is to ensure that bills are entered correctly and their classification is proper.

(B) She plans to verify that all balances appearing under trade payables are genuine and not fake.

(C) She plans to compare amount of wages paid in current year and last year. It is also planned to verify relationship between the number of employees and wages paid in both years.

(D) She is of the view that it is necessary to examine title deeds of "land" appearing in financial statements of the firm.

(E) The firm is engaged in export of goods to Europe. The sales invoices raised in Euros are converted into Indian rupees as per applicable norms.

6. As regards description given regarding verification of bills debited in "Machinery repair" account, identify what she intends to perform?

(a) Tests of Controls

(b) Tests of transactions

(c) Tests of balances

(d) Risk assessment procedures

Ans: (b)

7. Identify which type of assertion she intends to focus when she wants to ensure genuineness of trade payables.

(a) Occurrence

(b) Cut-off

(c) Existence

(d) Accuracy

Ans: (c)

8. As regards comparison of wages of current year and last year and comparison of relationship between the number of employees and wages paid in both years, identify what she is trying to do?

(a) She is intending to perform tests of details.

(b) She is intending to perform tests of transactions.

(c) She is intending to perform tests of balances.

(d) She is intending to perform substantive analytical procedures.

Ans: (d)

9. In case of examination of title deeds of "land", which of the following fits into most appropriate description of such an audit procedure?

(a) Observation

(b) Inspection

(c) External confirmation

(d) Enquiry

Ans: (b)

10. She wants to verify whether conversion of foreign currency into Indian rupees is proper or not. Identify what she is trying to do?

(a) Performance

(b) Recalculation

(c) Observation

(d) Inspection

Ans: (b)

TEST YOUR KNOWLEDGE

11. Which of the following is not one of functions of internal auditor of an organization?

(a) Performing assurance activities

(b) Performing consulting activities to improve governance of organization

(c) Performing risk management activities

(d) Expressing independent opinion on financial statements of organization

Ans: (d)

12. An auditor finds during course of an audit that the entity has entered into many related party transactions. Which of the following statements is true?

(a) The risk that management may override controls in respect of related party transactions is lower.

(b) The risk that management may override controls in respect of related party transactions is higher.

(c) There is no effect on the risk that management may override controls in respect of related party transactions.

(d) Risk of overriding of controls by management has no relationship at all with related party transactions.

Ans: (b)

13. Which of the following is not an objective of a company's policies for ensuring "internal financial controls"?

(a) Efficient conduct of business

(b) Safeguarding of assets

(c) Prevention and detection of frauds and errors

(d) Assessing audit risk

Ans: (d)

14. Which of the following is not an advantage of statistical sampling?

(a) Sample size does not increase in proportion to size of area tested.

(b) Sample selection is more objective.

(c) It provides a means of deriving a calculated risk and corresponding precision.

(d) In case of verifying compliance with specific legal requirements, it is suitable.

Ans: (d)

15. A company auditor receives external confirmation from an entity to whom company has sold goods.

The said amount is properly classified in financial statements of company. Which of the following statements is not true in this regard?

(a) It shows that said trade receivable exists.

(b) It shows that said trade receivable is properly valued.

(c) It shows that company has a right to said trade receivable.

(d) It shows that amount of said trade receivable has been recorded in proper account.

Ans: (b)

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

Question 1

Purchase invoice is an example of internal evidence.

Answer 1

Incorrect: Internal evidence is the evidence that originates within the client's organisation. Since purchase invoice originates outside the client's organisation, therefore, it is an example of external evidence.

Question 2

Sufficiency is the measure of the quality of audit evidence.

Answer 2

Incorrect: Sufficiency is the measure of the quantity of audit evidence. On the other hand, appropriateness is the measure of the quality of audit evidence.

Question 3

Inquiry alone is sufficient to test the operating effectiveness of controls.

Answer 3

Incorrect: Inquiry along with other audit procedures (for example observation, inspection, external confirmation etc.) would only enable the auditor to test the operating effectiveness of controls. Inquiry alone is not sufficient to test the operating effectiveness of controls.

Question 4

When auditor inquires the management as part of the audit procedures it should be formal written form only and not informal oral inquiries.

Answer 4

Incorrect: When auditor inquires the management as part of audit procedures such inquiries may range from formal written inquiries to informal oral inquiries.

Question 5

Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur.

Answer 5

Incorrect: Assertions refer to representations by management that are embodied in the financial statements as used by the auditor to consider the different types of the potential misstatements that may occur.

Question 6

The method which involves dividing the population into groups of items is knows as block sampling.

Answer 6

Incorrect: The method which involves dividing the population into groups of items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.

Question 7

Universe refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Answer 7

Incorrect: Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Question 8

Non-Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

Answer 8

Incorrect: Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

Question 9

Sample need not be representative.

Answer 9

Incorrect: Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

Question 10

The objective of stratification is to increase the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

Answer 10

Incorrect: The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

Question 11

When statistical sampling is used to select a sample, sample need not be representative because the statistical sampling takes care of the representation.

Answer 11

Incorrect: Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

Question 12

Stratified Sampling is used for homogeneous population.

Answer 12

Incorrect: Stratified sampling is used when the population is diversified i.e heterogeneous. The population is divided into sub population having similar characteristics. Sample are then chosen from these sub populations which are called as Stratum. Therefore, stratified sampling is not useful in case of homogeneous population.

Question 13

Non statistical sampling is considered to be more scientific than the statistical sampling.

Answer 13

Incorrect: Statistical sampling uses scientific method of choosing samples from a given population. The use of probability theory is involved in statistical sampling so that every sampling unit has an equal chance of getting selected. In the non-statistical sampling, auditors' judgment and past experience is used to choose samples without any scientific method.

Question 14

In case of Statistical sampling, auditor's bias in choosing sample is involved.

Answer 14

Incorrect: Statistical sampling uses scientific method choosing samples from a given population. The use of probability theory is involved in statistical sampling so that every sampling unit has an equal chance of getting selected. In the non statistical sampling, auditor's judgment and past experience is used to choose samples without and scientific method. Hence, personal bias is involved in Non statistical sampling and not Statistical.

Question 15

In stratified sampling, the conclusion drawn on each stratum can be directly projected to the whole population.

Answer 15

Incorrect: In case of stratified sampling, the conclusions are drawn on the stratum. The combination of all the conclusions on stratum together will be used to determine the possible effect of misstatement or deviation. Hence the samples are used to derive conclusion only on the respective stratum from where they are drawn and not the whole population.

Question 16

Low acceptable sampling risk requires larger sample size.

Answer 16

Correct: Sampling risk arises from possibility that the auditor's conclusion based upon sample may be different from conclusion that would have been reached if same audit procedures were applied on the entire population. If acceptable sampling risk is low, large sample size is needed.

Question 17

As per the Standard on Auditing (SA) 520 "Analytical Procedures" 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among financial data only.

Answer 17

Incorrect: As per the Standard on Auditing (SA) 520 "Analytical Procedures" the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non- financial data.

Question 18

Auditor can depend on routine checks to disclose all the mistakes or manipulation that may exist in accounts.

Answer 18

Incorrect: Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests.

Question 19

Only purpose of analytical procedures is to obtain relevant and reliable audit evidence when using substantive analytical procedures.

Answer 19

Incorrect: Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical procedures are used for the following purposes:

(i) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

Question 20

Analytical Procedures are required in the planning phase only.

Answer 20

Incorrect. Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition, these are also required during the completion phase.

Question 21

Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time.

Answer 21

Incorrect. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

Question 22

Ratio analysis is useful in analyzing revenue and expense account only.

Answer 22

Incorrect: Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts

Question 23

Reasonableness test rely only on the events of the prior period like other analytical procedures.

Answer 23

Incorrect: Unlike trend analysis, Reasonableness test does not rely on events of prior periods, but upon non-financial data for the audit period under consideration.

Question 24

The statutory auditor of the company can apply analytical procedures to the standalone financial statements of a company only and not to the consolidated financial statements.

Answer 24

Incorrect: Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

THEORETICAL QUESTIONS ANSWER

Question 1

Many related party transactions are in the normal course of business. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Give few examples of such areas.

Answer 1

For Example-

(A) Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.

(B) Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.

(C) Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Question 2

An auditor is appointed for the first time for audit of accounts of an entity. The accounts of previous year were unaudited. He is unable to obtain sufficient appropriate audit evidence regarding the opening balances. What is his responsibility in this regard?

Answer 2

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.

Question 3

Discuss some of circumstances when work of the internal auditor cannot be used by external auditor.

Answer 3

The external auditor shall not use the work of the internal audit function if the external auditor

determines that:

(a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;

(b) The function lacks sufficient competence; or

(c) The function does not apply a systematic and disciplined approach, including quality control.

Question 4

Discuss what is understood by "appropriateness" of audit evidence.

Answer 4

Appropriateness: The auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective. Appropriate means population from which the samples are drawn shall be relevant for the specific objective under audit. This is because when the samples are drawn, the audit procedures are applied on the sample and the conclusions are projected on the population.

It is important for the auditor to ensure that the population is appropriate to the objective of the audit procedure, which will include consideration of the direction of testing.

Example

If the auditor's objective were to test for overstatement of accounts receivable, the population could be defined as the accounts receivable listing. On the other hand, when testing for understatement of accounts payable, the population would not be the accounts payable listing, but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports, or other populations that would provide audit evidence of understatement of accounts payable.

Question 5

Maintaining accounts using accounting software having a feature of recording audit trail can be useful for an auditor. Discuss some of the advantages for such a feature in accounting software for auditors.

Answer 5

An audit trail is a documented flow of a transaction. It is used to investigate how a source document was translated into an account entry and from there it was inserted into financial statement of an entity. It is used as audit evidence to establish authentication and integrity of a transaction. Audit trails help in maintaining record of system and user activity. Like, in case of banks, there is an audit trail keeping track of log-on activity detailing record of log-on attempts and device used.

It is a step-by-step record by which accounting, trade details, or other financial data can be traced to their source. Audit trails are used to verify and track many types of transactions including accounting and financial transactions.

Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use. Audit trails help to enhance internal controls and data security. Audit trails can help in fixing responsibility, rebuilding events and in thorough analysis of problem areas. For example, audit trails can track activities of users thus fixing responsibility for users. These can also be used to rebuild events upon occurring of some problem. Audit trail analysis can specify reason of the problem. It can also help in ensuring operation of system as intended. In this way, audit trails can help entities in their regular system operations.

Systems which have a feature of audit trail inspires confidence in auditors. It helps auditors in verifying whether controls devised by the management were operating effectively or not. It aids in verification whether a transaction was indeed performed by a person authorised to do it. Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.

Question 6

Explain how a statutory auditor of a company can apply analytical procedures at the planning phase of audit.

Answer 6

Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.

Analytical Procedures in Planning the Audit

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non- financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

For example, analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

Question 7

Discuss the objective of Auditor with respect to Opening balances in conducting an initial audit engagement.

Answer 7

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

(a) Opening balances contain misstatements that materially affect the current period's financial statements; and

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Question 8

M/s Pankaj & Associates, Chartered Accountants, have been appointed as an auditor of ABC Limited. CA Pankaj did not apply any audit procedures regarding opening balances. He argued that since financial statements were audited by the predecessor auditor therefore he is not required to verify them. Is CA Pankaj correct in his approach?

Answer 8

Initial audit engagement is an engagement in which either:

(i) The financial statements for the prior period were not audited; or

(ii) The financial statements for the prior period were audited by a predecessor auditor.

From the above, it is quite clear that CA Pankaj is not correct in his approach and therefore would be required to follow the initial audit engagement and also apply audit procedures regarding opening balances.

Audit Procedures regarding Opening Balances; The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;

(b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(c) Performing one or more of the following:

(i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;

(ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

(iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

Question 9

While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence?

Answer 9

While applying the Substantive Analytical Procedures the statutory auditor of a company may use the following techniques to obtain sufficient and appropriate audit evidence

Trend analysis – Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Ratio analysis – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Reasonableness tests – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

Structural modelling – A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression). The statutory auditor may use any of the above mentioned techniques while applying substantive analytical procedures depending upon the availability of data and requirements of the case.

Question 10

The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Explain with the help of at least three examples.

Answer 10

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

Example

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

Question 11

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow -up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests.

Answer 11

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

(a) Determining the information to be confirmed or requested;

(b) Selecting the appropriate confirming party;

(c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and

(d) Sending the requests, including follow-up requests when applicable, to the confirming party.

Question 12

Explain clearly the examples of matters relevant in planning attendance at physical inventory counting.

Answer 12

Matters relevant in planning attendance at physical inventory counting include, for example:

(a) Nature of inventory.

(b) Stages of completion of work in progress.

(c) The risks of material misstatement related to inventory.

(d) The nature of the internal control related to inventory.

(e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.

(f) The timing of physical inventory counting.

(g) Whether the entity maintains a perpetual inventory system.

(h) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate

(i) Whether the assistance of an auditor's expert is needed.

Question 13

The statutory auditor of MNO Ltd., CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non financial data of MNO Ltd. What should CA Kishore do in this case with reference to SA 520 on "Analytical Procedures"?

Answer 13

As per SA 520- "Analytical Procedures" If while applying analytical procedures in accordance with SA 520, the statutory auditor identifies fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) **Inquiring of management and obtaining appropriate audit evidence relevant to management's responses:** Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) **Performing other audit procedures as necessary in the circumstances:** The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

In the present case, CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non financial data of MNO Ltd. CA Kishore should inquire the management of MNO Ltd. and obtain sufficient and appropriate audit evidence relevant to management response. Further, CA Kishore should also perform other audit procedures if required in the circumstances of the case to obtain further sufficient and appropriate audit evidence.

Question 14

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Explain

Answer 14

Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence.

Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re- performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

The sufficiency and appropriateness of audit evidence are interrelated.

Question 15

What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures".

Answer 15

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

(i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence

in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls.

Question 16

Define Analytical Procedures.

Answer 16

Meaning of Analytical Procedures: As per the Standard on Auditing (SA) 520 "Analytical Procedures" 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. Thus, analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.

Question 17

M/s PQR and associates are the statutory auditors of TUV Ltd. for the FY 2022-23-. They have been appointed as statutory auditors of TUV Ltd. for the first time. What is the objective of the engagement partner in terms of SA 510?

Answer 17

As per SA 510, "Initial Engagement- Opening balances" the objective of the auditor with respect to the opening balances is to obtain sufficient and appropriate audit evidence about whether:

(a) Opening balances contain misstatements that materially affect the current period's financial statements; and

(b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Question 18

What is meant by sufficiency of Audit Evidence? Explain the factors affecting the auditor's judgement as to the sufficiency of audit evidence.

Answer 18

Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher

the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

Following are the factors affecting the auditor's judgement as to the sufficiency of audit evidence:

(a) Materiality: It may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.

(b) Risk of material misstatement: It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level:

- **Inherent risk**—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.
- **Control risk**—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control.

Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand, if assertions have a higher risk of material misstatement, more evidence would be required.

(c) Size of a population: It refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

Question 19

What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 "Audit Sampling".

Answer 19

Meaning of Audit Sampling: "Audit Sampling" means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

Some of the important methods of selecting the sample are discussed below

(1) Random Sampling: Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below–

(i) **Simple Random Sampling:** Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection. Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum). Today random numbers are also generated using various applications on the cellphones like the random number generator. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e it is suitable for a homogeneous population having a similar range.

(ii) **Stratified Sampling:** This 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 if 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.

(2) **Interval Sampling or Systematic Sampling:** Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables.

When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

To minimise the effect of the possible known buyers through a pattern in the population, more than one starting point may be taken. The multiple random starting point is taken because it minimises the risk of interval sampling pattern with that of the population being sampled.

(3) **Monetary Unit Sampling:** It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(4) **Haphazard sampling:** Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

(5) **Block Sampling:** This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to

each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample. 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. Further, if the client has the idea of the block selection pattern of the auditor, then material misstatements and deviations can be easily overlooked by management's practice of recording them.

Question 20

With reference to Standard on Auditing 530, state the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

Answer 20

Audit Sampling: As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is – the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The requirements relating to sample design, sample size and selection of items for testing are explained below-

Sample design - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

Sample Size- The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Selection of Items for Testing- The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

Question 21

While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?work to establish that initial conclusions were incorrect.

Answer 21

Risk Factors while applying Sampling Techniques: As per SA 530 "Audit Sampling", sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions.

i) In the case of a test of controls, that controls are more effective than they actually are, or in the case

of tests of details, that a material misstatement does not exists when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

ii) In the case of test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Question 22

Write short notes on the following:

(a) Advantages of Statistical sampling in Auditing.

(b) Stratified sampling

Answer 22

(a) The advantages of statistical sampling may be summarized as follows -

(1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.

(2) The sample selection is more objective and thereby more defensible.

(3) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.

(4) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.

(5) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

(6) It is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

(b) Stratified Sampling: This 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 if 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.

Example

In the above case, trade receivables balances may be divided into four groups as follows:-

(a) balances in excess of ₹ 10,00,000;

(b) balances in the range of ₹ 7,75,001 to ₹ 10,00,000;

(c) balances in the range of ₹ 5,50,001 to ₹ 7,75,000;

(d) balances in the range of ₹ 2,25,001 to ₹ 5,50,000; and

(e) balances ₹ 2,25,000 and below.

From these above groups the auditor may pick up different percentage of items from each of the group. From the top group i.e. balances in excess of ₹ 10,00,000, the auditor may examine all the items; from the second group 25 per cent of the items; from the third group 10 per cent of the items; and from the lowest group 2 per cent of the items may be selected. Random sample is chosen from each stratum using random number tables.

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

Therefore, we can say that random selection method is applied through random number generators, for example, random number tables.

Question 23

What precautions should be taken by the auditor while applying test check techniques?

Answer 23

Precautions to be taken while applying test check techniques are

- Thorough study of accounting system should be done before adopting sampling.
- Proper study of internal control systems.
- Areas which are not suitable for sampling should be carefully considered. Eg:compliance with statutory provisions, transactions of unusual nature etc.
- Proper planning for Sampling methods to be used and explaining the staff,
- Transactions and balances have to be properly classified (stratified)
- Sample size should be appropriately determined.
- Sample should be chosen in unbiased way,

Errors located in the sample should be analysed properly.

Question 24

Explain the factors to be considered while determining the extent of checking on a sampling plan.

Answer 24

The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

(i) Size of the organisation under audit.

(ii) State of the internal control.

(iii) Adequacy and reliability of books and records.

(iv) Tolerable error range.

(v) Degree of the desired confidence.

Question 25 Illustration

The auditor of JPJ Limited explained to the audit team members about the relationship between Audit Evidence and Opinion of Auditor. Explain what relationship exists between Audit Evidence and Opinion of Auditor.

Answer 25

There exists a very important relationship between Audit Evidence and opinion of the Auditor. While conducting an audit of a company, the auditor obtains audit evidence and with the help of that audit evidence obtained, the auditor forms an audit opinion on the financial statements of that company.

Question 26 Illustration

An audit team member of the auditors of Genuine Limited was of the view that audit evidence obtained internally from within the company under audit are more appropriate from the reliability point of view as compared to audit evidence obtained externally as evidence obtained internally are obtained from the company whose audit is being conducted.

Give your views as auditor of Genuine Limited.

Answer 26

Audit evidence obtained externally is more appropriate from reliability point of view as compared to those which are obtained internally. The reason that audit evidence obtained externally is more appropriate from the point of view of reliability is that there is a very low risk that they can be altered or changed.

Question 27 Illustration

There was a Partnership Firm of Chartered Accountants VM and Associates. Mr. M, one of the partners of VM and Associates, while explaining to his audit team members about importance of audit evidence informed them about sufficiency and appropriateness of audit evidence. Mr. A, one of the members of audit team of VM and Associates was of the view that sufficiency of audit evidence means simplicity of audit evidence and appropriateness of audit evidence means ease of obtaining audit evidence. Explain whether sufficiency and appropriateness of audit evidence mean simplicity and ease of obtaining audit evidence.

Answer 27

Sufficiency and Appropriateness of audit evidence does not mean simplicity and ease of obtaining audit evidence rather sufficiency of audit evidence is related to the quantity of audit evidence and appropriateness of audit evidence is related to quality of audit evidence.

Question 28 Illustration

While auditing the books of accounts of AB Limited for the financial year 2022 -23, the auditor of the company used an audit procedure according to which complete documents and records of the company were checked in detail in order to obtain audit evidence. Explain the audit procedure used by the auditor of Extremely Distinct Limited.

Answer 28

The audit procedure used by auditor of AB Limited is known as Inspection because inspection is an audit procedure in which complete documents and records of a company are checked in detail for the purpose of obtaining audit evidence.

Question 29 Illustration

JK Exports Ltd is a manufacturer exporter having its own production capacity and also gets the job work done through various job workers. The auditor of JK Exports Ltd. Considers that inventory held with job workers is material to the financial statements.

Required

Suggest the audit procedures in the given case.

Answer 29

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.

Question 30 Illustration

Parag India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements.

Required

Suggest the auditor with reference to SAs.

Answer 30

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

(a) Inquiry of management and, where applicable, others within the entity, including in house legal counsel;

(b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(c) Reviewing legal expense accounts.

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.

Question 31 Illustration

During the financial year 2022-23, the auditor of Healthy and Wealthy Limited asked a Trade Receivable to respond directly to the auditor whether or not the amount they were required to pay to Healthy and Wealthy Limited was ₹ 1,23,000. That trade receivable confirmed to the auditor of Healthy and Wealthy Limited, that they were required to pay an amount of ₹ 1,23,000 to Healthy and Wealthy Limited. State and explain the type of Confirmation Request as required by the auditor.

Answer 31

The above-mentioned situation is an example of Positive Confirmation Request because in Positive Confirmation Request the party confirms the auditor of a company whether such party agrees or whether such party disagrees with the information for which the confirmation is required by auditor of that company.

Question 32 Illustration

While conducting the audit of AB Ltd, the auditor K of KLM and Associates, Chartered Accountants observes that there are large number of Trade payables and receivables standing in the books of accounts as on 31st March. The auditor wanted to send confirmation request to few trade receivables, but the management refused the auditor to send confirmation request.

Required

How would the auditor proceed?

Answer 32

If management refuses to allow the auditor to send a confirmation request, the auditor shall:

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

(b) 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

(c) 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.

The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

Question 33 Illustration

CA Aarav wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2022-23. The rent amounts to ₹50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of ₹ 10,000/- per month for a similar location. How will applying the analytical procedures impact the verification process of such rental payments by XYZ Ltd.?

Answer 33

If CA Aarav checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e. XYZ Ltd. paid ₹ 50,000/- per month as rent and the same is getting reflected in the rent agreement. Here, CA Aarav may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location.

If CA Aarav applies analytical procedure i.e. compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.

However, if CA Aarav does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.

Meaning of Analytical Procedures. As per the Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Question 34 Illustration

Analytical procedure involves analysis of relationship among financial and non- financial data.

Explain with the help of an example as to how, the statutory auditor of ABC Ltd. will analyse such relationship with respect to the total wages paid by ABC Ltd. during the FY 2022-23.

Answer 34

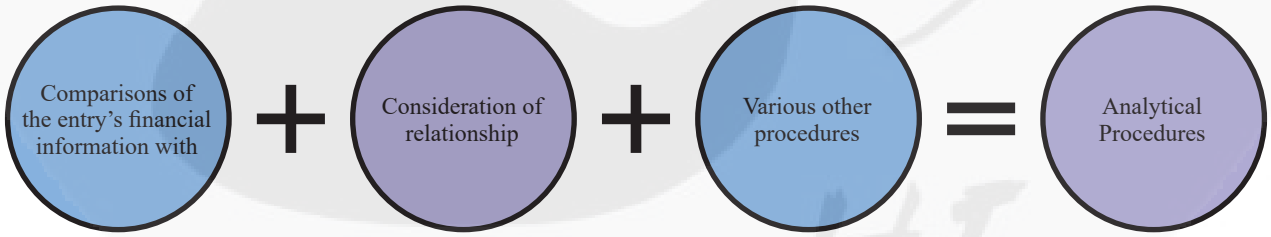
As per SA 520, Analytical Procedures means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. The following example explains the analysis of relationship between financial and non-financial data while applying analytical procedures.

The statutory auditor of ABC Ltd. has to verify the total wages paid by the company having factories in various states. He can verify the same by analyzing the relationship between wages per worker and total number of workers across all the factories.

i.e. Total wages = Wages per worker x Total number of workers.

Here wages per worker is financial data i.e. in ₹ and total number of workers is a number which is a non financial data. Thus, the statutory auditor of ABC Ltd. is evaluating financial information i.e. total wages paid (in ₹) by analyzing the relationship between wages per worker (in ₹) which is financial data and number of workers which is a non financial data.

Analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.



Examples of Analytical Procedures having consideration of comparisons of the entity's financial information are:

Comparable information for prior periods.

Question and answer Illustration 35

Particulars	Client		Industry	
Year	2021-22	2022-23	2021-22	2022-23
Inventory Turnover	2.8	2.9	3.1	2.8
Gross Margin	22.5%	22.7%	23.6%	22.2%

- Various methods may be used to perform analytical procedures.
- These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques.
- Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Thus, we can say that Analytical Procedures may be segregated into the following major types:

- as comparison of client and industry data,
- comparison of client data with similar prior period data,
- comparison of client data with client-determined expected results,
- comparison of client data with auditor-determined expected results and
- comparison of client data with expected results, using non financial data.

Test Your Understanding

Question 1

On perusal of financial statements of a company, auditor of company finds that notes to accounts contain aging of trade payables in accordance with requirements of Schedule III of Companies Act, 2013.

The accountant of company is responsible for ensuring proper aging of trade payables included in notes to accounts. The auditor wants to verify whether aging of trade payables made in financial statements is proper or not. Identify what he is trying to do.

Answer 1

The auditor is verifying aging of trade payables. He is "reperforming" the control which was mandated by the management.

Question 2

CA Sooryagaythri is conducting audit of an entity. During the course of audit, she has made oral inquiries from head accountant regarding preparing of bank reconciliations every month as has been laid down by the management. Discuss, whether inquiries as stated above would provide satisfaction to her that controls in respect of preparing bank reconciliations statements have operated effectively.

Answer 2

Inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. Mere inquiry does not lead to obtaining of sufficient appropriate audit evidence. In the instant case, CA Sooryagaythri should verify whether proper bank reconciliations have been carried out monthly as stipulated by management.

Only then, she can be satisfied about operating effectiveness of controls in this regard.

Question 3

A company has stipulated a control that reconciliations of its records showing quantitative details of its property, plant and equipment are carried out at regular intervals with physical verification of such items. The auditor has found that such reconciliations are being carried out as stipulated. Discuss, whether above factor, increases reliability of other internally generated evidence within the company relating to existence of such items.

Answer 3

The management is carrying out reconciliations of items contained in Property, Plant and Equipment records with physical verification of such items at regular intervals. It means that controls in this regard have operated effectively. 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.

Question 4

A company has stipulated a control through its automated software that interest @ 12% p.a. is charged in case of those customers who fail to make payment within a month of a sales transaction. The internal auditor of the company finds that during a certain period, software has failed to charge interest due to certain technical glitches. Does reporting of above situation fall in domain of internal auditor's work?

Answer 4

One of the functions of internal auditor includes responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In the given case, internal auditor has found that controls relating to levying of interest have not operated. The system has not levied stipulated interest in respect of a certain period. It can result in loss of income for the company and improper financial reporting. Such a matter, definitely, falls in the domain of reporting by internal auditor.

Question 5

CA Sukesh is external auditor of an entity. He comes to know that there is also an internal auditor in the entity. However, he finds that internal auditor is not reporting directly to higher echelons of the management. CA Sukesh has also assessed risk of material misstatement to be high. Discuss, whether it would be proper for CA Sukesh to rely upon work of internal auditor extensively in above situation.

Answer 5

In the given case, the organizational status of internal audit function is not commensurate with his duties.

He is not reporting directly to higher echelons of management. It shows that such a function is not given its due importance in entity. Since risk of material misstatements has also been assessed as high by CA Sukesh, both the above factors suggest that he should not rely upon work of internal auditor extensively.

Question 6

An auditor, while conducting audit of an entity, has selected samples based upon his personal experience and knowledge. Later on, it turns out that selected samples were not representative and it has led to faulty selection of samples. The auditor contends that samples were selected based upon his personal experience and knowledge. Can auditor escape from his responsibility in this regard?

Answer 6

In the provided situation, the auditor has selected samples based upon his personal experience and knowledge. It, is a case of non-statistical sampling approach adopted by the auditor. Whatever may be the approach non- statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The auditor cannot escape his responsibility in this regard.

Question 7

The audit procedures performed so far by auditor of a company indicate that there is a possibility that company has not disclosed all material litigation cases involving the company. Does such a situation warrant direct communication by auditor with external lawyer of the company?

Answer 7

As per requirements of SA-501, 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, seek direct communication with the entity's external legal counsel. The above situation warrants direct communication with company's standing external lawyer.

Question 8

CA Jignesh Desai is in midst of audit of a company. The company is fairly large one and has a well - functioning internal audit department. While considering sending out external confirmation requests to trade receivables outstanding as on date of financial statements, he has delegated the process of choosing trade receivables, designing requests and receiving responses from customers to internal audit department. The responses are also received on the mail id of internal audit department. Is approach of CA Jignesh Desai proper?

Answer 8

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

(a) Determining the information to be confirmed or requested;

(b) Selecting the appropriate confirming party;

(c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and

(d) Sending the requests, including follow-up requests when applicable, to the confirming party.

In the given case, it appears that external auditor has delegated entire work of sending out external confirmation requests to internal audit department over which he has no control. Further, responses to external confirmation requests are received on mail id of internal audit department. All these acts are not in line with requirements under SA 505.

Question 9

On reviewing schedule of trade receivables of a company, CA Mary finds that in respect of one outstanding balance, the CFO of the company is not willing to allow her to send external confirmation request due to the reason that sending out such request could spoil precariously placed business relations with the customer. On further inquiry, she finds out that there is a dispute going on with the company relating to some quality issues of goods sent to the customer and matter is sub judice. Efforts are also being made by the company for out of court settlement. Reviewing correspondence with the customer, she finds that issue is near resolution and no fraud risk factors exist. Is unwillingness of CFO justifiable?

Answer 9

In terms of requirements of SA 505, if management refuses to allow the auditor to send a confirmation request, the auditor shall inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness.

A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. Further, fraud risk factors do not exist. Keeping in view, unwillingness of CFO is justifiable.

Question 10

An auditor of a company intends to apply analytical procedures for verifying revenue. Discuss any two analytical procedures which may be performed by auditor relating to revenues.

Answer 10

Analytical procedures in relation to revenue can include:-

(i) Comparing revenue of current year with previous year and investigating significant fluctuations

(ii) Comparing revenue of current year with budgeted targets and investigating significant fluctuations.

CHAPTER 5
AUDIT OF ITEMS OF FINANCIAL STATEMENTS

Question 1

Ongoing through the financial statements of PQR Ltd, its auditors Kamal Gagan and Associates observed that company has taken Loans from banks and financial institutions. Further, the audit team discusses the following about Liabilities:

"Liabilities are the financial obligations of an enterprise other than owners' funds. Liabilities include loans/ borrowings, trade payables and other current liabilities, deferred payment credits and provisions.

Verification of liabilities is as important as that of assets, for, if any liability is omitted (or understated) or over stated, the Balance Sheet would not show a true and fair view of the state of affairs of the company."

Advise stating clearly the audit procedures generally required to be undertaken for verification of existence of Borrowings (MTP 5 Marks March '18, Oct '18)

Answer 1

Review board minutes for approval of new lending agreements. During review, make sure that any new loan agreements or bond issuances are authorized. Ensure that significant debt commitments should be approved by the board of directors

- Agree details of loans recorded (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits imposed by agreements are not exceeded.
- Agree overdrafts and loans recorded to bank confirmation / confirmation to lenders.
- Agree details of leases and hire purchase creditors recorded to underlying agreement.
- 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.
- If we become aware of significant transactions that are outside the normal course of business or that otherwise appear to be unusual given our understanding of the entity and its environment, perform the following procedures:

(a) Gain an understanding of the business rationale for such significant unusual transaction.

(b) Consider whether the transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity we are auditing.

Question 2

"Until the invoice is paid, the invoice amount is recorded on the organization's balance sheet as accounts receivable. If balances are not recoverable, then these amounts will need to be written off as an expense in the income statement/ profit and loss account." It is important to carry out compliance procedures in the sales audit as part of the debtors' audit procedure. Verify to ensure that the system for receivables has the necessary features. (MTP 5 Marks March '18, MTP 5 Marks Oct'18)

Answer 2

Trade receivable are an essential part of any organization's balance sheet. Often referred to as debtors, these are monies which are owed to an organization by a customer. The most common form of an account receivable is a sale made on credit, via an invoice, to a customer. Typically, an invoice is raised and issued to the customer with the invoice amount being recorded as a debtor balance. Until the invoice is paid, the invoice amount is recorded on the organization's balance sheet as accounts receivable. If balances are not recoverable, then these amounts will need to be written off as an expense in the income statement/ profit and loss account. It is important to carry out compliance procedures in the sales audit as part of the debtors' audit procedure. In summary, check to ensure that the system for receivables has the following features:

- Only bona fide sales lead to receivables
- All such sales are to approved customers
- All such sales are recorded
- Once recorded, the debts can only be eliminated by receipt of cash or on the authority of a responsible official
- Debts are collected promptly
- Balances are regularly reviewed and aged, a proper system of follow up exists and if necessary adequate provision for bad debt exists
- Clear segregation of duties relating to identification of debt, receipt of income, reconciliations and write off of debts

Question 3

Liabilities include trade payables and other current liabilities, deferred payment credits and provisions. Verification of liabilities is as important as that of assets, considering if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the entity. Advise stating clearly the audit procedure to establish the existence of trade payables and other current liabilities as at the period-end. (MTP 10-Marks Aug '18)

Answer 3

Audit Procedure to establish the existence of trade payables and other current liabilities:

1. Check whether there are controls in place to ensure that the same purchase/ expense invoice cannot be recorded more than once and payable balances are automatically recorded in the general ledger at the time of recording of expense.
2. To ensure that trade payable ledger reconciles to general ledger, ask for a period - end accounts payable aging report and trace the grand total to the amount in the accounts payable account in the general ledger.
3. Calculate the accounts payable report total. Add up the expense/ liability items on the accounts payable aging report to verify that the total traced to the general ledger is correct.
4. Investigate reconciling items. If there are journal entries in the accounts payable account in the general ledger, review the justification for larger amounts. This implies that these journal entries should be fully documented.

Direct confirmation procedures

5. An important audit activity is to contact vendors directly and ask them to confirm the amounts of accounts payable as of the end of the reporting period under audit. This should necessarily be done for all significant account payable balances as at the period- end and for parties from whom material purchases have been made during the period under audit even if period- end balance of such parties is not significant.
6. The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain trade payables. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.
7. The trade creditors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be decided by the auditor in consultation with the Company.
8. The form of requesting confirmation from the trade creditor may be either (a) the 'positive' form of request, wherein the trade creditor is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' form of request wherein the trade creditor is requested to respond only if he disagrees with the balance shown. The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reasons to believe that there may be a substantial number of accounts in dispute or inaccuracies or irregularities. The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the trade creditors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent

of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the trade payable balances. In many situations, it may be appropriate to use the positive form for trade creditors with large balances and the negative form for trade creditors with small balances

9. The method of selection of the trade creditors to be circularized should not be revealed t o the Company until the trial balance of the trade payables' ledger is handed over to the auditor. A list of trade creditors selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed and auditor should insert an identification mark, example- a team member inserting his initials in the letter (without informing the Company) to enable the auditor to continue to maintain unpredictability in audit and to avoid any wrong doing from management side. The auditor should maintain strict control to ensure the correctness and proper dispatch of request letters. In the alternative, the auditor may request the client to furnish duly authorized confirmation letters and the auditor may fill in the names, addresses and the amounts relating to trade creditors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

10. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of trade payables taken as a whole.

11. Where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include:

    • Agreeing the balance to subsequent cash paid;

    • Agreeing the detail of the respective balance to the underlying vendor invoices;

    • Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these purchases/ expense transactions actually occurred;

    • Prepare a final summary of the results of the circularization and draw the final conclusion

12. Related party payables. If there are any related party payables, review whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

13. Trend analysis. Review a trend line of purchases/ expenses and accounts payable, or a comparison of the two over time, to see if there are any unusual trends. Make inquiries about reasons for changes in trends from the management and document the same in audit work papers.

Question 4

Explain the difference between reserves and provisions. (MTP 3 Marks March '19)

Answer 4

Difference between Reserves and Provisions

- The difference between the two is that provisions are amounts set aside to meet specific/ identified liabilities or diminution in recoverable value of assets. These must be provided for regardless of the fact whether the Company has earned profit or not.
- Reserves on the other hand, represent amounts appropriated out of profits, held for equalizing the dividends of the company from one period to another or for financing the expansion of the company or for generally strengthening the company financially.
- If we examine the Balance Sheet of a company, at a given time, and deduct the total liabilities to outside trade payables from the value of assets shown therein, the difference between the two figures will represent the net worth of the company based on the book values of assets as on that date. The same shall include the capital contributed by the shareholders as well as total undistributed profit held either to the credit of the Statement of Profit and Loss or to reserves; the reserves again will be segregated as revenue or capital reserves.

Question 5

Explain with examples the audit procedure to establish the existence of intangible fixed assets as at the period- end. (MTP 3 Marks April 19, RTP Nov '19 & Nov '18)

Answer 5

Since an Intangible Asset is an identifiable non-monetary asset, without physical substance, for establishing the existence of such assets, the auditor should verify whether such intangible asset is in active use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Example- for verifying the existence of software, the auditor should verify whether such software is in active use by the entity and for the purpose, the auditor should verify the sale of related services/ goods during the period under audit, in which such software has been used.

Example- For verifying the existence of design/ drawings, the auditor should verify the production data to establish if such products for which the design/ drawings were purchased, are being produced and sold by the entity.

In case any intangible asset is not in active use, deletion should have been recorded in the books of account post approvals by the entity's management and amortization charge should have ceased to be charged beyond the date of deletion.

Question 6

Verification of liabilities is as important as that of assets, considering if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the entity. Explain stating also criteria for a liability to be classified as current liability. (MTP 3 Marks April 19, RTP Nov 18)

Answer 6

Liabilities in addition to borrowings (discussed above), include trade payables and other current liabilities, deferred payment credits and provisions. Verification of liabilities is as important as that of assets, considering if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the entity.

Further, a liability is classified as current if it satisfies any of the following criteria:

- It is expected to be settled in the entity's normal operating cycle
- It is held primarily for the purpose of being traded
- It is due to be settled within twelve months after the reporting period
- The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments does not affect its classification.

Question 7

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

(i) Statement of Profit and Loss

Travelling Expenditure Rs. 50,000

(ii) Balance Sheet

Trade receivable Rs. 2,00,000 (MTP 3 Marks Oct 19)

Answer 7

(i) Travelling Expenditure Rs. 50,000

- Expenditure has been actually incurred for the purpose of travelling.
- Travelling has been undertaken during the year under consideration.
- Total amount of expenditure incurred is Rs. 50,000 during the year.
- It has been treated as revenue expenditure and charged to Statement of Profit and Loss.

(ii) Trade receivable Rs. 2,00,000

- These include all sales transaction occurred during the year.

- These have been recorded properly and occurred during the year.
- These constitute assets of the entity.
- These have been shown at proper value, i.e. after showing the deduction on account of provision for bad and doubtful debts.

Question 8

The auditor A of ABC & Co.- firm of auditors is conducting the audit of XYZ Ltd and while performing testing of additions wanted to verify that all PPE (Property Plant and Equipment) purchase invoices are in the name of the entity he is auditing. For all additions to land, building in particular, the auditor desires to have concrete evidence about ownership. The auditor is worried about whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Advise the auditor. (MTP 3 Marks Oct 19, RTP Nov '19 & May '18, Old & New SM)

Answer 8

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, building in particular, the auditor should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date. In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not 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. In addition, the auditor should also verify the register of charges, available with the entity to assess the PPE that has been given as security to any third parties.

Question 9

"P India" Ltd. is a manufacturer of various sports products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims, which may give rise to risk of material misstatements. Suggest the audit procedures in the given case. (MTP 4 Marks May 20, Apr'21)(PYP 4 Marks , May '19)

Answer 9

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

(i) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;

(ii) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and

(iii) Reviewing legal expense accounts.

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.

Question 10

Write the audit procedures to be performed as an auditor for valuation (assertion) of following:

(i) Loans and Advances and other current assets. (PYP 5 Marks Nov '18)

(ii) Finished goods and goods for resale. (MTP 6 Marks May '20, PYP 5 Marks Nov '18)

Answer 10

(i) Audit procedure for valuation of Loans and Advances and other current assets

- Assess the allowance for doubtful accounts. Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.
- Obtain the ageing report of loans and advances, split between not currently due, 30 days old, 30-60 days old, 60-180 days old, 180-365 days old and more than 365 days old. Also, obtain the list of loans and advances under litigation and compare with previous year.
- Scrutinize the analysis and identify those loans and advances that appear doubtful; Discuss with management their reasons, if any of these loans/ advances are not included in the provision for bad recoverable; Perform further testing where any disputes exist; Reach a final conclusion regarding the adequacy of the bad and doubtful loans/ advances provision.
- Assess bad loans/ advances write-offs. Prepare schedule of movements on Bad loans/ advances – Provision Accounts and loans/ advances written off.
- Check that write-offs or other reductions in the recoverable balances have been approved by an appropriate and authorised member of senior management, for example the financial controller or finance director.
- Check that the restatement of foreign currency loans and advances/ other current assets has been done properly.

(ii) Audit procedure for valuation of finished goods and goods for resale

- Enquire into what costs are included, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the draft financial statements.
- Ensure that inventories are valued at net realizable value if they are likely to fetch a value lower than their cost. For any such items, also verify if the relevant semi/ partly processed inventories (work in progress) and raw materials have also been written down.
- Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. For the purpose, request the client to provide inventory ageing split between less than 30 days, 30-60 days old, 60-90 days old, 90-180 days old, 180-385 days old and more than 365 days old (refer screenshot below).
- Follow up 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 labor, direct material and overhead have been included.
- Verify the correct application of lower-of-cost-or-net realizable value principles.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Many examinees could not understand the requirement of question pertaining to Valuation aspect of Loans and advances and other current assets, Finished Goods and goods for resale. They wrote about the audit procedures to be followed for the same like existence, rights and obligations, completeness, disclosure etc. rather than writing about valuation aspect.

Question 11

Examine with reasons (in short) whether the following statement is correct or incorrect :

Tangible assets are depreciated when the asset is actually put to active use. (MTP 2 Marks Oct 20) (Old SM)

Answer 11

Incorrect: Depreciation is a fall in value of asset due to obsolescence, usage and effluxion of time, Therefore, depreciation is charged when the asset is ready for use . Active use of asset is not a mandatory criteria for charge of depreciation.

Question 12

As per AS 26, internally generated goodwill is not recognised as an asset. (MTP 2 Marks March '21)

Answer 12

Correct: As per AS 26, Intangible Assets, internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

Question 13

No entry is passed for cheques received by the auditee on the last day of the year and not yet deposited with the Bank. (MTP 2 Marks March '21 & Sep '22, RTP May'22)

Answer 13

Incorrect: The person who is controlling the trade receivables should ensure that proper accounting entries have been passed by crediting respective trade receivables account. The balance of cheque in hand should be disclosed along with the cash and bank balances in the financial statements.

Question 14

You are an auditor of PQR Ltd. which has spent Rs. 10 lakhs on Research activities of the product during period under audit. Board of Directors want to recognize it as an internally generated intangible asset.

Advise and discuss the conditions necessary to be fulfilled to recognize the intangible assets in the financial statements. (MTP 4 Marks March '21, PYP 4 Marks May'19)

OR

You are an auditor of PQR Ltd. which has spent Rs. 50 lakhs on Research activities of the product during period under audit. Board of Directors want to recognize it as an internally generated intangible asset.

Advise and discuss the conditions necessary to be fulfilled to recognize the intangible assets in the financial statements. (MTP 3 Marks Oct '20 & April '23)

Answer 14

No Intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research shall be recognised as an expense when it is incurred since in the research phase of an internal project, an entity cannot demonstrate that an i ntangible asset exists that will generate probable future economic benefits. Thus, board of directors of PQR Ltd cannot recognize the expense as internally generated intangible asset.

An intangible asset shall be recognised if, and only if:

(i) the said asset is identifiable;

(ii) the entity controls the asset i.e. the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits;

(iii) it is probable that future economic benefits associated with the asset will flow to the entity;

(iv) the cost of the item can be measured reliably.

Question 15

Auditor of ABC Ltd while auditing its financial statements wants to ensure whether the disclosures regarding sales has been made as required under Schedule III (Part 1) to Companies Act, 2013. Explain such disclosure requirements. (MTP 3 Marks March '21)

Answer 15

With respect to sales of the client entity, the auditor is required to ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made:

• Whether disclosure of sales in respect of each class of goods has been made.

• Whether revenue from operations is disclosed separately in the notes as revenue arising from:

• Sale of products (including excise duty)

• Sale of services

• Other operating revenues.

• Whether brokerage and discount on sales other than usual trade discount has been disclosed.

• Whether the transactions with related parties are appropriately disclosed in notes to accounts.

Question 16

From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statements as required by AS 29. What type of disclosures should be made for each class of contingent liability as at the balance sheet date? (MTP 3 Marks March '21, Apr'21)

Answer 16

Disclosure for each class of Contingent Liability: From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. As per, AS 29 an enterprise should disclose for each class of contingent liability at the balance sheet date.

(i) A brief description of the nature of the contingent liability and where practicable.

(ii) An estimate of the amount as per measurement principle as prescribed for provision in AS 29.

(iii) Indication of the uncertainty relating to outflow.

(iv) The possibility of any reimbursement.

Where any of the information as required above is not disclosed because it is not practicable to do so, that fact should be stated.

Question 17

Expenses which are essentially of a revenue nature if incurred for creating an asset or adding to its value for achieving higher productivity are regarded as expenses of a capital nature. Describe any six such expenses. (MTP 3 Marks April '21)(PYP 5 Marks May '18)

Answer 17

Expenses which are essentially of a Revenue Nature, if incurred for creating an asset or adding to its value for achieving higher productivity, are regarded as expenditure of a capital nature. Examples of capital expenditure are-

(i) **Material and wages-** capital expenditure when expended on the construction of a building or erection of machinery.

(ii) **Legal expenses-** capital expenditure when incurred in connection with the purchase of land or building.

(iii) **Freight-** capital expenditure when incurred in respect of purchase of plant and machinery.

(iv) **Repair-** Major repairs of a fixed asset that increases its productivity.

(v) **Wages-** Wages paid on installation costs incurred in Plant & machinery.

(vi) **Interest-** Interest paid for the qualification period as per AS-16 i.e. before the asset is constructed.

Whenever, therefore, a part of the expenditure, ostensibly of a revenue nature, is capitalized it is the duty of the auditor not only to examine the precise particulars of the expenditure but also the considerations on which it has been capitalized.

Question 18

"While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel but for other expenses, an auditor generally prefers to verify other attributes." Mention those attributes. (MTP 4 Marks Oct '21, PYP 5 Marks Nov '18)

Answer 18

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 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

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Examinees did not understand the requirement of question related to attributes rather than monthly trends and mentioned the use of analytical procedures like ratio analysis, trend analysis and structured modelling etc.

Question 19

Write the audit Procedure for verification of existence of Trade Receivables. (MTP 6 Marks Nov '21) (Old & New SM)

Answer 19

For Verification of Existence of Trade Receivables, the auditor should check the following:

i. Check whether there are controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice.

Ask for a period-end accounts receivable aging report and trace the balance as per the report to the general ledger.

ii. Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoice-wise and on FIFO basis i.e. previous bill is adjusted first.

iii. If any large balance is due for a long time, auditor should ask for reasons and justification for the same.

iv. A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed.

v. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

vi. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample.

vii. Where no reply is received, the auditor should perform alternate procedures regarding the balances. This could include:

viii. Agreeing the balance to cash received subsequently;

ix. Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (examination in depth for those balances)

x. If there are any related party receivables, review them for collectability as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

xi. Check that receivables for other than sales or services are not included in the list.

xii. Review a trend line of sales and accounts receivable, or a comparison of the two over time, to check if there are any unusual trends i.e. perform Analytical procedures. Make inquiries about reasons for changes in trends with the management and document the same in audit work papers

Question 20

Management of Z Ltd. wants to include all the cost incurred by the Company in valuing the cost of its inventories. The Accountant is, however, of the view that certain costs should be excluded from the cost of inventories and should be recognised as expenses for the period in which they are incurred.

What are such costs that should be excluded while determining the cost of inventories? (4 Marks Nov '21)

Answer 20

Examples of costs to be excluded in determining cost of Inventory:

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

(i) abnormal amounts of wasted materials, labour, or other production costs;

(ii) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(iii) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(iv) selling and distribution costs.

In the given situation, contention of Z Ltd. is not correct to include all the cost of its inventories while determining the cost of inventory. However, contention of accountant is correct that certain cost should be excluded from the cost of inventories and to be recognised as expenses in period in which they are incurred.

Question 21

What audit points are to be borne in mind in case of issue of "Sweat Equity Shares" by a limited company? (MTP 3 Marks Oct 19)

Answer 21

Issue of Sweat Equity Shares: As per section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares".

"Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

The auditor may see that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions are fulfilled-

(a) The issue is authorized by a special resolution passed by the company;

(b) The resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

~~(c) Not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business; and~~ (Removed as per Nov 21 amendment)

(d) Where the equity shares of the company are listed on a recognized stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

The rights, limitations, restrictions and provisions as are for the time being applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank paripassu with other equity shareholders.

Question 22

While conducting audit of Air Space Ltd, the auditor observes that it has issued shares at discount to its creditors when its debt is converted into shares in pursuance of debt restructuring scheme in accordance with any guidelines specified by the Reserve Bank of India. Discuss explaining clearly the provisions relating to discount on issue of shares and its verification by the auditor. (MTP 3 Marks March 22, RTP May 22)

OR

Any share issued by a company at a discounted price shall be void. Explain stating also the audit procedure in this regard. (MTP 3 Marks March '19)

OR

Validity and consequence of issue of shares at discount, check with respect to the provisions of the Companies Act 2013. (PYP 4 Marks, Nov'19)

OR

Management of D Ltd. has issued shares at a discount to its creditors. Explain the provisions of the Companies Act, 2013 when shares are issued at a discount to creditors?

As an auditor what will be your concern of checking in such a case? (PYP 4 Marks May '23)

Answer 22

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.

(2A) Notwithstanding anything contained in 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.

(1) 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.

The auditor needs to check

(i) the movement in share capital during the year and wherever there is any issue,

(ii) he should verify that the Company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorizing issue of share capital and the issue price.

(iii) Further, auditor should also verify that in case a company has issued 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.

In the given case of Air Space Ltd, it is clear that it can issue shares to its creditors when its debt is converted into shares in accordance with approved restructuring scheme.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Many examinees were not aware about the penal consequences to the Company.

Question 23

XYZ Ltd made huge additions to Intangible assets during the period 01-04-2021 to 31-03-2022 i.e period under audit. You have been appointed as an auditor and you want to verify the additions made to intangible assets during the period. Suggest the audit procedure to verify the additions to intangible assets. (MTP 6 Marks March 22, Sep 22)

Answer 23

1. Verify the movement in the intangible assets schedule (asset class wise like software, designs/ drawings, goodwill etc.) compiled by the management i.e. Opening balances + Additions – Deletions = Closing balances. Tally the closing balances to the entity's books of account.
2. Check the arithmetical accuracy of the movement in intangible assets schedule.

For additions during the period under audit, obtain a listing of all additions from the management and undertake the following procedures:

(i) For all material additions, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26.

(ii) Ensure that no cost related to research (or from the research phase of an internal project) gets recognized as intangible asset.

(iii) Check the certificate or report or other similar documentation maintained by the entity to verify the date of use of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit.

(iv) Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel.

(v) Verify whether proper internal processes and procedures like inviting competitive quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis.

(vi) In relation to deletions of intangible assets, understand from the management the reason and rationale for deletion and the manner of disposal. Obtain the management approval and disposal note authoring disposal of the asset from its active use.

(vii) Verify the process followed for sale of discarded asset, example inviting competitive quotes, tenders and the basis of calculation of sales proceeds. Verify that the management has accurately recorded the deletion of intangible asset (original cost and accumulated amortization up to the date of disposal) and the resultant gain/ loss on disposal in the entity's books of account.

Question 24

While auditing the accounts of ABC Ltd, a member of audit team is not clear about:

(i) the criteria regarding classification of liability into current liability and non-current liability.

(ii) Classification of Reserves and Surplus

You being the senior member of audit team guide the member of the audit team about such criteria and classification as per general instructions for preparation of balance sheet as per Schedule III. (MTP 6 Marks April 22)

Answer 24

A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

Reserves and Surplus shall be classified as:

(a) Capital Reserves;

(b) Capital Redemption Reserve;

(c) Securities Premium;

(d) Debenture Redemption Reserve;

(e) Revaluation Reserve;

(f) Share Options Outstanding Account;

(g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);

(h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

Note: A reserve specifically represented by earmarked investments shall be termed as a 'fund'.

Note: Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

Question 25

Reserves are a vital source of financing by internal means. Explain and also discuss the meaning of reserves along with revenue reserve and capital reserve.(MTP 3 Marks Sep'22)

Answer 25

Reserves are the amounts appropriated out of profits that are not intended

• to meet any liability,

• contingency,

• commitment or

• diminution in the value of assets known to exist as at the date of the Balance Sheet.

Reserves are a vital source of financing by internal means. They are held for the purpose of distribution of dividend or financing the expansion of the company or strengthening the company financially. The company utilizes the reserves according to the nature and type of such reserve. The reserves can be segregated as revenue or capital reserves.

Revenue reserves represent profits that are available for distribution to shareholders or below purposes such as:

To supplement divisible profits in lean years, to finance an extension of business,

to augment the working capital of the business or

to generally strengthen the company's financial position.

Capital Reserve represents a reserve which does not include any amount regarded as free for distribution. They can be utilized only for certain limited purposes.

Example

Securities premium, capital redemption reserve.

It may be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve shall also be in the nature of a capital reserve.

Question 26

Explain how you would verify Employee Benefit Expense incurred by a Company.(MTP 3 Marks Sep'22)

Answer 26

The auditor shall verify that:

(i) Employee benefit expense has been incurred during the period in respect of the personnel employed by the entity. Employee benefit expense does not include the cost of any unauthorized personnel.

(ii) Employee benefit expenses in respect of all personnel have been fully accounted for.

(iii) Employee benefit expenses recognized during the period relates to the current accounting period only.

(iv) Employee benefit expense has been measured/ calculated accurately.

Any adjustments such as tax deduction at source have been correctly reconciled and accounted for.

(v) Employee benefit expense has been fairly allocated between:

- Operating expenses incurred in production activities;
- General and administrative expenses; and
- Cost of personnel relating to any self-constructed assets other than inventory.

Question 27

The securities premium account may only be applied by the Company towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares. Is the statement correct. Explain.(MTP 4 Marks Oct'22, PYP 3 Marks May'19)(Old & New SM)

Answer 27

The statement is not correct.

The securities premium account may be applied by the Company for the following purposes:

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the Company;

(c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68.

Question 28

The auditor has to ensure whether PPE has been valued appropriately and as per generally accepted accounting policies and practices and also the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Explain how the auditor will verify the same.(MTP 6 Marks Oct'22)

Answer 28

The auditor has to ensure whether PPE has been valued appropriately and as per generally accepted accounting policies and practices.

The value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of PPE would be shown at higher amounts.

The auditor should:

- Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non depreciable like freehold land;
- Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 - Impairment of Assets.

To verify whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements

- 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 the original title deeds for all immoveable properties held as at the balance sheet date.
- In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not 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.
- In addition, 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 29

Explain how you would verify rent expense incurred by a Company. (MTP 3 Marks Oct'22, RTP May 19)

Answer 29

Rent expense can be verified by:

- Obtaining a month wise expense schedule along with the rent agreements.
- Verifying if expense has been recorded for all 12 months and whether the rent amount is as per the underlying agreement.
- Giving specific consideration to the escalation clause in the agreement to verify if the rent was required to be recorded on a straight line basis during the period under audit.
- Also, verifying if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity.

Question 30

While checking sales of the client, the auditor has to ensure that all sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted. Explain the audit procedures to ensure the same. (MTP 3 Marks Oct'22)

Answer 30

While checking sales of the client, the auditor has to ensure that all sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted. The auditor can perform the following procedures to ensure the same.

- Trace a few transactions from inception to completion. (Examination in depth)
- E.g: Take few sales transaction, and check from the receipt of sales order to the payment of receivable balance, every underlying document to ensure if it is properly recorded at every stage and measured accurately taking into consideration all the incentives, discounts, if any. The recognition shall be according to the revenue recognition policy of the entity.
- If the client is engaged in export sales, then compliance with AS 11 shall be ensured.
- Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.
- Compare the rate of sales affected with related parties and review them for collectability, as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

Question 31

The auditor may choose to analyse the monthly trend for Power & Fuel expense. Explain how this analysis will be performed by the auditor (MTP 4 Marks Nov '21, RTP May 19)

Answer 31

Power and fuel expense -

- Obtain a month wise expense schedule along with the power bills.
- Verify if expense has been recorded for all 12 months.
- Also, compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis.
- In relation to the units consumed, analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends.

Question 32

BNP Ltd has reduced its Share Capital to a greater extent in the year for which you are conducting the audit. State how will you proceed for verifying the reduction of Capital. (MTP 6 Marks Oct 20)

Answer 32

Reduction of Capital

For verifying reduction of capital, the auditor needs to undertake the following procedures:

(i) Verify that the meeting of the shareholders held to pass the special resolution was properly convened and that the proposal was circularized in advance to all the shareholders;

(ii) Verify that the Articles of Association authorizes reduction of capital;

(iii) Examine the order of the Tribunal confirming the reduction and verify that a copy of the order and the minutes have been registered and filed with the Registrar of Companies;

(iv) Check the Registrar's Certificate as regards to reduction of capital;

(v) Vouch the accounting entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also check whether the requirements of Schedule III, Part I, have been complied with in relation to presentation;

(i) Confirm whether the revaluation of assets has been properly disclosed in the Balance Sheet;

(ii) Verify the adjustment made in the members' accounts in the Register of Members and confirm that either the paid up amount shown on the old share certificates has been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled;

(iii) Confirm that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet.

(iv) Verify that the Memorandum of Association of the company has been suitably amended.

Question 33

What are the required disclosures for cash & Cash equivalents to be made by the company as per Schedule III (Part I) to Companies Act, 2013? (MTP 4 Marks March '23, RTP May 23, PYP 3 Marks Dec'21, New SM)

Answer 33

The following are the required disclosures for cash & Cash equivalents to be made by the company as per Schedule III (Part I) to Companies Act, 2013:

Cash and cash equivalents

(i) Cash and cash equivalents shall be classified as:

  (a) Balances with banks;

  (b) Cheques, drafts on hand;

  (c) Cash on hand;

  (d) Others (specify nature)

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months' maturity shall be disclosed separately.

Question 34

Study mate Limited is a company engaged in the manufacture of stationery items. The company sells its goods on credit. The debtors as on 31.03.2022, amounted to ₹ 10 crores. What is the disclosure requirement for the company with respect to the ageing schedule of the trade receivables in terms of Schedule III (Part I) to the Companies Act, 2013? (MTP 6 Marks March '23)

Answer 34

The following is the disclosure requirement for Study mate Limited with respect to the ageing schedule of the trade receivables in terms of Schedule III (Part I) to the Companies Act, 2013

Trade Receivables ageing schedule

						(Amount in ₹)
Particulars	**Outstanding for following periods from due date of payment#**					
	Less than 6 months	**6 months-1 year**	**1-2 years**	**2-3 years**	**More than 3 years**	**Total**
(i) Undisputed Trade receivables – considered good						
(ii) Undisputed Trade Receivables – considered doubtful						
(iii) Disputed Trade Receivables considered good						
(iv) Disputed Trade Receivables considered doubtful						

similar information shall be given where no due date of payment is specified, in that case disclosure shall be from the date of the transaction.

Unbilled dues shall be disclosed separately.

Question 35

Name the assertion that the auditor will check by performing the following audit procedures.

a) Employees benefit expense in respect of all personnel have been fully accounted for.

b) Discounts on sales has been properly adjusted/ accounted for.

c) Employee benefit expense recorded during the period relates to the current accounting period only. (MTP 3 Marks March '23)

Answer 35

(a) Completeness

(b) Measurement

(c) Cut Off

Question 36

CA Mehta is the statutory auditor of ABC Ltd. While performing testing of additions during the year, he wanted to verify that:

(i) All PPE (property, plant and equipment) are in the name of the entity he is auditing.

(ii) For all additions to land and building in particular, the auditor desires to have concrete about the ownership.

(iii) The auditor wants to know whether the entity has valid legal ownership rights over the PPE, where it is kept as security for any borrowings.

Advise the auditor on the audit procedure to be undertaken by him to establish the Rights and Obligations of the entity over the PPE. (MTP 3 Marks April '23, PYP 4 Marks Dec '21)

Answer 36

Audit procedure to establish Rights and Obligations of the entity over PPE:

(i) In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, CA Mehta, the statutory auditor of ABC Ltd, 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. Verify whether the PPE additions have been approved by authorized personnel.

(ii) For all additions to land, building in particular, CA Mehta, the statutory auditor of ABC Ltd, should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

(i) The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date.

(ii) In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, CA Mehta, the statutory auditor of ABC Ltd 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.

(iii) In addition, 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 37

Examine with reasons (in short) whether the following statements are correct or incorrect:

Dividends are recognized in the statement of profit and loss only when the amount of dividend can be measured reliably. (MTP 2 Marks Sep '23, PYP 2 Marks, Nov '20, old & New SM)

Answer 37

Incorrect: Dividends are recognised in the statement of profit and loss only when:

(i) the entity's right to receive payment of the dividend is established;

(ii) it is probable that the economic benefits associated with the dividend will flow to the entity; and

(iii) the amount of the dividend can be measured reliably.

Question 38

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

Less:			(₹)
	Plant and Machinery (at Cost)		**4,00,000**
	Depreciation:		
	Up to Previous year	**1,40,000**	
	For the year	**26,000**	**1,66,000**
			2,34,000

(i) Indicate different assertions in respect of account balances at period end.

(ii) State specific assertions relating to the above extract of financial statement. (MTP 6 Marks Sep '23, MTP 6 Marks April 19, March'21)

Answer 38

(i) Assertions about account balances at the period end:

(a) Existence – assets, liabilities, and equity interests exist.

(b) Rights and obligations – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(c) Completeness – all assets, liabilities and equity interests that should have been recorded have been recorded.

(d) Valuation and allocation – assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(ii) The specific assertions are as follows:

(1) the firm owns the plant and machinery;

(2) the historical cost of plant and machinery is ₹ 4 lacs;

(3) the plant and machinery physically exists;

(4) the asset is being utilised in the business of the company productively;

(5) total charge of depreciation on this asset is ₹ 1,66,000 to date on which ₹ 26,000 relates to the year

in respect of which the accounts are drawn up; and

(6) the amount of depreciation has been calculated on recognised basis and the calculation is correct.

Question 39

Discuss the audit procedures generally required to be undertaken by the auditor while auditing Goods sent out on Sale or Return Basis. (MTP 3 Marks Sep '23, PYP 3 Marks Nov '20, Old & New SM)

Answer 39

The audit procedure generally required to be undertaken by the auditor while auditing Goods sent out on Sale or Return Basis is as under:

(i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.

(ii) Verify that price of such goods is unloaded from the sales account and the trade receivables record. Check the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

(iii) Ensure that the goods in respect of which the period of approval has expired at the end of the year, have either been received back or customers' accounts have been debited.

(iv) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the end of the year lying with the party, has been included in the closing inventory.

Question 40

ABC Ltd. wants to buy some equipment on lease and hence is required to sign lease agreement with the supplier of the equipment. What are the important points to be considered in the lease agreement? (MTP 4 Marks Sep '23)

Answer 40

The important points to be examined in the lease agreement are:

(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 assigning the subletting the equipment and authorises the lessor to do so.

Question 41

Examine with reasons (in short) whether the following statements are correct or incorrect:

PPE is/are depreciated when the asset is actually put to active use. (MTP 2 Marks Oct '23, New SM)

Answer 41

Incorrect: Depreciation is a fall in value of asset due to obsolescence, usage and effluxion of time, Therefore, depreciation is charged when the asset is ready for use. Active use of asset is not a mandatory criteria for charge of depreciation.

Question 42

Depreciation and amortisation expense generally constitute an entity's significant part of overall expenses and have direct impact on the profit/loss of the entity. What are the attributes, the Auditor needs to consider while verifying Depreciation and amortisation expense. (MTP 4 Marks Oct'23)

Answer 42

Depreciation and amortisation generally constitute an entity's significant part of overall expenses and have direct impact on the profit/ loss of the entity, hence auditors need to verify and ensure that such expenditure is appropriate, accurately calculated and has been accounted as per applicable provisions of Companies Act or other statutes, to the extent applicable on the respective industry and as per generally accepted accounting principles.

Auditor needs to consider the following attributes while verifying the depreciation and amortisation expense:

- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- Ensure the Company's policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act/ applicable accounting standards.
- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.

- Whether all depreciation and amortisation charges are recorded in the appropriate period.
- Ensure the parts (components) of each item of property, plant and equipment that are to be depreciated separately have been properly identified.
- Whether the most appropriate depreciation method for each separately depreciable component has been used.

Question 43

The auditor of Saturn Ltd. wants to verify whether the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2023. What audit procedures should the statutory auditor of the company perform? (MTP 4 Marks Oct'23, New SM)

Answer 43

The statutory auditor of Saturn 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 31.03.2023. The auditor should:

- 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 44

While verifying the legal and professional expenses of the client company, what audit procedures should the auditor perform? (MTP 3 Marks March '23)

Answer 44

While verifying the legal and professional expenses of the client company, the auditor should perform the following audit procedures

- Obtain a month-wise and consultant-wise summary.
- In case of monthly retainership agreements, verify whether the expenditure for all 12 months has been recorded correctly.
- For non- recurring expenses, select a sample and vouch for the attributes discussed above.
- The auditor should be cautious while vouching for legal expenses as the same may highlight a dispute for which the entity may not have made any provision and the matter may also not have been discussed/ highlighted to the auditor for his specific consideration.

Question 45

Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP), also commonly referred to as accounting standards (AS). In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable accounting standards. Explain with example stating the relevant assertions involved in this regard. Also explain financial statement audit. (RTP May '20)

Answer 45

Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP), also commonly referred to as accounting standards (AS).

A financial statement audit comprises the examination of an entity's financial s statements and accompanying disclosures by an independent auditor. The result of this examination is a report by the auditor, attesting to the truth and fairness of presentation of the financial statements and related disclosures.

In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding:

- completeness;
- cut-off;
- existence/ occurrence;
- valuation/ measurement;
- rights and obligations; and
- presentation and disclosure of assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable accounting standards.

Example

If Company X's balance sheet shows building with carrying amount of ₹ 50 lakh, the auditor shall assume that the management has claimed/ asserted that:

- The building recognized in the balance sheet exists as at the period- end (existence assertion);
- Company X owns and controls such building (Rights and obligations assertion);
- The building has been valued accurately in accordance with the measurement principles (Valuation assertion);
- All buildings owned and controlled by Company X are included within the carrying amount of ₹ 50 lakh (Completeness assertion).

Question 46

What does the Valuation assertion mean in respect of Assets, liabilities and equity balances? Explain with the help of example in respect of Inventory. (RTP May '20)

Answer 46

Meaning of Valuation Assertion– Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Example of Inventory explaining the valuation assertion is given hereunder: Inventory has been recognized at the lower of cost and net realizable value in accordance with AS 2 - Inventories. 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 (egg. FIFO, Weighted average etc.) has been used to value inventory as at the period-end.

Question 47

One of the key principles of accrual basis of accounting requires that an asset's cost is proportionally expensed based on the period over which the asset is expected to be used. (RTP Nov'20)

Answer 47

Correct: One of the key principles of accrual basis of accounting requires that an asset's cost is proportionally expensed based on the period over which the asset is expected to be used. Both depreciation and amortization are methods that are used to prorate the cost of a specific type of asset over its useful life. Depreciation represents systematic allocation of the depreciable value of an item of PPE over its useful life while amortization represents systematic allocation of the depreciable amount of an intangible asset over its useful life.

Question 48

How will you vouch/verify the following?

(a) Trademarks and copyrights

(b) Investments income in the case of charitable institutions

(c) Contingent liabilities

(d) Leasehold rights (RTP Nov'20)

Answer 48

a) Trademarks and Copyrights:

(i) Obtain schedule of Trade Marks and Copyrights duly signed by the responsible officer and scrutinise the same and confirm that all of them are shown in the Balance Sheet.

(ii) Examine the written agreement in case of assignment of Copyrights and Assignment Deed in case of transfer of trade marks. Also ensure that trademarks and copyrights have been duly registered.

(iii) Verify existence of copyright by reference to contract between the author & the entity and note down the terms of payment of royalty.

(iv) See that the value has been determined properly and the costs incurred for the purpose of obtaining the trademarks and copyrights have been capitalised.

(v) Ascertain that the legal life of the trademarks and copyrights has not expired.

(vi) Ensure that amount paid for both the intangible assets is properly amortised having regard to appropriate legal and commercial considerations, as per the principles enunciated under AS 26 on Intangible Assets.

b) Investment Income in the case of Charitable Institution:

(i) Vouching the amounts received with the dividend and interest counterfoils.

(ii) Checking the calculations of interest received on securities bearing fixed rates of interest.

(iii) Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.

(iv) Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

c) Contingent liabilities:

(i) Inspect the minute books of the company to ascertain all contingent liabilities known to the company.

(ii) Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating therefrom.

(iii) Scrutinise the lawyer's bills to track unreported contingent liabilities.

(iv) Examine bank letters in respect of bills discounted and not matured.

(v) Examine bank letters to ascertain guarantees on behalf of other companies or individuals.

(vi) Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.

(vii) Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.

(viii) Ensure that proper disclosure has been made as per Schedule III to the Companies Act, 2013 and AS 29, "Provisions, Contingent Liabilities and Contingent Assets".

d) Leasehold Rights:

(i) Inspect the lease or assignment thereof to ascertain the amount of premium, if any, for securing the lease, and its terms and conditions; and that the lease has been duly registered. A lease exceeding one year is not valid unless it has been granted by a registered instrument.

(ii) Ascertain that all the conditions, the failure to comply with which might result in the forfeiture or cancellation of the lease, e.g., payment of ground rent on the due dates, insurance of property, its maintenance in a satisfactory state of repairs, etc. prescribed by the lease, are being duly complied with.

(iii) Examine the counterpart of the tenants' agreements, if part of the leasehold property has been sublet.

(iv) Make certain that due provisions for any claim that might arise under the dilapidation clause on the expiry of the lease has been made, and, if no such provision has been made, draw the client's attention to the matter.

(v) Ensure that the outlay as well as any legal expenses incurred to acquire the leases which are shown as an asset in the Balance Sheet is being written off at a rate which could completely wipe off the asset over the unexpired term of the lease.

Question 49

A significant and important audit activity is to contact banks/ financial institution s directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, etc. as at the end of the reporting period under audit. Explain the audit procedure in this context. (RTP Nov'20)

Answer 49

Direct confirmation procedure

- A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account,

cash credit accounts, restrictive use accounts like dividend, escrow accounts as of the end of the reporting period under audit. This should necessarily be done for all account balances as at the period-end.

- The Company should be asked to investigate and reconcile the discrepancies, if any, including seeking written explanations/ clarifications from the banks/ financial institutions on any unresolved queries.
- The auditor should emphasize for confirmation of 100% of bank account balances. In remote situations, where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include:
- Agreeing the balance to bank statement received by the Company or internet/ online login to account in auditor's personal presence;
- Sending the audit team member to the bank branch along with the entity's personal to obtain balance confirmation from the bank directly.

Question 50

List out the steps to be taken by auditor while vouching/ verifying the 'Refund of General Insurance premium paid'. (RTP May '21)

Answer 50

Refund of General Insurance Premium paid: The refund of insurance premium may be because of earlier provisional payment of premium or may be a policy might have been cancelled at a later date. The auditor should take following steps while vouching such refunds:

(i) Ascertain the reasons for refund of insurance premium.

(ii) Examine insurance policy or cover note to find out the amount of premium.

(iii) Verify advice of refund received from the insurance company. When refund is admitted, the insurance company sends the advice. This will be evidence as a covering letter to the cheese for the refund. Sometimes, a cheese is issued after a receipt is sent in advance to the insurance company.

(iv) Scrutinize correspondence between the insurance company and the client.

(v) Check entries in the bank book or the bank statement. If necessary, the counterfoil of the pay-inslips can also be verified.

Question 51

Newton Ltd. has made loans and advances on the basis of following securities to various borrowers. As an auditor what type of documents can be verified to ensure that the company holds a legally enforceable security?

(i) Shares and Debentures

(ii) Life Insurance Policy

(iii) Hypothecation of goods. (RTP May '21)

Answer 51

Documents to be seen in case of Securities:

Types of Security	Documents etc. to be seen
(I) Shares and debentures (ii) Life Insurance Policy. (iii) Hypothecation of goods	The scrip and the endorsement thereon of the name of the transferee, in the case of transfer. Assignment of policy in favor of the lender, duly registered with the insurer Deed of hypothecation or other document creating the charge, together with a statement of inventories held at the Balance Sheet date

Question 52

State with reason (in short) whether the following statements are true or false:

Computer software which is the integral part of the related hardware should be treated as fixed asset/tangible asset. (RTP Nov '21)

Answer 52

Correct: As per AS-26 on Intangible Assets, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. Therefore, computer software which is the integral part of the related hardware should be treated as fixed asset/tangible asset.

Question 53

APQ Ltd. deals in real estate and classifies all of its land holding under current assets as inventory. The same is, therefore valued at cost or market value whichever is less. How would you verify profit or loss arising on sale of plots of land by such a dealer? (RTP Nov '21)

Answer 53

Verification of Profit & Loss Arising on sale of Plots by real estate dealer: The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value whichever is less. The amount of profit or loss arising on sale of plots of land by such a dealer should be verified as follows:

(i) Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realised for it.

(ii) This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinized.

(iii) If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.

(iv) Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.

(v) The prices obtained for various plots of land sold should be checked with the plan map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be very feed on a reference to certified copies of sale deeds executed.

(vi) Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.

Question 54

ABC Ltd. has issued shares for cash at a premium of Rest 450, that is, at amount in excess of the nominal value of the shares which is Rest 10 for cash. Section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account. Advise the means in which the amount in the account can be applied. (RTP May '18, Old & New SM)

Answer 54

Shares Issued at Premium: In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the means in which the amount in the account can be applied. As per the section, where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account" and the provisions of this Act relating to reduction of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.

Application of securities premium account: The securities premium account may be applied by the Company:

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the Company;

(a) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(b) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(c) for the purchase of its own shares or other securities under section 68.

The auditor needs to verify whether the premium received on shares, if any, has been transferred to a "securities premium account" and whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above.

Question 55

State with reason (in short) whether the following statements are true or false:

The preparation of financial statements does not involve judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. (RTP Nov 18)

Answer 55

Incorrect: The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.

Question 56

Reserves are amounts appropriated out of profits whereas on the contrary, provisions are amounts charged against revenue. Discuss explaining the difference between the two and also explain clearly revenue reserve and capital reserve. (RTP May '19)

Answer 56

Reserves are amounts appropriated out of profits that are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist as at the date of the Balance Sheet.

On the contrary, provisions are amounts charged against revenue to provide for:

(i) Renewal or diminution in the value of assets; or

(ii) a known liability, the amount whereof could only be estimated and cannot be deter- mined with accuracy; or

(iii) a claim which is disputed.

Amounts contributed or transferred from profits to make good the diminution in value of assets due to the fact that some of them have been lost or destroyed as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions. Provisions are normally charged to the Statement of Profit and Loss before arriving at the amount of profit. Reserves are appropriations out of profits.

Difference between Reserves and Provisions

The difference between the two is that provisions are amounts set aside to meet specific/ identified liabilities or diminution in recoverable value of assets. These must be provided for regardless of the fact whether the Company has earned profit or not.

Reserves on the other hand, represent amounts appropriated out of profits, held for equalising the dividends of the company from one period to another or for financing the expansion of the company or for generally strengthening the company financially.

If we examine the Balance Sheet of a company, at a given time, and deduct the total liabilities to outside trade payables from the value of assets shown therein, the difference between the two figures will represent the net worth of the company based on the book values of assets as on that date. The same shall include the capital contributed by the shareholders as well as total undistributed profit held either to the credit of the Statement of Profit and Loss or to reserves; the reserves again will be segregated as revenue or capital reserves.

Revenue reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose

Examples - to supplement divisible profits in lean years, to finance an extension of business, to augment the working capital of the business or to generally strengthen the company's financial position.

Capital Reserve, on the other hand represents a reserve which does not include any amount regarded as free for distribution through the Statement of Profit and Loss

Examples - share premium, capital redemption reserve.

It may be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve shall also be in the nature of a capital reserve.

A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But the amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.

Question 57

Explain how you will verify the items given while conducting an audit of an entity:

(a) Recovery of Bad debts written off (RTP May '22, Nov'21)

(b) Receipt of Insurance claims (RTP May '22, Nov'21)

(c) Payment of Taxes (RTP May '22, Nov'21)

Answer 57

(a) Recovery of Bad Debts written off: Recovery of bad debts written off is verified with reference to relevant correspondence and proper authorisation.

(i) Ascertain the total amount lying as bad debts and verify the relevant correspondence with the trade receivables whose accounts were written off as bad debt.

(ii) Ensure that all recoveries of bad debts have been properly recorded in the books of account.

(iii) Examine notification from the Court or from bankruptcy trustee. Letters from collecting agencies or from account receivables should also be seen.

(iv) Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.

(v) Vouch acknowledgement receipts issued to account receivables or trustees.

(vi) Review the internal control system regarding writing off and recovery of bad debts

(b) Receipt of Insurance Claims: Insurance claims may be in respect of fixed assets or current assets. While vouching the receipts of insurance claimsa.

The auditor should examine a copy of the insurance claim lodged with the insurance company correspondence with the insurance company and with the insurance agent should also be seen. Counterfoils of the receipts issued to the insurance company should also be seen.

b. The auditor should also determine the adjustment of the amount received in excess or short of the value of the actual loss as per the insurance policy.

c. The copy of certificate/report containing full particulars of the amount of loss should also be verified.

d. The accounting treatment of the amount received should be seen particularly to ensure that revenue is credited with the appropriate amount and that in respect of claim against asset, the Statement of Profit and Loss is debited with the short fall of the claim admitted against book value, if the claim was lodged in the previous year but no entries were passed, entries in the Statement of Profit and Loss should be appropriately described.

(c) Payment of Taxes:

a. Obtain the computation of taxes prepared by the auditee and verify whether it is as per the Income Tax Act/GST Act/ Rules/ Notifications/ Circulars etc.

b. Examine relevant records and documents pertaining to payment of advance income tax and self assessment tax.

c. Payment on account of income-tax and other taxes like GST consequent upon a regular assessment should be verified by reference to the copy of the assessment order, notice of demand and the receipted challan acknowledging the amount paid.

d. The penal interest charged for non-payment should be debited to the interest account.

e. Nowadays, electronic payment of taxes is also in trend. Such electronic payment of taxes by way of internet banking facility or credit or debit cards shall also be verified.

f. The assessee can make electronic payment of taxes also from the account of any other person. Therefore, it should be verified that the challan for making such payment is clearly indicating the PAN No./TAN No./TIN No./GSTIN etc. of the assessee on whose behalf the payment is made.

Question 58

Name the assertions for the following audit procedures:

(i) Year end inventory verification.

(ii) Depreciation has been properly charged on all assets.

(iii) The title deeds of the lands disclosed in the Balance Sheet are held in the name of the company.

(iv) All liabilities are properly recorded in the financial statements.

(v) Related party transactions are shown properly.(RTP Nov'22, MTP 4 Marks Oct '23)

Answer 58

(i) Year-end inventory verification: Existence Assertion.

(ii) Depreciation has been properly charged on all assets: Valuation Assertion.

(iii) Title deed of lands disclosed in the Balance Sheet are held in the name of the Company: Rights & Obligations Assertion.

(iv) All liabilities are properly recorded in the financial statements: Completeness.

(v) Related party transactions are shown properly: Presentation & Disclosure.

Question 59

PK Pvt Ltd, based in Moradabad, is engaged in export of brassware goods. The company has huge export receivables as on 31st March 2022. It is also analysed from Export Sales account of the company that large number of small shipments were almost despatched daily during month of March 2022. List out few audit procedures you would adopt as an auditor to verify completeness assertion of export trade receivables. (RTP Nov'22)

Answer 59

Completeness assertion in respect of account balances means that all balances which should have been recorded have been recorded. The auditor needs to satisfy himself about cut off so that there is no understatement or overstatement in account balances of export receivables.

In this context, while verifying completeness assertion of export trade receivables, following audit procedures are required: -

(1) Check that in respect of invoices raised in last few days nearing the cut off date, goods have been actually dispatched and not lying with the company.

(2) Check stock records, e-way bill, and transporter receipt regarding actual movement of goods. It would provide assurance that export invoices in respect of which revenue was booked have been actually moved out of company's premises.

(3) Ensure that all goods invoiced prior to cut off date/year end have been included in export receivables on test check basis.

(4) Ensure that no goods despatched after year end have been included in export receivables by tracing entries in export sales, stock records of next year. The same can be verified from e-way bills also.

(5) Match invoices to despatch/shipping details. Further match invoices dates to dispatch dates to see if sales are being recorded in correct accounting period.

(6) Test invoices in receivable report. Select invoices from ageing report of export receivables and compare them with supporting documentation to ensure that these are billed with correct names, dates and amounts.

Question 60

State with reason (in short) whether the following statements are true or false:(RTP Nov '19) An intangible asset is an identifiable monetary asset.

Answer 60

Incorrect: An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Question 61

CA Saurabh is the statutory auditor of UVW Ltd. for the FY 20 -21. While verifying the purchases made by UVW Ltd., CA Saurabh decided to perform analytical procedures to obtain audit evidence regarding the overall reasonableness of purchase quantity and price of purchases. What analysis should CA Saurabh perform? (RTP May '23)

Answer 61

CA Saurabh should perform following analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price:

(i) **Consumption Analysis:** He 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:** He should 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:** He should compare the creditors' turnover ratios and stock turnover ratios of the current year with previous years.

He should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.

Question 62

State with reason (in short) whether the following statements are true or false:

Internally generated Goodwill can be recognized as an asset. (RTP Nov '23)

Incorrect: As per AS-26, internally generated goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

Answer 62

State with reason (in short) whether the following statements are true or false:

An unexplained decrease in GP Ratio may result due to fictitious sales. (RTP Nov '23 & Nov '22)

Incorrect: A fictitious sale will increase the GP Ratio, instead of decreasing it. GP ratio normally comes down if there are unrecorded sales or reversal of fictitious sale entries recorded in the previous year or fictitious purchase or decrease in closing stock.

Question 63

M/s MP & Co, Chartered Accountants, have been appointed as auditors of LMP Private Limited. The partner of the firm asked the Audit assistant to carry out the 'examination-in- depth' of the payment made to a creditor. Advise him about the documents to be verified. (RTP Nov '23)

Answer 63

Examination – in depth of the payment made to creditor: The Audit Assistant of M/s MP & Co., should verify the following documents of LMP Private Limited in case of payment to a creditor is to be verified "in depth":

(i) The invoice and statement of account received from the supplier.

(ii) The entry in the inventory record showing that the goods were received.

(iii) The Goods Received Note and Inspection Certificate showing that the goods on receipt were verified and inspected.

(iv) The copy of the original order and authority showing that the goods in fact were ordered by an authority which was competent to do so.

Question 64

(a) As an auditor, how will you verify the hire purchase transaction in the case of an entity engaged in the business of hire purchase?

(b) A junior accountant of a limited company has not separated transactions of one period from those in the ensuing period. As an Auditor, state the correct procedure to be followed and the areas in which it can be applied. (RTP Nov '23)

Answer 64

(a) Verification of Hire-purchase transactions: While checking the hire-purchase transaction, the auditor may examine the following:

1. Hire purchase agreement is in writing and is signed by all parties.

2. Hire purchase agreement specifies clearly -

(i) The hire-purchase price of the goods to which the agreement relates;

(ii) The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;

(iii) The date on which the agreement shall be deemed to have commenced;

(iv) The number of instalments by which the hire-purchase price is to be paid, the amount of each of those instalments, and the date, or the mode of determining the date, upon which it its payable, and the person to whom and the place where it is payable; and

(v) The goods to which the agreement relates, in a manner sufficient to identify them.

3. Ensure that payments are being received regularly as per the agreement.

(b) Cut-off Arrangement:

1. Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separated from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for this purpose is technically known as "cut-off arrangement".

2. It essentially forms part of the internal control system of the organisation.

3. Accounts, other than sales, purchase and inventory are not usually affected by the continuity

of the business and therefore, this arrangement is generally applied only to sales, purchase and inventory.

4. The auditor satisfies by examination and test-checks that the cut-off procedures are adequately followed and ensure that:

(i) Goods purchased, property in which has already been passed on to the client, have in fact been included in the inventories and that the liability has been provided for in case credit purchase.

(ii) Goods sold have been excluded from the inventories and credit has been taken for the sales. If the value of sales is to be received, the concerned party has been debited.

5. The auditor may examine a sample of documents, evidencing the movement of inventory into and out of stores, including documents pertaining to period shortly before and after the cut-off date and check whether inventories represented by those documents were included or excluded as appropriate during inventory taking for perfect and correct presentation in the financial statements.

Question 65

While verifying the PPE of the client entity, the auditor also needs to consider whether the PPE has been valued appropriately and as per the generally accepted accounting principles and practices. Explain. (RTP May '23)

Answer 65

While verifying the PPE of the client entity, the auditor also needs to consider whether the PPE has been valued appropriately and as per the generally accepted accounting principles and practices. The auditor should:

- Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is nondepreciable like freehold land;
- Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 - Impairment of Assets.

Question 66

As statutory auditor of the company, list out audit procedures required to be undertaken for the following:

(i) Interest income from fixed deposits (PYP 4 Marks, May'18)

(ii) Dividend income. (PYP 2 Marks, May'18)

(iii) Gain/(loss) on sale of investment in Mutual funds. (PYP 2 Marks, May'18)

Also indicate disclosure requirements of above as per Companies Act, 2013. (PYP 2 Marks, May'18)

Answer 66

(i) For verifying interest income on fixed deposits:

- Obtain a listing of fixed deposits opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period. Verify the arithmetical accuracy of the interest calculation made by the entity by multiplying the deposit amount with the applicable rate and number of days during the period under audit.
- For deposits still outstanding as at the period- end, trace the same to the direct confirmation obtained from the respective bank/ financial institution.
- Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity.
- Also, obtain a copy of Form 26AS (TDS withholding by the bank/ financial institution) and reconcile the interest reflected therein to the calculation shared by client.

(ii) Dividend Income: For Dividends, verify that the same are recognized in the statement of profit and loss only when the entity's right to receive payment of the dividend is established, provided it is probable that the economic benefits associated with the dividend will flow to the entity and the amount of the dividend can be measured reliably.

(iii) Gain/(loss) on sale of investment in mutual funds: Verify that Gain/(loss) on sale of investment in mutual funds is recorded as other income only on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments. For the purpose, obtain the mutual fund statement and trace the gain / loss as recorded in the books of account to the gain/ loss as reflected in the statement.

Disclosure Requirements: Ensure whether the following disclosures as required under Ind AS compliant Schedule III to Companies Act, 2013 have been made:

Whether 'other income" has been classified as:

• Interest income

• Dividend income

• Other non-operating income (net of expenses directly attributable to such income)

Question 67

While reviewing Employee benefits expenses of a company, how you as an auditor you will evaluate its hiring, appraisal and retirement process? (PYP 3 Marks, May'19)

Answer 67

While reviewing Employee Benefits expenses auditor needs to obtain a clear understanding about the organization and its hiring, appraisal and retirement process in the following manner:

i. The auditor first tests the controls the company has set around the employee benefit payment process to determine how strong and reliable they are. I they are strong; the auditor can minimize the amount of transaction testing he must do. Common internal controls over the employee benefit payment cycle includes maintaining of attendance records, authorization and approval of monthly payroll processing and disbursement.

ii. The auditor selects a random sample of transactions and examines the related appointment letters, appraisal letters, attendance records, HR policies, employee master etc.

iii. The auditor performs Substantive analytical procedure consisting of monthly expense reasonability, comparison with previous accounting period, any analysis auditor may find relevant and most important of all setting an expectation in relation to the expense incurred during the period under audit and compare that with the client's business operations and overall trend in the industry.

Question 68

"Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets." State any three examples of such occurrence of misappropriation of such assets. (PYP 4 Marks, Nov'19)

Answer 68

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

(i) Inadequate segregation of duties or independent checks.

(ii) Inadequate oversight of senior management expenditures, such as travel and other reimbursements

(iii) Inadequate record keeping with respect to assets.

(iv) Inadequate system of authorization and approval of transactions (for example, in purchasing).

(v) Inadequate physical safeguards over cash, investments, inventory, or fixed assets.

(vi) Lack of complete and timely reconciliations of assets.

(vii) Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.

(i) Lack of mandatory vacations for employees performing key control functions.

(ii) Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.

(iii) Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Question 69

ABC limited appointed XYZ & Company, Chartered Accountants, as a Statutory Auditor of the Company for the year 2019-20. CA X, partner of XYZ & Company, was looking after the audit of other income of the company which consists of interest income on fixed deposits. As a Statutory Auditor how would CA X verify interest income on fixed deposits for the year 2019-20? (PYP 4 Marks, Nov'20)

Answer 69

CA X, partner of XYZ & Company, would carry out the following audit procedure for verifying interest income on fixed deposits of ABC Limited:

1. Obtain a listing of fixed deposits opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period.

   Verify the arithmetical accuracy of the interest calculation made by the entity by precomputing i.e. multiplying the deposit amount with the applicable rate and number of days during the period under audit.
2. For deposits still outstanding as at the period- end, trace the same to the direct confirmations obtained from the respective bank/ financial institution.
3. Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity.
4. Also, obtain a copy of Form 26AS (TDS withholding by the bank/ financial institution) and reconcile the interest reflected therein to the calculation shared by client.

Question 70

Depreciation and amortization expense generally constitute an entity's significant part of overall expenses and have direct impact on the profit/loss of the entity. What are the attributes, the Auditor needs to consider while verifying Depreciation and amortization expense? (PYP 4 Marks, Jan'21 & May '18)

Answer 70

Depreciation and amortization generally constitute an entity's significant part of overall expenses and have direct impact on the profit/ loss of the entity, hence auditors need to verify and ensure that such expenditure is appropriate, accurately calculated and has been accounted as per applicable provisions of Companies Act or other statutes, to the extent applicable on the respective industry and as per generally accepted accounting principles.

Auditor needs to consider the following attributes while verifying for depreciation and amortization expenses:

- Obtain the understanding of entity's accounting policy related to depreciation and amortization.
- Ensure the Company policy for charging depreciation and amortization is as per the relevant provisions of Companies Act/ applicable accounting standards.

- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortization charges are valid.
- Whether depreciation and amortization charges are accurately calculated and recorded.
- Whether all depreciation and amortization charges are recorded in the appropriate period.
- Ensure the parts (components) of each item of property, plant and equipment that are to be depreciated separately have been properly identified.
- Whether the most appropriate depreciation method for each separately depreciable component has been used.

Question 71

ABC Limited has a closing balance of work in progress of inventories aggregating ₹ 850 lakhs in their balance sheet as at March 31, 2020.

As Statutory Auditor of ABC Limited, explain various audit procedures which need to be performed to confirm Work-in-progress of inventories have been valued appropriately and as per generally accepted accounting policies and practices. (PYP 3 Marks, Jan'21)

Answer 71

Audit procedure which needs to be performed to confirm work in progress worth Rs.850 lakhs has been valued appropriately and as per generally accepted accounting policies and practices is given hereunder:

(1) Ascertain how the various stages of production/ value add are measured and in case estimates are made, understand the basis for such estimates.

(2) 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.

(3) Ensure that material costs exclude any abnormal wastage factors.

Question 72

As a Statutory Auditor of the company list out audit procedure required to be undertaken for the recognition of following other income:

i. Interest income from fixed deposit

ii. Dividend income

iii. Gain/(loss) on sale of investment in mutual funds. (PYP 3 Marks, Jan'21)

Answer 72

Statutory auditor would perform the following audit procedure for recognition of different items given in the question:

(1) Interest income on fixed deposits is recognized on a time proportion basis taking into account the amount outstanding and the applicable interest rate.

(2) Dividends are recognized in the statement of profit and loss only when:

(i) the entity's right to receive payment of the dividend is established;

(ii) it is probable that the economic benefits associated with the dividend will flow to the entity; and

(iii) the amount of the dividend can be measured reliably.

(3) Gain/(loss) on sale of investment in mutual funds is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

Question 73

CA "X" while conducting an audit of Joyful Ltd. found a considerable increase in sales as compared to the previous year, he doubts that few fictitious sales have been recorded by the company to overstate its revenues. Discuss any four audit procedures to be undertaken by the auditor to ensure revenue from sales of goods and services performed during the period is not overstated? (PYP 4 Marks, July'21)

Answer 73

CA X, having doubts about fictitious sales being recorded by Joyful Ltd would ensure that revenue is not overstated by performing following audit procedures:

- Check whether a single sales invoice is recorded twice or a cancelled sales invoice could also be recorded.
- Test check few invoices with their relevant entries in sales journal.
- Obtain confirmation from few customers to ensure genuineness of sales transaction
- Whether any fictitious customers and sales have been recorded.
- Whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure
- Whether unearned revenue recorded as earned.
- Whether any substantial uncertainty exists about collectability
- Whether customer obligations are contingent on other actions (financing, resale etc.)

Question 74

The value of intangible assets may diminish due to efflux of time, use and/or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period. Discuss the audit procedures to be applied by the auditor to ensure that Intangible assets have been valued appropriately and as per generally accepted accounting policies and practices. (PYP 3 Marks, July'21)

Answer 74

The value of intangible assets may diminish due to efflux of time, use and/ or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period. Unless this cost in the form of amortization is charged to the accounts, the profit or loss would not be correctly ascertained and the values of intangible asset would be shown at higher amounts. The auditor should:

- Verify that the entity has charged amortization on all intangible assets;
- Verify that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

The auditor should also verify whether the management has done an impairment assessment to determine whether an intangible asset is impaired. For this purpose, the auditor needs to verify whether the entity has applied AS 28 - Impairment of Assets for determining the manner of reviewing the carrying amount of its intangible asset, determining the recoverable amount of the asset to determine impairment loss, if any

Question 75

When Profit before tax from continuing operations is non-volatile, other benchmarks will be appropriate. (PYP 2 Marks Dec '21)

Answer 75

Incorrect: Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

Question 76

When inventory under the custody and control of a third party is material to the financial statements, the auditor can obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by taking written representation from management. (PYP 2 Marks Dec '21)

Answer 76

Incorrect: 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.

Question 77

Proft and Loss account of an organization shows various types of expenses like rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc., that are essential and incidental to running of business operations. What are the attributes that an auditor generally prefers for vouching these types of expenses? (PYP 3 Marks Dec '21)

Answer 77

Attributes to be preferred for vouching other expenses:

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 documents 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.

Question 78

Whether it is possible to independently verify the correctness of some of the items of expenses included in the statement of profit and loss? Explain with the help of some examples. (PYP 3 Marks Dec '21)

Answer 78

Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss.

For instance, the cost of importing goods which are subjected to an ad-valorem duty at uniform rate

can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of excise duty/ GST paid.

Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, e.g., commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

Thus, it is important to note that 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.

Question 79

Proceedings have been initiated against False Limited for holding benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, but such property is not recorded in books of accounts. As a consultant to the company, what will you advice to the company as far as disclosure requirements are concerned in relation to said proceedings? (PYP 4 Marks May'22,MTP 4 Marks Apr'22)

Answer 79

Disclosure in case of Benami Properties held by the Company: Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, the company shall disclose the following:

(a) Details of such property, including year of acquisition,

(b) Amount thereof,

(c) Details of Beneficiaries,

(d) If property is not in the books, then the fact shall be stated with reasons,

(e) Where there are proceedings against the company under this law as an abetter of the transaction or as the transferor, then the details shall be provided,

(f) Nature of proceedings, status of same and company's view on same.

Question 80

Explain whether the following statements are correct or incorrect, with reasons/ explanations/ examples If the purpose of an audit procedure is to test for understatement in the existence or valuation of accounts payable then testing the recorded accounts payable may be relevant audit procedure. (PYP 2Marks, Jan 21)

Answer 80

Incorrect: If the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure.

On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

Question 81

State with reasons whether the following statements are correct or incorrect:

A company should disclose in its Annual Report, the shares in the company held by each shareholder holding more than 10 percent shares specifying the number of shares held. (PYP 2 Marks Nov 22)

Answer 81

Incorrect: Schedule III to the Companies Act, 2013 requires the company to disclose- "shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held" in notes to accounts.

Question 82

S& Co., Chartered Accountants, are appointed as the auditors of ABC Ltd. CA S, the engagement partner, has come across the following while verifying equity share capital of the company:

(i) He noticed that some of the equity shares are held by promoters.

(ii) Some shares are issued as sweat equity shares to the employees. What is the meaning of sweat equity shares?

What are the disclosure requirements of such promoter's shareholding? (PYP 4 Marks Nov 22)

Answer 82

Meaning of Sweat Equity & Disclosure of shares held by Promotors:

Meaning Sweat Equity Shares: According to Section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares".

"Sweat Equity Shares" mean equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

Disclosure requirements of such promoter's shareholding: A company shall disclose Shareholding of Promoters* as below:

Shares held by promoters at the end of the year				% Change during the year***
S. No.	Promoter Name	No. of shares	% of total shares**	

* Promoter here means promoter as defined in the Companies Act, 2013.

** Details shall be given separately for each class of shares.

*** percentage change shall be computed with respect to the number at the beginning of the year or if issued during the year for the first time then with respect to the date of issue.]

Question 83

M/s SS & Associates have been appointed as statutory auditors of Green 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. (PYP 4 Marks Nov 22)

Answer 83

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:

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

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

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

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

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

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

Question 84

While auditing books of accounts of SOLAR Ltd., you observed that an amount due from a debtor for invoice issued on 31.03.2022 has not been recognized in the books of accounts. As an auditor, you want to ensure that all trade receivable balances that are supposed to be recorded

have been recognized in the financial statements. How will you achieve the stated objective? (PYP 3 Marks Nov 22)

Answer 84

Audit of Trade Receivable:

All Trade receivable balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS): The auditor needs to satisfy himself of the cut-offs. Without a cut-off, sales could be understated or overstated, hence there is a need to perform the following cut off procedure:

(a) For the invoices issued during the last few days (last 5 days of the reporting year) i.e. cut-off date and which have been included in the debtors; check that the goods should have been dispatched and not lying with the Company;

(b) Ensure that all goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis;

(c) Ensure that no goods dispatched after the year- end have been invoiced and included in debtors for the period under audit.

Question 85

A Ltd. has traded for 50.00 Lacs in "TETRA", a virtual currency, during the F.Y. 2021 -2022 and earned a profit of 20.00 Lacs on it. What disclosure requirements are prescribed for such type of transactions done by the company? (PYP 3 Marks Nov 22)

Answer 85

Disclosure of Crypto Currency or Virtual Currency:

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:

(a) profit or loss on transactions involving Crypto currency or Virtual Currency

(b) amount of currency held as at the reporting date,

(c) deposits or advances from any person for the purpose of trading or investing in Crypto Currency/ virtual currency.

Question 86

Amortization represents systematic allocation of the depreciable amount of an item of Property, Plant and Equipment (PPE) over its useful life. (PYP 2 Marks May '23)

Answer 86

Incorrect: Depreciation represents systematic allocation of the depreciable value of an item of PPE over its useful life whereas amortisation represents systematic allocation of the depreciable amount of an intangible asset over its useful life.

Question 87

X Ltd. is a hardware manufacturing company. At each and every stage of production processes, large amount of scrap is generated in the factory and subsequently sold. As an auditor how will you vouch/ verify the sale of scrap? (3 Marks May '23, RTP May '22, RTP Nov'21, Old & New SM)

Answer 87

Vouching/Verification of the Sale of Scrap by Auditor would be undertaken as under:

(i) Review the internal control as regards generation, storage and disposal of scrap.

(ii) Check whether the organization is maintaining reasonable record for generation of scrap.

(iii) Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.

(iv) Check the rates at which scrap has been sold and compare the rate with previous year.

(v) Vouch sales with invoices raised, advertisement for tender, rate contract with scrap dealers.

(vi) Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.

(vii) Make an overall assessment of the value of realization from scrap as to its reasonableness.

Question 88

CA Q, the auditor of XYZ Ltd, while conducting audit observes that the company has made various provisions in the books of account. What are the audit procedures that CA Q will follow to verify the existence, completeness, and valuation of the provisions made? (PYP 3 Marks May '23)

Answer 88

Audit Procedures that CA Q will follow to verify the existence, completeness, and valuation of provisions made are given hereunder:

Existence

1. Obtain a list of all provisions and compare them with balances in the ledger.
2. Inspect the underlying agreements like agreements with customers to assess warranty commitments, any legal and other claims on the entity i.e. litigations.

Valuation

3. Wherever required, obtain the expert's report, calculation and underlying working for the provision amount. For example - for warranty involving complex calculations, some entities get that valued through an actuary.

   In such a case, the auditor may request the management to share the actuarial valuation report and in case of any matter under legal dispute, the auditor should request for assessment made by

   a legal expert in relation to likelihood of a liability devolving on the entity i.e. whether probable or possible or remote as defined above. The auditor should then verify the underlying assumptions used by the expert with the data shared by the management.

Completeness

4. Obtain the underlying working and the basis for each of the provisions made from the management and verify whether the same is complete and accurate.
5. The auditor shall obtain a written representation from the management that it has made all the provisions which were required to be made as per the recognized accounting principles.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. Which of the following is an example of revenue expenditure-

(a) Wages on installation of Machinery

(b) Regular repairs incurred on PPE

(c) Legal expenses in purchase of land and building

(d) Freight inwards on purchase of PPE (MTP 2 Marks March '21)

Ans: (b)

2. Obtaining trade receivables ageing report and analysis and identification of doubtful debts is performed during audit of accounts receivable balances to address the following balance sheet assertion:

(a) Valuation

(b) Rights and obligations

(c) Existence

(d) Completeness (MTP 1 Marks March 22)

Ans: (a)

3. ……. is a possible obligation that arises from the past events and whose existence will be confirmed only by the occurrence/ non occurrence of one or more uncertain future events not wholly within the control of the entity:-

(a) Provisions

(b) Reserves

(c) Contingent Liabilities

(d) Liability (MTP 1 Mark April 22, Oct'20, Sep 22)

Ans: (c)

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

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

Read the following statements on basis of above: -

(i) The firm owns machinery.

(ii) The machinery is being utilized in business of firm productively.

(iii) The machinery physically exists.

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

(a) Only assertions (i) and (ii) can be inferred.

(b) Only assertions (ii) and (iii) can be inferred.

(c) Only assertions (i) and (iii) can be inferred.

(d) All assertions (i), (ii) and (iii) can be inferred. (MTP 1 Marks Oct'22)

Ans: (d)

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5. Cut-off testing is performed during audit of sales to address the following assertion:

(a) Occurrence

(b) Measurement

(c) Cut-off

(d) Accuracy (MTP 1 Marks April '23)

Ans: (c)

6. _____are charges against profits to provide for known liabilities for which amounts cannot be determined with accuracy

(a) Contingent Liabilities

(b) Provision

(c) Securities Premium Reserve.

(d) Liabilities (MTP 1 Marks April '23)

Ans: (b)

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7. Financial statements of a company have been put up for audit before the auditor. On going through financial statements, he wants to verify some major bills debited in "Machinery repair" account. The purpose of it is to ensure that bills are entered correctly and their classification is proper.

As regards verification of bills debited in "Machinery repair" account, identify what he intends to perform?

(a) Tests of Controls

(b) Tests of transactions

(c) Tests of balances

(d) Risk assessment procedures (MTP 1 Mark Sep '23)

Ans: (b)

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8. The securities premium account may be applied by the Company for which of the following purpose:

(a) payment to creditors for material

(b) purchase of fixed assets

(c) repayment of loans

(d) writing off the preliminary expenses (MTP 1 Mark Sep '23)

Ans: (d)

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9. During the audit of sales, the auditor found that recorded sales represent goods which were ordered by valid customers and were dispatched and invoiced in the period. The auditor is addressing which of the following assertions:

(a) Occurrence

(b) Measurement

(c) Cut-off

(d) Accuracy (MTP 1 Mark Sep '23)

Ans: (a)

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10. ABC Ltd is engaged in manufacturing of fabrics from yarn purchased from different suppliers. Occasionally, it also manufactures fabrics tailor made in accordance with requirements of certain mills from yarn received from these mills. ABC Ltd raises bills of its labour charges only on mills for converting yarn into fabrics. The auditor of ABC Ltd tries to ensure that stocks of the company as at year end do not include stocks pertaining to these mills. Which assertion auditor tries to verify in above situation:

(a) completeness

(b) Occurrence

(c) rights and obligations

(d) cut -off (MTP 1 Mark Sep '23)

Ans: (c)

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11. is a possible obligation that arises from the past events and whose existence will? be confirmed only by the occurrence/ nonoccurrence of one or more uncertain future events not wholly within the control of the entity: -

(a) Provisions

(b) Reserves

(c) Contingent Liabilities

(d) Liability (RTP May '21)

Ans: (c)

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12. While auditing the books of accounts of QHMP Ltd., CA. Ranker, the statutory auditor of the company, came to know that the management of the company has recognized internally generated goodwill as a fixed asset. CA. Ranker discussed with the management that according to accounting standards, internally generated goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost. However, the management is quite rigid to the accounting treatment followed for internally

generated goodwill and not paying attention to the auditor. Thus, through an example, CA. Ranker explained which type of goodwill may be recognized as a fixed asset for which the management got justified. State which of the following examples the auditor must have given to the management?

(a) If an item meeting the definition of an intangible asset is acquired in a business combination, it forms part of the goodwill to be recognized at the date of the amalgamation.

(b) Only those goodwill needs to be recognized as a fixed asset which can be touched like physical assets, for example, land and buildings.

(c) Goodwill is recognised only when there is a contractual or other legal rights for a physical asset which shall not be amortized over the period.

(d) All of the above. (RTP May '19)

Ans:(a)

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13. Which of the following is not correct:-

(a) AS 18 – Related Party Disclosures

(b) AS 10 – Property, Plant & Equipment

(c) AS 28 – Impairment of Assets

(d) AS 16 – Intangible Assets (RTP May '23)

Ans: (d)

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14. ABC Limited is engaged in manufacturing of electric two-wheelers. During the year, a customer has gone to court due to incident of fire in battery-operated vehicle. The damages claimed are to tune of `5 lakhs. The company insists that this incident was due to improper charging of battery and has nothing to do with manufacturing design of vehicle. The company's lawyers advise that it is probable that company is not likely to be held liable. It is likely to be reflected in financial statements of company under?

(a) Provisions

(b) Reserves

(c) Contingent liabilities

(d) Other current Liabilities (RTP Nov '23)

Ans: (c)

CASE STUDY 1

Sunsteel Ltd. is a company engaged in the manufacture of variety of stainless steel household items ranging from hot pot, pressure cooker, cutlery set, bottles, to serving trays. The company has its corporate office in Delhi and its plant in Raigarh, a city in the state of Chhattisgarh. The company is planning to expand its manufacturing activities by setting up two new plants in the Raipur district of the state. For this purpose, the company also raised funds by making a follow-on public offer during the financial year 2022-23. R K Maheshwari & Associates are the statutory auditors of the company since the year 2020 -21. The engagement team consisted of 5 members, with CA Raman as the engagement partner, CA Madhu as the senior associate and three articled trainees namely, Aman, Chetanya and Depesh.

The company raised fresh capital of ` 5 Cr during the FY 2022-23. The shares with the nominal value of ` 10 per share were issued at a premium of ` 5 per share.

The company has the Reserves and Surplus totaling to ` 2 Cr, comprising of securities premium and general reserve.

CA Raman directed CA Madhu to verify the issue of the share capital in detail giving special consideration to the utilization of the securities premium amount.

The audit engagement team discussed with the management about the performance of the company during the year under consideration. To this, the management told the engagement team that the company is performing very well and the company has doubled its revenue during the year as compared to the last year. The management of the company also told the auditors that during the year the company has made majority of its sales on credit basis to its customers.

CA Raman directed Mr. Aman to send balance confirmation requests to debtors having balance in excess of ` 1 lakh.

During the course of audit, CA Raman, Chetanya and Depesh also visited the power plants in Raigarh to get a detailed understanding of the manufacturing process. The team performed analytical procedures to obtain audit evidence with respect to the overall reasonableness of purchase quantity and price of inventory. More specifically, Chetanya collected the reports from the management for composition of stock i.e. raw materials as a percentage of total stock and compared the same with the data of the previous year. CA Raman and Chetanya thereafter, discussed the reasons for the variations with the management.

Also, while considering the presentation and disclosure requirements as per Schedule III to the Companies Act, CA Madhu discussed with CA Raman the disclosure with respect to the following account balances:

- **Current maturities to long term borrowings**
- **Long term maturities of finance lease obligations**
- **Interest accrued but not due on borrowings**
- **Interest accrued and due on borrowings**

MULTIPLE CHOICE QUESTIONS (MCQS)

Based on above, answer the following questions: -

1. Which of the following is not correct with respect to shares issued at premium and securities premium account in terms of Section 52 of the Companies Act, 2013?

(a) Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a securities premium account.

(b) The securities premium account can be applied by the company in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares.

(c) The securities premium account cannot be applied by the company in writing off the expenses of or the commission paid or discount allowed on any issue of equity shares of the company.

(d) The securities premium account can be applied by the company for the purchase of its own shares or securities under section 68.

Ans: (c)

2. Which of the following is not an example of capital reserve?

(a) Revaluation reserve arising from revaluation of fixed assets

(b) Securities Premium

(c) Capital redemption reserve

(d) General reserve

Ans: (d)

3. Statement 1: Confirmations as well as undelivered letters should be given/ returned to the auditor and not to the client.

Statement 2: When no reply is received, the auditor should perform alternate procedures regarding the balances.

(a) Only statement 1 is correct

(b) Only statement 2 is correct

(c) Both statements 1 & 2 are correct

(d) Both statements 1 & 2 are incorrect

Ans: (c)

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4. Mr. Chetanya performed which of the following analytical procedures to obtain the audit evidence with respect to the overall reasonableness of purchase quantity and price of raw material?

(a) Consumption Analysis

(b) Stock Composition Analysis

(c) Reasonableness test

(d) Ratio analysis

Ans: (b)

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5. Which of the following is not correct with respect to the disclosure requirements of Schedule III to the Companies Act 2013?

(a) Current maturities of long term borrowings is to be disclosed under the head long term borrowings

(b) Long term maturities of finance lease obligations is to be disclosed under the head long term borrowings

(c) Interest accrued but not due on borrowings is to be disclosed under the head Other Current Liabilities

(d) Interest accrued and due on borrowings is to be disclosed under the head Other Current Liabilities

Ans: (a)

TEST YOUR KNOWLEDGE

6. An auditor is verifying purchases to ensure their genuineness. Consequently, he is also trying to verify that no fake "trade payables" are present in financial statements. Which assertions concerning purchase transactions and trade payables respectively are being verified by auditor?

(a) Occurrence; Existence

(b) Occurrence; Completeness

(c) Existence; Occurrence

(d) Completeness; Occurrence

Ans: (a)

7. Which of the following statement is most appropriate as regards to disclosure of goods in transit in financial statements of a company?

(a) No separate disclosure of goods in transit is required.

(b) Disclosure of total goods in transit under head of inventories is required.

(c) Disclosure of goods in transit under each sub-head of inventories is required.

(d) Disclosure of goods in transit for raw material and finished goods is required.

Ans: (c)

8. Sweat Equity shares are issued by a company at a discount or for consideration other than cash to its:-

(a) Directors only

(b) Clients only

(c) Directors or employees

(d) Auditors only

Ans: (c)

9. Which of the following is not an element of cost of an item of machinery included under head "Property, Plant and Equipment"?

(a) Installation costs

(b) Freight cost of bringing the item to its location

(c) Inaugural costs

(d) Employee benefit cost for making such an item suitable for production

Ans: (c)

10. Which of the classification is not required by a company in respect of its "Cash and cash equivalents?"

(a) Balance with Banks

(b) Balance with scheduled banks

(c) Cash on hand

(d) Cheques on hand

Ans: (b)

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

Question 1

Employee benefits expenses represent the sum an entity pays to its employees for their labour/ efforts only.

Answer 1

Incorrect: Employee benefits expenses, commonly called payroll expenses, represent the aggregate sum an entity pays to its employees for their labour/ efforts, as well as associated expenses such as perquisites/ benefits, post- employment benefits like gratuity, superannuation, leave encashment, provident fund contribution etc. as well as towards their hiring, their welfare and training.

Question 2

Dividends are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established.

Answer 2

Incorrect: Dividends are recognised in the statement of profit and loss only when:

(i) the entity's right to receive payment of the dividend is established;

(ii) it is probable that the economic benefits associated with the dividend will flow to the entity; and

(iii) the amount of the dividend can be measured reliably.

Question 3

"Sweat Equity Shares" means equity shares issued by the company to employees or directors at a premium or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

Answer 3

Incorrect: "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

Question 4

Capital reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose.

Answer 4

Incorrect: Revenue reserves represent profits that are available for distribution to shareholders.

Question 5

A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised.

Answer 5

Correct: A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But the amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.

Question 6

If Company X's balance sheet shows building with carrying amount of ` 100 lakh, the auditor shall assume only one point that the management has only asserted that the building recognized in the balance sheet exists as at the period-end.

Answer 6

Incorrect: If Company X's balance sheet shows building with carrying amount of ` 100 lakh, the auditor shall assume that the management has claimed/ asserted that:

- The building recognized in the balance sheet exists as at the period- end (existence assertion);
- Company X owns and controls such building (Rights and obligations assertion);
- The building has been valued accurately in accordance with the measurement principles (Valuation assertion);
- All buildings owned and controlled by Company X are included within the carrying amount of ` 100 lakh (Completeness assertion).

Question 7

The securities premium account may only be applied by the Company towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares.

Answer 7

Incorrect: The securities premium account may be applied by the Company:

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the Company;

(c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68.

Question 8

Material and wages are considered to be revenue expenditure when incurred for construction of building.

Answer 8

Incorrect: Material and Wages incurred on construction of building qualify to be capital expenditure as per AS 10 "Property, Plant and Equipment". Therefore, these have to be added to the cost of the asset i.e building and shall not be expensed off to Statement of Profit and Loss.

Question 9

PPE are depreciated when the asset is actually put to active use.

Answer 9

Incorrect: Depreciation is a fall in value of asset due to obsolescence, usage and effluxion of time, Therefore, depreciation is charged when the asset is ready for use. Active use of asset is not a mandatory criteria for charge of depreciation.

Question 10

Increase in authorised capital of the company requires special resolution to be passed at the general meeting.

Answer 10

Incorrect: Increase in Authorised capital requires alteration of capital clause of memorandum of Association. Therefore, ordinary resolution is passed for increase in authorised capital of the company as per the Companies Act, 2013.

Question 11

Capital redemption reserve can be used for distribution of dividends.

Answer 11

Incorrect: Capital Redemption reserve is not a free reserve. It is a restrictive reserve and can be used only for purposes given in the Act. Since it is not a free reserve, it cannot be utilised for payment of dividends.

CRR can be used only for the purpose of issuing fully paid up bonus shares.

Question 12

Dividends are recommended by the Board, and declared by the Shareholders.

Answer 12

Correct: The dividends are recommended by the Board of Directors by passing a resolution at the board meeting. The Shareholders declare the dividends at the AGM by passing an ordinary resolution.

Declaration of dividend is an item of ordinary business. However, the shareholders can decrease the amount of dividends recommended by the board but cannot increase it.

Question 13

In verifying Trade Receivables balance, Direct Confirmation Procedure is one of the important audit activity

Answer 13

Correct: While auditing trade receivable balance, direct confirmations as per SA 505, is considered to be the most important audit activity. Direct confirmation can be sought from the debtors directly confirming their balance due. The replies to the confirmation can be then matched with the records maintained by the client. Any discrepancies so revealed, can be investigated and checked in detail for possibility of any risk of material misstatement. Auditor selects few debtors' balances and ask the client to prepare the confirmations properly addressed to the debtors. Auditor maintains strict control over this process.

THEORETICAL QUESTIONS ANSWER

Question 1

How will you vouch and/or verify the following:

(a) Goods sent out on Sale or Return Basis.

(b) Borrowing from Banks.

Answer 1

(a) Goods Sent Out on Sale or Return Basis:

(i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.

(ii) Verify that price of such goods is unloaded from the sales account and the trade receivables record. Check the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

(iii) Ensure that the goods in respect of which the period of approval has expired at the end of the year, have either been received back or customers' accounts have been debited.

(iv) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the end of the year lying with the party, has been included in the closing inventory.

(b) Borrowing from Banks: Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows-

(i) Reconcile the balances in the overdrafts or loan accounts with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.

(ii) Obtain independent balance confirmation from the bank showing balances, particulars of securities deposited with the bank as security for the loans or of the charge created on an asset and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.

(iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.

(iv) Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.

(v) Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

Question 2

How will you vouch/verify the following:

(a) Goods sent on consignment.

(b) Foreign travel expenses.

(c) Receipt of capital subsidy.

(d) Provision for income tax.

Answer 2

(a) Goods Sent on Consignment:

(i) Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.

(ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.

(iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.

(iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.

(v) See that goods in hand with the consignee have been shown separately under the head inventories.

(b) Foreign Travel Expenses:

(i) Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.

(ii) Verify that the tour programme was properly authorised by the competent authority.

(iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.

(iv) See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.

(v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".

(c) Receipt of Capital Subsidy:

(i) Check the application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.

(ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.

(iii) Ensure that the conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.

(iv) Check relevant entries for receipt of subsidy.

(v) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

(d) Provision for Income Tax:

(i) Obtain the computation of income and income tax prepared by the entity and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.

(ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.

(iii) Examine relevant records and documents pertaining to advance tax, self-assessment tax and other demands.

(iv) Compute tax payable as per the latest applicable rates in the Finance Act.

(v) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc.

(vi) Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under audit.

Question 3

How will you vouch and/or verify payment of taxes?

Answer 3

(a) Vouching of Payment of Taxes:

(i) Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan.

(ii) Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.

(iii) The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.

(iv) Nowadays, electronic payment of taxes is also in trend. Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards.

(v) The entity can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account

Number (PAN) of the assessee on whose behalf the payment is made. This should be checked by the auditor.

(vi) It is not necessary for the entity to make payment of taxes from his own account in an authorized bank. While vouching such e-payment, the auditor should cross verify the payments of taxes through the receipted challan along with PAN No /TAN No. etc.

Question 4

How would you vouch/verify the following:

(a) Advertisement Expenses.

(b) Sale of Scrap.

Answer 4

(a) Advertisement Expenses:

(i) Verify the bills/invoices from advertising agency to ensure that rates charged for different types of advertisement are as per the contract.

(ii) See that the advertisement relates to client's business.

(iii) Inspect the receipt issued by the agency.

(iv) Ascertain the nature of expenditure – revenue or capital expenditure and see that it has been recorded properly.

(v) Ascertain the period for which payment is made and see that prepaid amount, if any, is carried to the balance sheet.

(vi) See that all outstanding advertisement bills have been provided for.

(b) Sale of Scrap:

(i) Review the internal control as regards generation, storage and disposal of scrap.

(ii) Check whether the organization is maintaining reasonable record for generation of scrap.

(iii) Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.

(iv) Check the rates at which scrap has been sold and compare the rate with previous year.

(v) Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.

(vi) Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.

(vii) Make an overall assessment of the value of realization from scrap as to its reasonableness.

Question 5

ABC Ltd. has issued shares for cash at a premium. Section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account. Advise the means in which the amount in the account can be applied.

Answer 5

Shares Issued at Premium: In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the means in which the amount in the account can be applied. As per the section, where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account" and the provisions of this Act relating to reduction of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.

Application of securities premium account: The securities premium account may be applied by the Company:

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the Company;

(c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68. The auditor needs to verify whether the premium received on shares, if any, has been transferred to a "securities premium account" and whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above.

Question 6

The auditor A of ABC & Co.- firm of auditors is conducting the audit of XYZ Ltd and while performing testing of additions wanted to verify that all PPE (Property Plant and Equipment) purchase invoices are in the name of the entity he is auditing. For all additions to land, building in particular, the auditor desires to have concrete evidence about ownership. The auditor is worried about whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Advise the auditor.

Answer 6

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, building in particular, the auditor should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date. In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not 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. In addition, 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 7

Write the audit Procedure for verification of existence of Trade Receivables.

Answer 7

For Verification of Existence of Trade Receivables, the auditor should check the following:

i. Check whether there are controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice.

   Ask for a period-end accounts receivable ageing report and trace the balance as per the report to the general ledger.

ii. Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoice- wise and on FIFO basis i.e. previous bill is adjusted first.

iii. If any large balance is due for a long time, auditor should ask for reasons and justification for the same.

iv. A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed.

v. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

vi. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample.

vii. Where no reply is received, the auditor should perform alternate procedures regarding the balances.

viii. Agreeing the balance to cash received subsequently;

ix. Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (examination in depth for those balances)

x. If there are any related party receivables, review them for collectability as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

xi. Check that receivables for other than sales or services are not included in the list.

Review a trend line of sales and accounts receivable, or a comparison of the two over time, to check if there are any unusual trends i.e. perform Analytical procedures. Make inquiries about reasons for changes in trends with the management and document the same in audit work papers.

Question 8

MNO & Associates are the statutory auditor of Venus Ltd. for the FY 2021 -22. During the course of audit, one of the audit team members, Mr. Viaan noticed that the company has made loans totaling to ` 50 lakhs to the promoters of the company, namely, Mr. Raj and Mr. Rajeev without specifying the period of repayment. Mr. Viaan discussed with Mr. Manik, the engagement partner, about the disclosure requirements with respect to such loans required by Schedule III to the Companies Act, 2013.

What should Mr. Manik advise Mr. Viaan?

Answer 8

(a) Mr. Manik should advise Mr. Viaan to consider whether the following disclosures as required by Schedule III to the Companies Act, 2013, has been made in respect of the loans granted to promoters, namely, Mr. Raj and Mr. Rajeev, either severally or jointly with any other person, that are:

(b) repayable on demand or without specifying any terms or period of repayment

Type of Borrower	Amount of loan or advance in the nature of loan outstanding	Percentage to the total Loans and Advances in the nature of loans
Promoters		
Directors		
KMPs		
Related Parties		

Question 9

What are the disclosures requirements as per Part I of Schedule III to the Companies Act with respect to the cash & cash equivalents held by a company?

Answer 9

The following are the disclosure requirements as per Schedule III to the Companies Act, 2013, with respect to the cash & cash equivalents held by the company:

Cash and cash equivalents

(i) Cash and cash equivalents shall be classified as:

(a) Balances with banks;

(b) Cheques, drafts on hand;

(c) Cash on hand;

(d) Others (specify nature)

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months' maturity shall be disclosed separately.

Question 10

Mercury Ltd. is a company engaged in the manufacture of floor mats. The company sells its goods on credit. The debtors balance as on 31.03.2022 amounted to ` 20 cr. What is the disclosure requirement as per Schedule III to the Companies Act 2013, with respect to the ageing schedule of debtors of the company?

Answer 10

The following are the disclosure requirement as per Schedule III to the Companies Act 2013, with respect to the ageing schedule of debtors of the company:

Trade Receivables ageing schedule

						(Amount in `)
Particulars	**Outstanding for following periods from due date of payment#**					
	Less than 6 months	**6 months - 1 year**	**1-2 years**	**2-3 years**	**More than 3 years**	**Total**
(i) Undisputed Trade receivables – considered good						
(ii) Undisputed Trade Receivables – considered doubtful						
(iii) Disputed Trade Receivables considered good						
(iv) Disputed Trade Receivables considered doubtful						

similar information shall be given where no due date of payment is specified, in that case disclosure shall be from the date of the transaction.

Unbilled dues shall be disclosed separately.

Question 11

You are the statutory auditor of Jupiter Ltd. for the FY 2022-23. During the course of audit, you noticed that the company has PPE under construction i.e. Capital Work in Progress. What disclosures should the company give with respect to the ageing schedule of such capital work in progress as required by Schedule III to the Companies Act, 2013?

Answer 11

Capital-Work-in Progress

a) For Capital-work-in progress, following ageing schedule shall be given:

CWIP ageing schedule

					(Amount in `)
	Amount in CWIP for a period of				**Total***
CWIP	**Less than 1 year**	**1-2 years**	**2-3 years**	**More than 3 years**	
Projects in Progress					
Projects temporarily suspended					

*Total shall tally with CWIP amount in the balance sheet.

b) For capital-work-in progress, whose completion is overdue or has exceeded its cost compared to its original plan, following CWIP completion schedule shall be given**:

				(Amount in `)
	To be completed in			
CWIP	Less than 1 year	1-2 years	2-3 years	More than 3 years
Project 1				
Project 2				

**Details of projects where activity has been suspended shall be given separately.

Question 12

The auditor of Saturn Ltd. wants to verify whether the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2023. What audit procedures should the statutory auditor of the company perform?

Answer 12

The statutory auditor of Saturn 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 31.03.2023. The auditor should:

- 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.

Test Your Understanding

Question 1

A company is engaged in manufacturing of fabrics from yarn purchased from different suppliers. Occasionally, it also manufactures fabrics tailor made in accordance with requirements of certain mills from yarn received from these mills. The company raises bill of its labour charges only on mills for converting yarn into fabrics. The auditor of company tries to ensure that stocks of the company as at year end do not include stocks pertaining to these mills. Which assertion auditor tries to verify in above situation? How he can ensure that?

Answer 1

The auditor is trying to verify assertion relating to "Rights and Obligations". He is verifying that the company owns or controls the inventory recorded in the financial statements. Any inventory held by the company on behalf of another entity has not been recognized as part of inventory of the company. This can be achieved by verifying stock records pertaining to goods received from mills and sent back to mills after carrying out necessary operations. Besides, agreements with such mills may also be verified.

Question 2

A company has availed cash credit facility of ` 2 crore (O/s balance ` 2 crore as at year end) from a bank for meeting its working capital requirements against security of stocks and debtors and guaranteed by directors of the company. Discuss, how the above cash credit facility, would be classified and disclosed in financial statements of company.

Answer 2

It shall be shown under the head "Borrowings" and classified as Short-term secured borrowings specifying nature of security. The above said outstanding amount shall be further sub-classified under heading "Loans repayable on Demand" from Banks. As per requirements of Schedule III of Companies Act, 2013, where loans have been guaranteed by directors or others, aggregate amount of such loans under each head shall be disclosed.

Question 3

Various ratios of current year and preceding year are disclosed in financial statements of a company in accordance with requirements of Schedule III of Companies Act, 2013. Discuss requirements of law in this regard (Do not list out names of ratios).

Answer 3

A company has to disclose various ratios in its financial statements in accordance with requirements of Schedule III of Companies Act, 2013. The company shall also explain the terms included in 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 4

An auditor of a company is focusing upon revenues of a company. In this regard, besides performing usual detailed checking of sales, he wants to perform substantive analytical procedures in respect of sales. Discuss how he can perform such procedures.

Answer 4

Substantive analytical procedures in respect of sales will consist of sales trend analysis, comparison with previous accounting period, category-wise sales analysis, any analysis the auditor may find relevant and most important of all, building a sales expectation and comparing that with the client's sales records. The auditor will need to know the sales prices of the products or services over the year, monthly average sales price per product or service, discount policy.

Question 5

While verifying depreciation charged to statement of profit and loss account of a company, it is noticed by auditor that one new machinery was purchased and installed in month of April. The necessary trials were carried out and machinery was ready for use in April itself. However, owing to lack of orders in the market, the said machinery was put into actual operation from 1st October. The company has, accordingly, provided depreciation in its books on this machinery w.e.f. 1st October. Is above recording of deprecation by company proper in its books?

Answer 5

Depreciation of an asset begins when it is available for use i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management. Depreciation on asset is charged on asset from the date when it is ready for use and not from date of actual usage. Hence, recording of depreciation by company w.e.f. 1st October is not proper.

CHAPTER 6
AUDIT DOCUMENTATION

SA 230- Audit Documentation

Question 1

Audit documentation provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor and evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements. Explain stating clearly purpose of audit documentation. (MTP 5 Marks Aug '18 & Oct '18)

OR

Audit documentation serves a number of purposes. List such purposes. (MTP 3 Marks March '21)

OR

A new team member of GSR & Co., the auditors of Esteem Limited, was of the view that Audit Documentation would not serve any purpose at any stage of Audit. Explain. (RTP May '21)

OR

CAM is the engagement partner of S Ltd. He has instructed his audit team to maintain proper audit documentation. The audit team members are not sure about the purpose for which the documentation should be made. Explain the various purposes of audit documentation with reference to SA 230. (PYP 3 Marks Nov 22)

OR

What do you mean by Audit Documentation? Also explain the nature and purpose of audit documentation. (RTP May '19)

OR

Discuss the meaning and nature of Audit Documentation (RTP Nov '19)

OR

Discuss any two purposes of audit documentation (New SM)

OR

SA 230, "Audit Documentation" deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. Such audit documentation serves various purposes. Explain. (RTP May '23)

Answer 1

Audit documentation: SA 230 on "Audit Documentation", audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as "working papers" or "work papers" are also sometimes used.)

Nature of Audit Documentation

Audit documentation provides:

(a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and

(b) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Purpose of Audit Documentation

The following are the purpose of Audit documentation:

1. Assisting the engagement team to plan and perform the audit.
2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
3. Enabling the engagement team to be accountable for its work.
4. Retaining a record of matters of continuing significance to future audits.
5. Enabling the conduct of quality control reviews and inspections.
6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

From the above, it can be concluded that Audit documentation serves a number of purposes and hence it would be incorrect to say that audit documentation would not serve any purpose at any stage of audit

Question 2

Discuss with reference to SA-230, factors affecting form, contents and extent of audit documentation. (MTP 4 Marks April 19)

OR

The form, content and extent of audit documentation depend on factors such as the size and complexity of the entity, the nature of the audit procedures to be performed etc. Explain in detail. (RTP Nov 18, New SM)

Answer 2

Form, Content and Extent of Audit Documentation: Working papers should record the audit plan, nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

The form, content and extent of working papers depend on factors such as:

- The size and complexity of the entity.
- The nature of the audit procedures to be performed.
- The identified risks of material misstatement.
- The significance of the audit evidence obtained.
- The nature and extent of exceptions identified.
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- The audit methodology and tools used.

Question 3

"Completion Memorandum" is helpful as part of the audit documentation. Explain. (MTP 3 Marks May 20, PYP 3 Marks, May '19, New SM)

Answer 3

Completion Memorandum or Audit Documentation Summary.

The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-

(i) the significant matters identified during the audit.

(ii) how they were addressed.

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Question 4

Give some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment where the matters and judgments are significant. (MTP 3 Marks Oct 20)

Answer 4

Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

Question 5

Examine with reasons (in short) whether the following statement is correct or incorrect:

Audit notes can serve as a guide in framing Audit programme. (MTP 2 Marks April '21)

Answer 5

Correct: Audit notes can serve as a guide in framing audit programme in the future as they indicate the weaknesses in the system of the client which specially need to be watched.

Question 6

Audit documentation provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered. Further, it is unnecessary for the auditor to document separately compliance with matters for which compliance is demonstrated by documents included within the audit file. Explain giving examples. (MTP 4 Marks Oct '21)

Answer 6

Audit documentation provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:

- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.
- An auditor's report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.

- In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
- For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with SAs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.
- Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussion required by SA 315.

Question 7

Electronic payment of Income Tax cannot be made by an assessee from the account of any other person. (MTP 2 Marks April 22)

Answer 7

Incorrect: Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards. The assessee can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account Number (PAN) of the assessee on whose behalf the payment is made. It is not necessary for the assessee to make payment of taxes from his own account in an authorized bank.

Question 8

Examine with reasons (in short) whether the following statements are correct or incorrect: (MTP 2 Marks Sep'22)

The auditor shall prepare audit documentation on a timely basis.

Answer 8

Correct: The auditor shall prepare audit documentation on a 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 finalised. 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.

Question 9

Newton Ltd. has made loans and advances on the basis of following securities to various borrowers. As an auditor what type of documents can be verified to ensure that the company holds a legally enforceable security?

(i) Shares and Debentures

(ii) Life Insurance Policy

(iii) Hypothecation of goods. (MTP 3 Marks April '21 & May 20)

Answer 9

Documents to be seen in case of Securities:

Types of Security	Documents etc. to be seen
(i) Shares and debentures	The scrip and the endorsement thereon of the name of the transferee, in the case of transfer.
(ii) Life Insurance Policy.	Assignment of policy in favour of the lender, duly registered with the insurer
(iii) Hypothecation of goods	Deed of hypothecation or other document creating the charge, together with a statement of inventories held at the Balance Sheet date

Question 10

The working papers of the branch auditor are also the property of the Principal Auditor and the Management of the Company, so they have right to access them. State the relevant SA and comment. (MTP 3 Marks March '21)

Answer 10

Ownership of Working Papers: As per SA 230 "Audit Documentation", working papers are the property of the auditor. He may at his discretion, make available portions or extracts from his working paper to his client. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers. An auditor is not required to provide the management/ clients or other auditors' access to his working papers. Main auditor of the company does not have right of access to the working papers of the branch auditor. In the case of a company, the main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for the copy of working paper and therefore, the branch auditor is under no compulsion to give photocopies of his working paper to the principal auditor. From above, it is clear that working papers of the branch auditor are his property only and neither the Principal auditor not management has right to access that. Therefore, statement given in the question is incorrect.

Question 11

Examine with reasons (in short) whether the following statements are correct or incorrect.

Narrative record is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. (MTP 2 Marks March '23)

Answer 11

Incorrect: Check list is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. Narrative record is a complete and exhaustive description of the system as found in operation by the auditor.

Question 12

Examine with reasons (in short) whether the following statements are correct or incorrect.

The internal control questionnaire is a series of instructions/ questions which a member of the auditing staff must follow and/or answer. (MTP 2 Marks Oct'22)

Answer 12

Incorrect: Checklist is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. Internal control questionnaire is a comprehensive series of questions concerning internal control. The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees.

Question 13

Examine with reasons (in short) whether the following statements are correct or incorrect:

It is the function of an audit to establish that payments have been made validly to the persons who are shown to be recipients. (MTP 2 Marks April '21)

Answer 13

Correct: It is the function of audit to establish that payments have been made validly to persons who are shown to be recipients. For checking the validity of a transaction, it is usually necessary to refer to documentary evidence.

Question 14

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 Nov'20).

OR

Judging the significance of a matter requires an objective analysis of the facts and circumstances.

Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Explain with the help of examples. (RTP May '19)

Answer 14

Documentation of Significant Matters and Related Significant Professional Judgments

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 judgment exercised in performing the work and evaluating the results.

Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. 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).

Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- The rationale for the auditor's conclusion when a requirement provides that the auditor 'shall consider' certain information or factors, and that consideration is significant in the context of the particular engagement.
- The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

Question 15

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. Explain with the help of examples. (RTP Nov'20)

Answer 15

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

Question 16

While documenting the nature, timing and extent of audit procedures performed in case of audit of PQR Ltd, explain the important matters its auditor should record. (RTP May '21)

Answer 16

In documenting the nature, timing and extent of audit procedures performed, the auditor of PQR Ltd shall record:

(i) The identifying characteristics of the specific items or matters tested.

(ii) Who performed the audit work and the date such work was completed; and

(iii) Who reviewed the audit work performed and the date and extent of such review?

Question 17

State with reason (in short) whether the following statements are true or false:

The auditor must include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking etc. (RTP Nov '21)

Answer 17

Incorrect: 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 18

State with reason (in short) whether the following statements are true or false:

As per SA 230 on "Audit Documentations", the working papers are not the property of the auditor. (RTP May '18, Old & New SM)

Answer 18

Incorrect: As per SA 230 on "Audit Documentations" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

Question 19

State with reason (in short) whether the following statements are true or false:

Audit documentation is a substitute for the entity's accounting records. (RTP May '19 & Nov 18)

Answer 19

Incorrect: The auditor may include copies of the entity's records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation is not a substitute for the entity's accounting records.

Question 20

(Includes concepts of Chapter 1.2- SQC 1)

State with reason (in short) whether the following statements are true or false:

An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 30 days after the date of the auditor's report. (RTP May '19 & Nov 18)

Answer 20

Incorrect: 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.

Question 21

CA R comes to know some very critical information with regards to the business cycle of an entity for which he has issued the audit report, which become known to him as an auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report. He wants to perform additional audit procedures to satisfy himself. As an auditor what he shall document, on the matters arising after the date of audit report? (RTP Nov'22)

Answer 21

As per SA 230, "Audit Documentation", if, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document:

(i) The circumstances encountered;

(ii) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and

(iii) When and by whom the resulting changes to audit documentation were made and reviewed.

Question 22

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor to understand significant matters arising during the audit. Explain the above statement and also give examples of significant matters. (RTP Nov'22)

Answer 22

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

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.

Question 23

Audit Documentation refers to the record of three items. Explain stating clearly the objective and nature of audit documentation. (RTP Nov '23)

Answer 23

Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

The objective of the auditor is to prepare documentation that provides:

(i) A sufficient and appropriate record of the basis for the auditor's report; and

(ii) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Nature of Audit Documentation Audit documentation provides:

(a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and

(b) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Question 24

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. Explain in detail. (RTP Nov '23, May'23, Nov '18 & May '22)

Answer 24

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 25

Examine with reasons (in short) whether the following statements are correct or incorrect:

Mr. A is a statutory auditor of ABC Ltd. The branch of ABC Ltd. is audited by Mr. B, another Chartered Accountant. Mr. A requests for the photocopies of the audit documentation of Mr. B pertaining to the branch audit. (PYP 2 Marks, May '18, Old & New SM)

Answer 25

Incorrect: SA 230 issued by ICAI on Audit Documentation, and "Standard on Quality Control (SQC) 1, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Question 26

State with reasons whether the following statements are correct or incorrect:

The auditor shall assemble the audit documentation in the audit file and complete the administrative process of assembling the final audit file before the date of the auditor's report. (PYP 2 Marks Nov 22)

Answer 26

Incorrect: 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. 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.

Alternative reason: 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.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. Audit documentation provides:

(a) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; or evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

(b) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

(c) evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor

(d) evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements. (MTP 1 Mark March '19, MTP 2 Marks Apr'21, Nov'21)

Ans: (b)

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2. Which of the following is not an example of audit documentation:?

(a) Audit Programmes

(b) Summaries of significant matters

(c) Audit file

(d) Checklists. (MTP 1 Mark March '19)

Ans: (c)

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3. Which of the following is correct:

(a) 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.

(b) The auditor shall assemble the audit documentation in an audit file and shall not complete the administrative process of assembling the final audit file.

(c) 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 before the date of the auditor's report.

(d) The auditor shall not assemble the audit documentation in an audit file. (MTP-Oct'19-MTPApril' 19, 1 Mark)

Ans: (a)

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4. Judging the significance of a matter requires _____ of the facts and circumstances.

(a) objective analysis

(b) subjective analysis

(c) Both subjective and objective analysis

(d) qualitative analysis (MTP 1 Mark April 22, RTP Nov'19)

Ans :(a)

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5. CA Amar is the statutory auditor of XYZ Ltd. for the FY 2020-21. During the process of assembling the audit file, CA Amar briefed his team as to what all changes can be made to the audit documentation at that stage.

Which of the following changes cannot be made to the audit documentation during the final assembly process?

(a) Sorting, collating & cross referencing of working papers.

(b) Signing off completion checklists relating to the file assembly process.

(c) Deleting or discarding superseded documents.

(d) Recalculation of Depreciation. (MTP 1 Mark March '23)

Ans: (d)

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6. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-

(a) evidence identified during the audit

(b) the significant matters identified during the audit and how they were addressed

(c) the significant evidence identified during the audit

(d) the significant matters identified during the audit (MTP 1 Marks April '23)

Ans: (b)

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7. Which of the following is not a likely purpose of audit documentation?

(a) It helps to show that audit was conducted in accordance with requirements of SQC 1.

(b) It serves as a record of maEers of conFnuing significance to future audits.

(c) It assists engagement team to plan and perform the audit.

(d) It can directly help auditor in expanding client base. (MTP 1 Mark Sep '23)

Ans: (d)

8. A company has started its manufacturing operations from a newly constructed building. CA Z is statutory auditor of company. Which of following is not likely to be an example of audit documentation?

(a) E-mail correspondence with CFO of company concerning significant maEers

(b) Audit programme

(c) Response to external confirmaFon requests

(d) Structural engineer's report on strength of building (MTP 1 Mark Oct '23)

Ans: (d)

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9. _____refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

(a) Audit Techniques

(b) Audit evidence

(c) Audit Documentation

(d) Audit Procedures record (MTP 1 Mark March '23)

Ans: (c)

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

(a) professional skepticism

(b) professional integrity

(c) professional judgment

(d) Professional sincerity (RTP Nov '19)

Ans: (c)

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11. CA. Bobby is a recently qualified Chartered Accountant. He is appointed as an auditor of Droopy Ltd. for the current Financial Year 2017-18. He is quite conservative in nature which is also replicated in his professional work. CA. Bobby is of the view that he shall record all the matters related to audit, audit procedures to be performed, audit evidence obtained and conclusions reached. Thus, he maintained a file and recorded each and every of his findings during the audit. His audit file, besides other thing, includes audit programmers, notes reflecting preliminary thinking, letters of confirmation, e-mails concerning significant matters, etc.

State which of the following need not be included in the audit documentation?

(a) Audit programmers.

(b) Notes reflecting preliminary thinking.

(c) Letters of confirmation.

(d) E-mails concerning significant matters. (RTP May '19)

Ans: (b)

CASE STUDY

CA Rajan Pillai is heading the engagement team conducting audit of a company. While audit is in progress, consider following issues regarding audit documentation:-

(A) Audit programme was prepared assigning responsibilities for different types of works to be performed to team members. The engagement team consists of 4 members Mohit (CA final student), Rohit (CA final student), Shobhit (Paid CA) and CA Rajan Pillai (partner of audit firm).

(B) The team has determined materiality for financial statements as a whole.

(C) The team has assessed risks of material misstatements to be low.

(D) CA Shobhit is responsible for attending inventory count process and putting down its documentation part.

(E) During the course of audit, many related party transactions have come to notice.

MULTIPLE CHOICE QUESTIONS (MCQS)

Based on above, answer the following questions: -

1. Work relating to verification of revenue was assigned to Mohit in audit programme. However, it is being performed by Rohit actually. Verification of trade receivables was planned to be carried out by Rohit in audit programme. However, it being performed by CA Rajan Pillai due to last minute practical issues.

Which of the following statements is most appropriate in this regard relating to audit documentation?

(a) Audit programme contains names of persons and work to be performed. It is immaterial whether work assigned to one person is performed by another person.

(b) Audit programme was already prepared. Only persons assigned specific responsibilities can perform those duties.

(c) It is necessary that audit programme be suitably updated or notes are given in working papers to this effect so that planned duties are in accordance with actual work performance.

(d) Changes in audit programme or notes clarifying the matter are required only when a person not forming part of engagement team is deputed to perform a duty. Otherwise, this issue of intershuffling of team members is frivolous.

Ans: (c)

2. As regards materiality, which of the following statements is most appropriate in context of audit documentation?

(a) Materiality has already been determined. There is no need to put it into working papers.

(b) Materiality depends upon professional judgment of auditor. Whatever amount has been determined can be documented in working papers.

(c) Materiality arrived on basis of professional judgment along with factors considered in the determination has to be documented.

(d) Materiality has been arrived upon professional judgment. It also depends upon professional judgment of auditor whether he wants to document it or not.

Ans: (c)

3. As regards team's assessment that risk of material misstatements is low, which of the following statements is odd one relating to documentation of risk?

(a) Discussion amongst engagement team members and detail of significant decisions reached has to be documented.

(b) Details of risk assessment procedures have to be documented.

(c) Details about how understanding of each component of internal control was obtained has to be documented.

(d) Precise calculation of risk of material misstatements has to be documented.

Ans: (d)

4. CA Shobhit is responsible for attending physical inventory count of the company. Which of the following is not true in this regard relating to audit documentation?

(a) Dates on which physical inventory count process was attended by him should be documented. It may also include photographs of that date showing his attendance of inventory counting process at a particular location.

(b) Detail of test counting undertaken should form part of audit documentation.

(c) Detail of obsolete goods found should form part of audit documentation.

(d) Reports showing that stocks conform to quality control standards in accordance with law are essential part of audit documentation.

Ans: (d)

5. As regards related party transactions, which of the following should not be part of audit documentation?

(a) Management representation letter in this regard

(b) Related party transaction policy of the company

(c) Documentation to show that such transactions are at arm's length basis

(d) Documentation to show that such transactions are at close length basis

Ans: (d)

TEST YOUR KNOWLEDGE

6. Which of the following statement is appropriately suited to preparation of audit documentation?

(a) Audit documentation has to be prepared simultaneously as audit progresses.

(b) Audit documentation has to be prepared 60 days after date of audit report.

(c) Audit documentation has to be prepared when information is required by regulator.

(d) Audit documentation has to be prepared 60 days after completion of audit work.

Ans: (a)

7. Audit documentation is owned by: -

(a) Client

(b) Auditor

(c) Team member responsible for documentation

(d) Regulator

Ans: (b)

8. Which of the following is least likely to be included in audit documentation of a company engaged in manufacturing and export of goods?

(a) Previous years audited financial statements

(b) Projected cash flow statement for next twelve months provided by management in support of going concern assumption

(c) Statements showing dispatch of overseas consignments in accordance with delivery schedules of overseas buyers

(d) Statement showing verification of ageing of trade receivables as on date of balance sheet

Ans: (c)

9. Which of the following is false in relation to audit documentation when an external auditor relies upon work of internal auditor?

(a) Evaluation of objectivity and competence of internal auditor has to be documented.

(b) Nature of work used and reason for relying upon work used forms part of documentation.

(c) Documentation on whether quality control is exercised in internal audit work forms part of audit documentation.

(d) Documentation on what specific recommendations were given by internal auditor for risk assessment to external auditor forms part of audit documentation.

Ans: (d)

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

Question 1

As per SA 230 on "Audit Documentation", the working papers are not the property of the auditor.

Answer 1

Incorrect: As per SA 230 on "Audit Documentation" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

Question 2

Mr. A is a statutory auditor of ABC Ltd. The branch of ABC Ltd. is audited by Mr. B, another Chartered Accountant. Mr. A requests for the photocopies of the audit documentation of Mr. B pertaining to the branch audit.

Answer 2

Incorrect: SA 230 issued by ICAI on Audit Documentation, and "Standard on Quality Control (SQC) 1, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

THEORETICAL QUESTIONS ANSWER

Question 1

The form, content and extent of audit documentation depends upon number of factors. List out any four such factors.

Answer 1

The form, content and extent of audit documentation depend on factors such as:

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
7. The audit methodology and tools used.

Question 2

Discuss any two purposes of audit documentation.

Answer 2

The following are the purpose of Audit documentation:

1. Assisting the engagement team to plan and perform the audit.
2. Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
3. Enabling the engagement team to be accountable for its work.
4. Retaining a record of matters of continuing significance to future audits.
5. Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Question 3

Define audit documentation. Also give some examples.

Answer 3

Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as "working papers" or "work papers" are also sometimes used.)

Audit Documentation include:

- Audit programmes.
- Analyses.
- Issues memoranda.
- Summaries of significant matters.
- Letters of confirmation and representation.
- Checklists.
- Correspondence (including e-mail) concerning significant matters.

Question 4

"Audit documentation summary may facilitate effective and eficient reviews and inspections of the audit documentation, particularly for large and complex audits". Explain.

Answer 4

The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-

- the significant matters identified during the audit and
- how they were addressed.

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Question 5

Illustration

A new team member of the auditors of Extremely Vibrant Limited was of the view that Audit Documentation does not help in planning the audit of any company. Explain whether Audit Documentation has any relation with regard to planning the audit of a company.

Answer 5

Audit Documentation helps in planning the audit of a company in a proper manner and also helps in conducting the audit of that company in a more effective way.

Question 6

Illustration

While auditing the books of accounts of Very Careful Limited for the financial year 2020-21, a team member of the auditors of Very Careful Limited was of the view that with regard to audit of the company, no relation exists between Audit File and Audit Documentation. Explain the relationship between Audit File and Audit Documentation.

Answer 6

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. 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.

Question 7

Illustration

A director of Very Different Limited was of the view that Audit Documentation of a company is the property of that company. Comment on the contention of the director regarding the audit documentation of the company.

Answer 7

Audit Documentation of a company is not the property of the company rather Audit Documentation is the property of Auditor of that company.

Test Your Understanding

Question 1

During the course of audit of a company, an issue arose relating to treatment of interest costs of company on its restructured loans taken from a bank. This important matter was discussed with CFO of the company and was properly resolved. Is it necessary for the auditor to include in its working papers?

Answer 1

The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

In the instant case, an important matter regarding treatment of interest costs of company on its restructured loans taken from a bank directly impacting profits of the company was discussed. Although issue was resolved, it is necessary to document the same by including detail of the person with whom discussions took place along with date.

Question 2

CA Sonali Morarka has completed audit of a listed company. The audit report dated 15th July, 2022 has been issued. However, audit working papers including record of discussions with management, details of audit procedures performed to obtain audit evidence and conclusions reached by her have not been properly assembled. More than six months have elapsed after issue of audit report. Subsequently, she has received a letter from regulator in connection with audit of the company requesting her to share copy of audit file.

The letter has woken up her from deep slumber. She hurriedly assembled audit file and inserted some more papers which were necessary. However, she put current date on these inserted papers and the copy of audit file was sent to regulator. Discuss, the issues involved, in context of "audit documentation".

Answer 2

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.

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, she has not assembled audit file. Besides, she has put in some papers with current date which is not permissible at all. It shows that part of audit documentation has been prepared afterwards putting a question mark on quality of audit.

CHAPTER 7 COMPLETION AND REVIEW

SA 560- Subsequent Events

Question 1

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. Explain the auditor's obligation in the above situation. (MTP 3 Marks Nov '21, RTP May 20, Old SM)

Answer 1

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:

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

(b) Determine whether the financial statements need amendment and If so,

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

Question 2

SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Explain those events and also define subsequent events. (MTP 3 Marks Sep '23, RTP Nov '21)

Answer 2

SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.

Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:

(a) Those that provide evidence of condi.ons that existed at the date of the financial statements; and

(b) Those that provide evidence of condi.ons that arose a1er the date of the financial statements.

SA 700 explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.

Subsequent events refer to events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

Question 3

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. Explain. (RTP May '19, PYP 4 Marks, July '21)

Answer 3

Audit Procedure Regarding Events Occurring Between the Date of The Financial Statements and The Date of the Auditor's Report The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.

The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto.

The auditor shall take into account the auditor's risk assessment which shall include the following:

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity's latest subsequent interim financial statements, if any.

Question 4

"The auditors should consider the effect of subsequent events on the financial statement and on auditor's report"– Comment according to SA 560. (MTP 4 Marks Oct 19)

Answer 4

Effect of Subsequent Events: SA 560 "Subsequent Events", establishes standards on the auditor's responsibility regarding subsequent events.

According to it, 'subsequent events' refer to those events which occur between the date of financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. It lays down the standard that the auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.

The auditor should obtain sufficient appropriate evidence that all events upto the date of the auditor's report requiring adjustment or disclosure have been identified and to identify such events, the auditor should-

(i) obtain an understanding of any procedures management has established to ensure that subsequent events are identified.

(ii) inquire of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

Examples of inquiries of management on specific matters are:

- Whether new commitments, borrowings or guarantees have been entered into.
- Whether sales or acquisitions of assets have occurred or are planned.
- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- Whether there have been any developments regarding contingencies.
- Whether there have been any developments regarding risk areas and contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
- Whether any events have occurred that are relevant to the recoverability of assets.

(iii) Read minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(iv) Read the entity's latest subsequent interim financial statements, if any.

(v) Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.

(vi) Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims.

(vii) Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. 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:

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

(b) Determine whether the financial statements need amendment.

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

(d) All of the above (MTP 1 Mark March '23, MTP 1 Mark Apr'19)

Ans: (d)

SA 570- Going Concern

Question 1

When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. Explain stating also the objective of the auditor regarding going concern. (RTP Nov '19)

OR

On the basis of which assumption the financial statements of a company are prepared. Explain. Also describe the objectives of the auditor regarding going concern. (RTP May '19)

Answer 1

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Objectives of the auditor regarding going concern The objectives of the auditor are:

(a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and

(c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

Question 2

When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor has determined that management of XYZ Ltd has already performed a preliminary assessment of the entity's ability to continue as a going concern. Explain how would auditor of XYZ Ltd proceed in the above case.

Also explain how would the auditor proceed if such an assessment has not yet been performed by the management. (RTP May '21)

Answer 2

When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:

(i) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or

(ii)If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

Question 3

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. Explain. Also discuss the objectives of an auditor regarding Going concern as per relevant standard on auditing. (RTP May '21)

Answer 3

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future.

General purpose financial statements are prepared using the going concern basis of accounting, unless management either

(i) intends to liquidate the entity or to cease operations,

(ii) or has no realistic alternative but to do so.

When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

The objectives of the auditor regarding Going Concern are:

(1) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;

(2) To conclude, based on the audit evidence obtained, whether 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; and

(3) To report in accordance with this SA.

Question 4

As described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. Explain stating the auditor's responsibilities with regard to going concern (RTP May '21).

Answer 4

The auditor's responsibilities are:

(1) to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and

(2) to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

However, as described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Question 5

While doing audit of ABC Pvt. Ltd, on the basis of sufficient and appropriate evidence, auditor comes to a conclusion that use of the Going Concern Basis of Accounting is appropriate, but a material uncertainty exists. Discuss the implications for auditor's report if: Adequate Disclosure of a Material Uncertainty is Made in the Financial Statements Adequate Disclosure of a Material Uncertainty is Made is not made in the Financial Statements (RTP Nov '21)

OR

S Ltd., a large textile manufacturing company, due to heavy recession in the market was unable to collect amount of huge receivables in time and also holding large amounts of stock of raw materials and finished goods since last 9 months of the Financial Year 2022-23.

From your primary observations of audit evidence, you feel that there is a material uncertainty existing about going concern.

How will you deal in your audit report?

What will be the effect on your audit opinion in the following situations?

(i) If adequate disclosure of such material uncertainty is already made in the financial statements.

(ii) If adequate disclosure of such material uncertainty is not made in the financial statements. (PYP 4 Marks May '23)

Answer 5

Use of the Going Concern Basis of Accounting is Appropriate but a Material Uncertainty Exists The identification of a material uncertainty is a matter that is important to users' understanding of the financial statements. The use of a separate section with a heading that includes reference to the fact that a material uncertainty related to going concern exists alerts users to this circumstance.

(a) Adequate Disclosure of a Material Uncertainty is Made in the Financial Statements 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."

(b) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

(i) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised); and

(ii) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

Question 6

Give examples of financial events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. (RTP Nov '21)

Answer 6

The following are examples of Financial events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern:

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.

Question 7

State with reason (in short) whether the following statements are true or false:

Communicating key audit matters in the auditor's report is a substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern. (RTP May '22)

Answer 7

Incorrect: Communicating key audit matters in the auditor's report is not a substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern

Question 8

Management's assessment of the entity's ability to continue as a going concern involves making a judgement about inherently uncertain future outcomes of events or conditions. What are relevant factors to that judgement? (PYP 4 Marks, Jan'21)

Answer 8

Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgment:

- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

Question 9

M/s ANS & Associates has been appointed as the statutory auditors of MNO Ltd. The company has been suffering losses due to the emergence of highly successful competitor, thereby leading to negative net worth. Also, the sales head, key management personnel, of the company left the company due to health issues. When CA Amar, the engagement partner discussed the scenario

with the management of the company, he did not get any satisfactory reply from the management. What is the responsibility of M/s ANS & Associates with regard to SA 570? (PYP)

Answer 9

As per SA 570, one of the objectives of the auditor regarding going concern is to obtain sufficient and appropriate audit evidence regarding the same and to conclude on the appropriateness of the management's use of the going concern basis of accounting in the preparation of the financial statements.

- Further it also contains the list of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern which are:
- Financial indicator- Negative net worth
- Operating indicator- Loss of key management and emergence of highly successful competitor.
- In the present case, MNO Ltd. has negative net worth on account of emergence of highly successful competitor and the sales head of the company has also left the company.
- Also, CA Amar did not get any satisfactory reply when he discussed the going concern matter with the management.
- Thus, from the above facts, it appears that MNO Ltd. is not going concern.
- If the management of MNO Ltd. has used the going concern basis of accounting, the auditor should first ask the management to adjust the financial statements.
- If the management of MNO Ltd. does not agree with the same, CA Amar shall consider the impact on his audit report.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. Which of the following is not an example of an event or condition that may cast significant doubt on entity's ability to continue as a going concern:

(a) Loss of key management without replacement

(b) Adverse key financial ratios

(c) Inability to pay creditors on due date

(d) Current year profit turns to loss after providing depreciation (MTP 2 Marks Oct 21, Nov 20, MTP 1 Mark Mar'22)

Ans: (d)

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2. A company is engaged in business of obtaining eggs from one day old chicks. Which of the following is NOT an example of an event or condition that may cast significant doubt on the ability of the company to continue as a going concern?

(a) Mortality of 90% of livestock of the company

(b) Decision by govt to ban commercial rearing of birds amidst protests by activists for preventing cruelty to animals

(c) Shifting of farm labour to respective villages due to MGNREGA scheme of Govt causing acute scarcity throughout the year

(d) Increase in cost of feed of chicks by 20% during the year. (RTP Nov'22)

Ans: (d)

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3. Following are examples of events or conditions that may cast significant doubt on an entity's ability to continue as a going concern. Which of following is an example of operating event/ conditions?

(a) Adverse key financial ratios

(b) Inability to pay creditors on due dates

(c) Indications of withdrawal of financial support by creditors

(d) Shortages of important supplies (MTP 1 Mark Oct '23)

Ans: (d)

SA 580- Written Representations

Question 1

Written representation in itself is a sufficient and appropriate audit evidence about any of the matters with which they deal. (MTP 2 Marks March 21)

Answer 1

Incorrect: Written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

Question 2

Explain the objectives of the auditor regarding written representations. (MTP 3 Marks Nov '21, RTP Nov '19, PYP 3 Marks Jan '21)

Answer 2

The objectives of the auditor regarding written representation:

(i) To obtain written representations

To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(ii) To support other evidence

To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and

(iii) To respond appropriately

To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

Question 3

Examine with reasons (in short) whether the following statements are correct or incorrect: (MTP 2 Marks Sep'22)

Written representations are requested from those responsible for the preparation and presentation of the financial statements.

Answer 3

Correct: Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation. However, management (rather than those charged with governance) is often the responsible party.

Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements

Question 4

Akash & Associates are the statutory auditors of Deluxe Ltd. for the FY 2020 -21. During the course of audit, CA Akash, the engagement partner requested the management of the company to provide written representation with respect to valuation of a transaction. The management, however does not provide the same to CA Akash. What course of action should CA Akash follow in such situation? (MTP 3 Marks March '23, RTP May'23)

Answer 4

If management of Deluxe Ltd. does not provide one or more of the requested written representations, CA Akash should:

(a) Discuss the matter with management;

(b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

(c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705.

Question 5

Examine with reasons (in short) whether the following statements are correct or incorrect:

When inventory under the custody and control of a third party is material to the financial statements, the auditor can obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by taking written representation from management. (MTP 2 Marks April '23)

Answer 5

Incorrect: 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.

Question 6

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Explain stating clearly objectives of the auditor regarding written representation. (RTP May '20)

Answer 6

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

Written representations are requested from those responsible for the preparation and presentation of the financial statements.

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

The objectives of the auditor regarding written representation

The objectives of the auditor are:

(a) To obtain written representations-To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(b) To support other evidence -To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and

(c) To respond appropriately-To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

Question 7

State with reason (in short) whether the following statements are true or false:

One of the objectives of the written representation is to support other audit evidence relevant to the financial statements. (RTP Nov '21 & May '22)

Answer 7

Correct: One of the objectives of the written representation is to support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representation. Written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available.

Question 8

The auditor P of PAR and Co., a firm of Chartered Accountants is conducting audit of AB Industries Ltd. The auditor requests management to provide Banker's certificate in support of Fixed deposits whereas management provides only written representation on the matter.

Analyse how would you deal as an auditor (RTP May '18, Old SM)

Answer 8

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

Applying the above to the given problem, the auditor would further request the management to provide him with the Banker's certificate in support of fixed deposits held by the company.

Question 9

Written representations are to be provided by the management to the auditor when requested. Explain (RTP Nov '23)

Answer 9

Management from Whom Written Representations Requested: SA-580, "Written Representations", the auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements.

If management does not provide one or more of the requested written representations, the auditor shall-

(i) discuss the matter with management;

(ii) re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

(iii) take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor shall disclaim an opinion on the financial statements if management does not provide the written representations.

Question 10

CA K is re-appointed as the auditor of B Ltd. He wants to re-confirm certain matters and has asked the management to give written representations for the same. Under what circumstances can an auditor ask the management to reconfirm its acknowledgement and understanding of responsibilities in written representation? (PYP 4 Marks Dec '21)

Answer 10

Other Written Representation: Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations.

The written representations draw on the agreed acknowledgement and understanding of management of its responsibilities by requesting confirmation that it has fulfilled them. The auditor, CA K of B Ltd, may also ask management of B Ltd to reconfirm its acknowledgement and understanding of those responsibilities in written representations. This is particularly appropriate when:

(i) Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;

(ii) The terms of the audit engagement were prepared in a previous year;

(iii) There is any indication that management misunderstands those responsibilities; or

(iv) Changes in circumstances make it appropriate to do so.

MULTIPLE CHOICE QUESTIONS (MCQS)

(1) Which of the following is incorrect:

(a) Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements.

(b) Similar to responses to inquiries, written representations are audit evidence.

(c) Written representations are requested from those responsible for the preparation and presentation of the financial statements.

(d) Written representations provide necessary audit evidence and also they provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. (MTP 2 Marks March '19)

Ans: (d)

SA 260- Communication with Those Charged with Governance

Question 1

State the significant difficulties encountered during audit with reference to SA-260 (communication with those charged with governance). (RTP May '18)

Answer 1

Significant Difficulties Encountered During the Audit: As per SA 260 "Communication with Those Charged with Governance", significant difficulties encountered during the audit may include such matters as:

- Significant delays in management providing required information.
- An unnecessarily brief time within which to complete the audit.
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- The unavailability of expected information.
- Restrictions imposed on the auditor by management.
- Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

CASE STUDY

CA. Gaurav Gogoi is about to conclude audit of a company. It has been noticed during the course of audit that there is shortage of important raw material supplies being imported from China due to prevailing geo-political situation. The company has shared with him its plan to deal with the situation. He is satisfied with assessment of the company for dealing with the matter. The issue is disclosed in financial statements and considering management's assessment, it is felt that use of going concern assumption by company in preparation of financial statements is appropriate.

Besides, he also wants to be sure that all subsequent events till now have been considered and accounted for, where ever necessary, in financial statements.

Before concluding audit, he requests written representations from management regarding its responsibilities. However, it is noticed that such written representations provided by management use qualifying language.

He has also communicated significant findings from audit in writing with those charged with governance in the company and has retained copy of relevant mails. Besides, there are certain matters which were communicated by him orally from time to time during the course of audit to those charged with governance.

MULTIPLE CHOICE QUESTIONS (MCQS)

Based on above, answer the following questions: -

(1) As regards description of matter above concerning issue of going concern, which of the following statements is most appropriate for auditor's report?

(a) The auditor should express an unmodified opinion.

(b) The auditor should express a qualified opinion as material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

(c) Besides expressing an unmodified opinion, the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" drawing attention to the note in which such disclosure is made in financial statements along with related matters.

(d) Such an issue does not affect auditor's opinion.

Ans: (c)

(2) As regards going concern basis of accounting is concerned, which of the following statements is true?

(a) A company showing net loss in its financial statements is essentially not a going concern.

(b) Following going concern assumption of accounting is primary duty of auditor.

(c) In case, a company is not a going concern, its financial statements must be prepared on liquidation basis.

(d) Audit procedure seeking confirmation from banker regarding outstanding balance relates to verification of going concern assumption.

Ans: (c)

(3) Which of the following statements is true in respect of auditor's responsibilities in respect of subsequent events?

(a) There is no obligation for an auditor to perform audit procedures for events occurring between date of financial statements and date of auditor's report.

(b) There is no obligation for an auditor to perform audit procedures after signing of auditor's report, even if he comes to know of an event, which if known to him earlier would have caused him to amend the audit report.

(c) The auditor has only to rely upon written representation of management regarding subsequent events. He has no other means to know about such events.

(d) The auditor should perform necessary audit procedures to know about events occurring between the date of financial statements and date of auditor's report.

Ans: (d)

(4) As regards use of qualifying language in written representations, which of the following statement is most appropriate?

(a) It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.

(b) Written representations should be unconditional. Such a wording is not acceptable.

(c) Such a wording dilutes intent of written representations. However, it can be accepted by auditor only in exceptional circumstances.

(d) Qualifying language in written representations is compulsory.

Ans: (a)

(5) As regards auditor's responsibility regarding matters communicated orally with those charged with governance, which of following is most appropriate?

(a) Matters communicated orally have to be documented by the auditor stating when and to whom these were communicated.

(b) Matters communicated orally need not be put into writing. It is sufficient for auditor to have communicated orally.

(c) Matters communicated orally need not be put into writing. It is not practically feasible.

(d) Matters communicated orally have to be documented by the auditor stating to whom these were communicated.

Ans: (a)

TEST YOUR KNOWLEDGE

(6) An auditor of a company communicates significant findings from audit with those charged with governance in the company. Which of the statements is false in regard to communication made?

(a) Evaluation of adequacy of communication process is required on part of the auditor.

(b) Planned scope and timing of audit has also to be communicated.

(c) Communication of rationale behind audit procedures is necessary.

(d) Significant difficulties encountered during audit, if any, have to be communicated.

Ans: (c)

(7) Written representations are: -

(a) Necessary audit evidence

(b) Sufficient appropriate audit evidence

(c) Not audit evidence

(d) Audit evidence depending upon auditor's professional judgment

Ans : (a)

(8) Which of the following is false regarding communication of misstatements identified during course of an audit?

(a) The auditor should request those charged with governance for correction of identified misstatements.

(b) The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is material.

(c) The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is immaterial.

(d) The auditor should communicate effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Ans: (b)

(9) Which of the following is not an example of subsequent event?

(a) Event occurring between date of financial statements and date of auditor's report.

(b) Event occurring on date of financial statements.

(c) Event occurring after filing audit report with tax authorities. Had such an event been known earlier, auditor would have amended report.

(d) Event occurring during course of performing audit procedures after date of financial statements

Ans: (b)

(10) Which of the following is not an example of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern?

(a) Adverse key financial ratios

(b) Inability to invest in modernisation of plant

(c) Inability to pay creditors on time

(d) Inability to pay salary of staff

Ans: (b)

Descriptive Questions Answer

Question 1

List out some matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency".

Answer 1

Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.

- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process, for example:
- General monitoring controls (such as oversight of management).
- Controls over the prevention and detection of fraud.
- Controls over the selection and application of significant accounting policies.
- Controls over significant transactions with related parties.
- Controls over significant transactions outside the entity's normal course of business.
- Controls over the period-end financial reporting process (such as controls over nonrecurring journal entries).
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency with other deficiencies in internal control.".

Question 2

In what ways an effective two-way communication between auditor and those charged with governance is important?

Answer 2

Communication from auditor is important with those charged with governance. An effective two-way communication is important in assisting: -

(a) The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity.

(b) The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and

(c) Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

Question 3

The auditor of a company is having concerns about following of going concern basis of accounting followed by management for preparation of financial statements. It asks the management to justify preparation of financial statements. However, management is not willing to make its assessment and share with auditor. What are implications for auditor's report in such ascenario?

Answer 3

(I) If use of Going concern basis of accounting is inappropriate

If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.

(II) If use of going concern basis of accounting is appropriate but a material uncertainty exists

(A) Adequate Disclosure of a Material Uncertainty is made in the Financial Statements

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.

(B) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements

If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

(a) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705.

(b) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

(III) Management unwilling to make or extend its assessment

If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report. In such a situation, a qualified opinion or a disclaimer of opinion in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements.

Question 4

Discuss documentation requirements for an auditor regarding misstatements identified during audit under SA 450.

Answer 4

The audit documentation shall include: -

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

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

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

Question 5

Discuss meaning of "Date the financial statements are issued" under SA 560.

Answer 5

It reflects the date that the auditor's report and audited financial statements are made available to third parties. The date the financial statements are issued generally depends on the regulatory environment of the entity. In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority. Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report, but must also be at or later than the date the auditor's report is provided to the entity.

Test Your Understanding

Question 1

CA PK Jacob is conducting audit of a company for year 2021-22. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2022. However, it becomes known to the auditor that one of overseas buyers has made a legal claim against the company on 1st June 2022 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August, 2021. The management of company has decided to agree to an out of court settlement of Rs.5 crore to protect its reputation. The financial statements of the company are silent on this issue.

Discuss, how, CA PK Jacob should proceed to deal with above issue.

Answer 1

In the given case, the auditor has come to know of legal claim against the company before issue of audit report. It has also come to his knowledge that management of company has agreed to an out of

court settlement of Rs.5 crore. It is an example of subsequent event between the date of the financial statements and the date of the auditor's report. It provides evidence of conditions that existed at the date of the financial statements and requires adjustment in financial statements.

He should ask company management to make necessary adjustment to the financial statements. If adjustment is not made by management, he should consider impact on auditor's report.

Question 2

CA Chandni Khanna is going to complete audit of a company within next few days. She has performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings held after date of financial statements, going through books of accounts after date of financial statements to make sure that all subsequent events before signing audit report have been considered by her. Still, she wants to be certain that no such events have been left out. What she should do in such a situation?

Also, discuss the rationale of doing so.

Answer 2

She has already performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings after date of financial statements and going through books after date of financial statements.

Now, she should request management and, where appropriate, those charged with governance, to provide a written representation in accordance with SA 580, "Written Representations" that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

The rationale of obtaining written representations is that even after performing abovesaid procedures, she may not come to know all subsequent events. Therefore, it is necessary from an auditor's point of view to obtain acknowledgment from management in the form of Written representations that all such events for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Question 3

During course of audit of a company, CA. Varun Aggarwal notices that company is facing significant skilled labour shortages resulting in hampering of operations of 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 going out from their native villages.

Such a situation has led to company not being able to keep its commitments, losing out on orders and fall in its revenues. Fixed costs of the company remain at a high level. As a result, company is facing a liquidity crunch and is not able to pay its creditors on time. The bankers of company are also not willing to help the company to tide over liquidity crisis. The auditor is having 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 auditor in such a situation?

Answer 3

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 4

You are nearing completion of audit of a company. On going through your working papers, it is noticed that finished goods inventory was overvalued by Rs. 2 crore. It has also been noticed that freight of Rs.10 lacs paid on import of machinery was charged to statement of profit and loss.

Discuss, how you should, proceed and communicate in above situation before signing audit report.

Answer 4

The instances highlighted in above situation are examples of misstatements identified during the audit. Over valuation of inventory of finished goods by Rs. 2 crore and wrongly charging freight of Rs. 10 lacs paid on machinery to statement of profit and loss instead of capitalizing are examples of misstatements.

The auditor should communicate above identified misstatements to those charged with governance and request for correction of these misstatements. In case, these are not corrected, understand the reasons for not making the corrections and reassess materiality. It should also be considered whether uncorrected statements are material individually or in aggregate. Effect of uncorrected misstatements on the opinion in auditor's report should be communicated to those charged with governance.

Question 5

CA R Gurumurthy is about to complete audit of a company. Before completion, he asks management to provide him a written representation confirming that management has fulfilled its responsibilities regarding preparation of financial statements. He also wants management to confirm in writing about providing of all the necessary information and completeness of transactions to him. The management feels that auditor is seeking irrelevant documents near the completion of audit. Why view of management is not proper? What possible implications it may lead to?

Answer 5

The view of management is not proper. Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities.

In case of refusal of management to provide such a confirmation, it may lead to disclaimer of opinion by the auditor.

Question 6

On reviewing internal control over inventories as part of statutory audit of a company, auditor finds that physical verification is not being conducted at regular intervals as stipulated by the management.

The auditor finds it to be significant deficiency in internal control over inventories.

He points it out to the management in a one-liner as under: -

"Physical verification of inventories is not being conducted at regular intervals as stipulated by management."

Is above communication by auditor proper? Ignore statutory reporting requirements, if any in this regard.

Answer 6

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 not carrying out physical verification of inventories at regular intervals as stipulated by management. It should explain that such a significant deficiency can lead to misstatement of inventories impacting profits of the company.

Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

CHAPTER 8
AUDIT REPORT

SA 700- Forming an Opinion and Reporting on Financial Statements

Question 1

Examine with reasons (in short) whether the following statements are correct or incorrect:

The auditor shall express an adverse opinion when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(b) 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 (MTP 2 Marks March '18, Aug 18, Mar'19 & Oct '18)

Answer 1

Incorrect: The auditor shall express a qualified opinion when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(b) 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

Question 2

In order to form the audit opinion as required by SA 700, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Explain the conclusions that the auditor shall take into account. Also explain the objective of auditor as per SA 700. (MTP 5 Marks Aug '18)

Answer 2

The objectives of the auditor as per SA 700 (Revised), "Forming An Opinion And Reporting On Financial Statements" are:

(a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and

(b) To express clearly that opinion through a written report.

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

To form opinion - Auditor to obtain Reasonable assurance

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

That conclusion shall take into account:

(a) whether sufficient appropriate audit evidence has been obtained;

(b) whether uncorrected misstatements are material, individually or in aggregate;

(c) The evaluations

Question 3

The Auditor is fully satisfied with the audit of an entity in respect of its systems and procedures and wants to issue a report without any hesitation. What type of opinion can be given and give reasoning. (MTP 3 Marks April 19, May 20, RTP May '21)

Answer 3

Unqualified Opinion:

1. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements.
2. An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.
3. An unqualified opinion also indicates that:

(i) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;

(ii) the financial statements comply with relevant statutory requirements and regulations; and

(iii) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

Question 4

G & Associates are the Statutory Auditors of R Ltd., a company engaged in the business of manufacturing of blankets. The auditor has completed the audit and is in the process of forming an opinion on the financial statements for the F.Y. 2022-2023. CA L, the engagement partner, wants to conclude that whether the financial statements as a whole are free from material misstatements, whether due to fraud or error. What factors he should consider to reach that conclusion? (MTP 4 Marks Sep '23, PYP 4 Marks Dec '21)

Answer 4

Factors to be considered to form an opinion: The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

(a) The auditor's conclusion, in accordance with SA 330, whether sufficient appropriate audit evidence has been obtained

(b) The auditor's conclusion, in accordance with SA 450, whether uncorrected misstatements are material, individually or in aggregate.

(c) The evaluations required

(i) The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

(ii) This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Question 5

The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Explain (MTP 4 Marks April 19, Apr'21, May'20 & April '23, RTP Nov'18, Old & New SM)

OR

The description of management's responsibilities in the auditor's report includes reference to management's responsibilities as it helps to explain to users the premise on which an audit is conducted. Explain (RTP May '23)

OR

Give a brief description about the management responsibility to be mentioned in the statutory auditor's report. (Old SM)

Answer 5

Responsibilities for the Financial Statements: The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

This section of the auditor's report shall describe management's responsibility for:

(a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;[because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] and

(b) Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

Question 6

The auditor evaluated, in respect of T Ltd., whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. Auditor's evaluation included consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. Advise the qualitative aspects of the entity's account ing practices. (MTP 5 Marks March '18 & March 19 & Oct '18, RTP May'18, Old & New SM)

Answer 6

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:

(i) The selective correction of misstatements brought to management's attention during the audit Example

- Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
- The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives.

(ii) Possible management bias in the making of accounting estimates.

4. SA 540 addresses possible management bias in making accounting estimates.

   Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

Question 7

State with reason (in short) whether the following statements are true or false:

An Audit report is an opinion drawn on the entity's financial statements to make sure that the records are true and correct representation of the transactions they claim to represent. (RTP May '20)

Answer 7

Incorrect: The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements. The aforesaid purpose is achieved by the expression of an independent reporting by the auditor as to whether the financial statements exhibit a true and fair view of the affairs of the entity.

Thus, an Audit report is an opinion drawn on the entity's financial statements to make sure that the records are true and fair representation of the transactions they claim to represent.

Question 8

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also Identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section. (RTP May '20, Old & New SM)

OR

While drafting auditor's report of LK Ltd., what are the matter to be included by auditor in Opinion Section paragraph? (RTP Nov'22)

Answer 8

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

(a) Identify the entity whose financial statements have been audited;

(b) State that the financial statements have been audited;

(c) Identify the title of each statement comprising the financial statements;

(d) Refer to the notes, including the summary of significant accounting policies; and

(e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

Question 9

The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally. Explain (RTP May '21)

Answer 9

The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. This SA promotes consistency in the auditor's report but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

Question 10

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700. Explain (RTP May '22)

OR

CA Guru is in the process of preparing the final audit report of JPA Private Limited and would like to disclaim his opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence. How CA Guru shall amend the description of the auditor's responsibilities as required by SA 700 (Revised)? (PYP 3 Marks, July'21)

Answer 10

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

(a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;

(b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

(c) The statement about auditor independence and other ethical responsibilities required by SA 700 (Revised).

Question 11

State with reason (in short) whether the following statements are true or false

For auditor's opinion, reasonable assurance is an absolute level of assurance. (RTP Nov'22 & Nov '23)

Answer 11

Incorrect: Reasonable assurance is a high level but not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

Question 12

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. Explain stating clearly specific evaluations made by the auditor. (RTP May '22, MTP 3 Marks Oct '21, MTP 4 Marks Apr 21 & March '23, PYP 5 Marks, Nov'18)

OR

An auditor is required to make specific evaluations while forming an opinion in an audit report." State those evaluations. (Old & New SM)

Answer 12

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

In particular, the auditor shall evaluate whether:

(a) The financial statements adequately disclose the significant accounting policies selected and applied;

(b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(c) The accounting estimates made by management are reasonable;

(d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;

(e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Further, when the financial statements are prepared in accordance with a fair presentation framework, the evaluation mentioned above shall also include an evaluation by the auditor as to whether the financial statements achieve fair presentation which shall include consideration of:

(a) The overall presentation, structure and content of the financial statements; and

(b) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

Question 13

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required. (RTP May '23 & May 20, Old & New SM)

Answer 13

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated.

Indicators of a lack of neutrality include the following:

(i) The selective correction of misstatements brought to management's attention during the audit.

Example

- Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
- The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgement and involvement of audit executives.

(ii) Possible management bias in the making of accounting estimates.

Question 14

What an auditor should state in the "Basis for opinion" section of auditor's report ? When the auditor modifies the opinion on the financial statements, explain the amendments he should make in this section? (RTP Nov '23 , Nov '19 & Nov '20, MTP 3 Marks Oct '23)

OR

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section (Old & New SM)

Answer 14

An auditor should state in "Basis for Opinion" section of Auditor's Report as under:

Basis for Opinion:

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

(i) States that the audit was conducted in accordance with Standards on Auditing;

(ii) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;

(iii) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

(iv) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Amendments an Auditor should make:

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

(i) Amend the heading "Basis for Opinion" required by para of SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and

(ii) Within this section, include a description of the matter giving rise to the modification.

Question 15

State with reason (in short) whether the following statements are true or false: In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments (RTP May '21 & Nov 20)

Answer 15

Correct: In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated.

Question 16

Examine with reasons whether the following statements are correct or incorrect.

Where the firm is appointed as an auditor of the entity the audit report is signed only in the name of audit firm. (PYP 2 Marks, May'19)

Answer 16

Incorrect: Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India along-with registration number for the firm.

Question 17

State with reasons whether the following statements are correct or incorrect.

The Location of the description of the auditor's responsibilities for the audit of the financial statements is always within the body of the auditor's report. (PYP 2Marks, July'21)

Answer 17

Incorrect: The description of the auditor's responsibilities for the audit of the financial statement shall be always shown as below -

- Within the body of the auditor's report
- Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix or
- By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so

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Question 18

State with reasons whether the following statements are correct or incorrect:

Where a firm is appointed as the auditor of a company, the report is signed only in the personal name of the partner signing the report. (PYP 2 Marks Nov 22)

Answer 18

Incorrect: Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

Alternative Solution:

As per section 145 of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company. Whereas if a firm is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.

The partner signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. Which of the following is correct:

(a) The auditor shall express a qualified 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.

(b) The auditor shall express a disclaimer 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.

(c) 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.

(d) 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 material, but not pervasive, to the financial statements (MTP 2 Marks March '19)

Ans: (c)

2. Most of the auditor's work in forming the auditor's opinion consists of:

(a) obtaining audit evidence.

(b) evaluating audit evidence.

(c) obtaining or evaluating audit evidence.

(d) obtaining and evaluating audit evidence. (MTP 1 Mark Oct 19, Apr 19)

Ans: (d)

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3. An Audit report is:

(a) an opinion drawn on the entity's financial statements to make sure that the records are true and correct representation of the transactions they claim to represent.

(b) an opinion drawn on the entity's books of accounts to make sure that the records are true and fair representation of the transactions they claim to represent.

(c) an opinion drawn on the entity's financial statements to make sure that the records are true and fair representation of the transactions they claim to represent.

(d) an opinion drawn on the entity's books of accounts to make sure that the records are true and correct representation of the transactions they claim to represent. (MTP 1 Mark Oct 19)

Ans: (c)

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4. Which of the following is not correct:

(a) SA 700- Forming an Opinion and Repor4ng on Financial Statements

(b) SA 705- Modified Opinion

(c) SA 701- Communica4ng Key Audit MaEers

(d) SA 706-Compara4ve Informa4on (MTP 2 Marks Oct '20)

Ans: (d)

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5. Which of following is not an element of audit report in accordance with SA 700?

(a) Title

(b) Addressee

(c) Audit strategy

(d) Auditor's opinion (MTP 1 Mark Oct '23)

Ans: (c)

6. CA. Goofy has been appointed as an auditor for audit of a complete set of financial statements of Dippy Ltd., a listed company. The financial statements of the company are prepared by the management in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013.

However, the inventories are m isstated which is deemed to be material but not pervasive to the financial statements. Based on the audit evidences obtained, CA. Goofy has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570. Further, CA. Goofy is also aware of the fact that a qualified opinion would be appropriate due to a material misstatement of the Financial Statements.

State what phrases should the auditor use while drafting such opinion paragraph?

(a) In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.

(b) In our opinion and to the best of our information and according to the explanations given to us, with the foregoing explanation, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.

(c) In our opinion and to the best of our information and according to the explanations given to us, subject to the misstatement regarding inventories, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.

(d) In our opinion and to the best of our information and according to the explanations given to us, with the explanation described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework. (RTP May '19)

Ans: (a)

SA 705- Modifications to the Opinion in the Independent Auditor's Report

Question 1

While conducting audit of VED Ltd., you as an auditor are not only prevented in completing certain audit procedures but also are not able to obtain audit evidence even by performing alternative procedures.

How you will deal with this situation? (MTP 4 Marks March 22)

Answer 1

As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", if, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor sh all request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

(1) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or

(2) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:

(i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or

(ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

If the auditor withdraws, before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

Question 2

Distinguish between an adverse opinion and a qualified opinion. Also draft an opinion paragraph for both types of opinion. (MTP 4 Marks Oct'23, Old & New SM)

Answer 2

An auditor shall express an adverse opinion, when the auditor having obtained sufficient and appropriate audit evidence, concludes that misstatements, individually or in aggregate are both material and pervasive.

Whereas, when the auditor, having obtained sufficient and appropriate audit evidence, concludes that misstatements are material but not pervasive, shall express a qualified opinion.

SA705 – "Modifications to the Opinion in the Independent Auditor's Report" deals with the form and content of both types of report. The following are the draft of the opinion paragraphs of the reports.

(i) Adverse Opinion

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereina5er referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2023, the consolidated statement of profit and Loss, (consolidated statement of changes in equity) and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "consolidated financial statements"). In our opinion and to the best of our information and according to the explanations given to us, because of the significance of the maker discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 2023, of its consolidated profit/ loss, (consolidated position of changes in equity) and the consolidated cash flows for the year then ended.

(ii) Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 2023, and the statement of Profit and Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)) . In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the maker

described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2023 and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

Question 3

What an auditor should state in "Basis for opinion" section of auditor's report and when the auditor modifies the opinion on the financial statements, what amendments he should make in this section? (PYP 4 Marks, Jan'21)

Answer 3

An auditor should state in "Basis for Opinion" section of Auditor's Report as under: Basis for Opinion: The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

(i) States that the audit was conducted in accordance with Standards on Auditing;

(ii) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;

(iii) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

(iv) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Amendments an Auditor should make:

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

(i) Amend the heading "Basis for Opinion" required by para of SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and

(ii) Within this section, include a description of the matter giving rise to the modification.

Question 4

Explain whether the following statements are correct or incorrect, with reasons/ explanations/ examples Communicating Key Audit Matters is a substitute for the auditor expressing a modified audit opinion when required by the circumstances of a specific audit engagement in accordance with SA 705. (PYP 2 Marks, Jan' 21)

Answer 4

Incorrect: Communicating key audit matters in the auditor's report is not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

Question 5

Examine with reasons (in short) whether the following statements are correct or incorrect:

If financial statements are misstated, and in the auditor's judgment such misstatement is material and pervasive, he should issue a qualified opinion. (MTP 2 Marks Oct 19)

Answer 5

Incorrect: As per SA 705 "Modifications to the Opinion in the Independent Auditor's Report", 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. However, the auditor shall express qualified opinion when he concludes that misstatement, individually or in aggregate are material but not pervasive.

Question 6

Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2020 - 21 the company transferred its accounts to computerised system (SAP) from manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such the statutory auditors of the company were not able to extract correct data and reports from the system. Such data was not available manually also.

Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. The auditor believes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive.

Explain the kind of audit report that the statutory auditor of the company should issue in this case. (RTP Nov '21)

Answer 6

The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements. In the present case Delightful Ltd, the statutory auditor of the company is unable to extract correct data and reports from the SAP system for conduct of audit.

Also, such data and reports are not available manually. Moreover, the auditor believes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive.

As such, the statutory auditor of Delightful Ltd. should give a disclaimer of opinion.

Question 7

Examine with reasons (in short) whether the following statements are correct or incorrect:

An auditor should issue disclaimer of opinion when there is difference of opinion between him and the management on a particular point (PYP 2 Marks, Nov'18)

Answer 7

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

In case of difference of opinion, either the auditor will issue qualified report or adverse report and not disclaimer of opinion.

Question 8

Elucidate the circumstances when a modification to the Auditor's opinion is required. Also state the factors for making the decision regarding which type of modified opinion is appropriate. (PYP 3 Marks May '23, Old & New SM)

Answer 8

Circumstances When a Modification to the Auditor's Opinion Is Required

The auditor shall modify the opinion in the auditor's report in the following circumstances:

1. The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
2. The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(b) The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. A company did not disclose accounting policies required to be disclosed under Schedule III or any other provisions of the Companies Act, 2013, the auditor should issue–

(a) a qualified opinion

(b) an adverse opinion

(c) a disclaimer of opinion

(d) emphasis of matter paragraph. (MTP 1 Mark Oct 19)

Ans: (a)

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2. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances,

(a) the auditor shall express a qualified opinion in accordance with SA 705.

(b) the auditor shall express a disclaimer of opinion in accordance with SA 705.

(c) the auditor shall express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705.

(d) the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705. (MTP 2 Marks Oct 19, Apr'19 1 Mark, 2 Marks May'20, RTP Nov'19)

Ans: (d)

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3. An auditor disclaims opinion when_____?

(a) He is unable to obtain audit evidence and concludes that possible effects on financial statements of undetected misstatements could be material.

(b) He is unable to obtain audit evidence and concludes that possible effects on financial statements of undetected misstatements could be both material and adverse.

(c) He is unable to obtain audit evidence and concludes that possible effects on financial statements of undetected misstatements could be both material and pervasive.

(d) He is unable to obtain audit evidence and concludes that possible effects on financial statements of undetected misstatements could be both material and perverse. (MTP 1 Mark Oct '23)

Ans: (c)

SA 706- Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

Question 1

Examine with reasons (in short) whether the following statement is correct or incorrect:

Other matter paragraph is paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements. (MTP 2 Marks March '18, Aug'18, Oct'18, Mar'19)

Answer 1

Incorrect: Emphasis of Matter paragraph is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Question 2

State clearly the objective of the Auditor as per SA 706. Also define emphasis of matter paragraph and other matter paragraph. (MTP 4 Marks Oct 20)

Answer 2

As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or

(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Other Matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Question 3

The inclusion of an Emphasis of Matter paragraph in the Auditor's Report affects the auditor's opinion. (MTP 2 Marks March '21, RTP Nov '23)

Answer 3

Incorrect: When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Such a paragraph shall refer only to information presented or disclosed in the financial statements. The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion.

Question 4

Examine with reasons (in short) whether the following statements are correct or incorrect :

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall include an Emphasis of Matter paragraph in the auditor's report. (MTP 2 Marks April '21 & May 20)

Answer 4

Incorrect: If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.

Question 5

If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, what is required to be stated by the auditor in an Other Matter paragraph (MTP 3 Marks Sep'22)

Answer 5

If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

(i) That the financial statements of the prior period were audited by a predecessor auditor;

(ii) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and

(iii) The date of that report, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

Question 6

What is meant by Emphasis of Matter Paragraph? Give some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph. (MTP 4 Marks Oct'22)

OR

Discuss any four examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph in his report. (MTP 4 Marks Sep '23)

OR

Mention the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph. (MTP 3 Marks Nov '21, RTP Nov'22)

Answer 6

Examples of circumstances to include Emphasis of Matter Paragraph: As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are;

(a) An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.

(b) A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.

(c) Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.

(d) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Question 7

Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report? (RTP Nov'20, Old & New SM)

Answer 7

Emphasis of Matter paragraph: A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(i) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(ii) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disc losed in the financial statements; and Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Question 8

Define Emphasis of Matter paragraph. When the auditor shall include an Emphasis of Matter paragraph in the auditor's report? Also explain how the auditor would include an Emphasis of Matter in the auditor's report? (RTP May '19)

Answer 8

Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Emphasis of Matter Paragraphs in the Auditor's Report

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

(a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter; and

(b) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

Separate section for Emphasis of Matter paragraph When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

(c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Question 9

Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report? (PYP 5 Marks, May'18, Old & New SM)

Answer 9

Emphasis of Matter paragraph: A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(i) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(ii) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

(iii) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Question 10

D Ltd. is a company engaged in publishing business magazines. CA P is the statutory auditor of the company. The company takes property in the barter deal from its real estate customers against publication of their advertisements. The properties obtained during the year through such barter deals have been considered in the books of accounts on the basis of possession letter only and have been included in PPE in the financial statements. Considering this matter of such importance that is fundamental to the users understanding, CA P has decided to communicate the same in his report.

CA P seeks your guidance in reporting this matter in his audit report. (PYP 4 Marks May'22)

Answer 10

Emphasis of Matter Paragraphs in the Auditor's Report: If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

(i) The auditor would not be required to modify the opinion in accordance with SA 705 as a result of the matter; and

(ii) When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

In the given case as the properties obtained during the year through barter deals and included in the PPE in the books of accounts on the basis of possession letter only, hence there is a need to add Emphasis on Matter Paragraph in the Auditor's Report.

The draft of the same is as under:

Emphasis of Matter – Effect of Properties obtained through barter deals by the company We draw attention to Note (Y) of the financial statements, which describes the effects of the properties obtained through barter by the company. Our opinion is not modified in respect of this matter.

Alternative Solution:

In the given case as the properties obtained during the year through barter deals and included in the PPE in the books of accounts on the basis of possession letter only, hence there is a need to report the same under Clause i(c) of Paragraph 3 Companies (Auditor's Report) Order,2020.

Matters to be included in auditor's report - The auditor's report on the accounts of a company to which this Order applies shall include a statement on the following matter, namely:

(i) (c) whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company, if not, provide the details thereof in the format below:

Description of property	Gross carrying value	Held in name of	Whether promoter, director or their relative or employee	Period held– indicate range, where appropriate	Reason for not being held in name of company* *also indicate if in dispute
1	2	3	4	5	6

The auditor should state in the Reason (column 6) for not being held in name of company as follows "Properties obtained during the year through barter deals and included in the PPE in the books of accounts on the basis of possession letter only"

MULTIPLE CHOICE QUESTIONS (MCQS)

1. Which of the following is correct: (MTP 2 Marks April 19)

(a) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor need not disclose the substantive reasons for the different opinion.

(b) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with SA 706.

(c) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an emphasis of Matter paragraph in accordance with SA 706.

(d) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph or emphasis of matter paragraph in accordance with SA 706.

Ans: (b)

SA 701- Communicating Key Audit Matters in the Independent Auditor's Report

Question 1

Examine with reasons (in short) whether the following statements are correct or incorrect : The statutory auditor of ABC Ltd. is of the opinion that communicating key audit matters in the auditor's report constitutes a substitute for disclosure in the financial statements. (MTP 2 Marks April 19, PYP 2 Marks May'18, New SM)

Answer 1

Incorrect: Communicating key audit matters in the auditor's report is not a substitute for disclosures in the financial statements that the applicable Financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation.

Question 2

As an auditor of listed company, what are the matters that the auditor should keep in mind while determining "Key Audit Matters". (MTP 3 Marks Oct '21, RTP Nov'21)

OR

How would an auditor determine Key Audit Matters as per SA - 701, "Communicating Key Audit Matters in the Independent Auditor's Report"? (PYP 3 Marks, Nov'20)

Answer 2

Determining Key Audit Matters: As per SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report", the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

(i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.

(ii) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.

(iii) The effect on the audit of significant events or transactions that occurred during the period. The auditor shall determine which of the matters determined in accordance with above were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

Question 3

Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not considered as a substitute or alternative for a number of important items. What are those items? (MTP 3 Marks April 22, RTP Nov '19 & Nov '23)

OR

1. **Communicating Key Audit Matter is not a substitute for disclosure in the Financial Statements Rather Communicating key audit matters in the auditor's report is in the context of the Auditor having formed an opinion on the financial statements as a whole. Analyze. (Old & New SM)**
2. **The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.**

This evaluation shall include consideration of the qualitative aspects of the entity' s accounting practices, including indicators of possible bias in management's judgments.

Advise about qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. (RTP May'18)

Answer 3

As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

(i) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;

(ii) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report";

(iii) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or

(iv) A separate opinion on individual matters.

Question 4

Explain clearly the purpose of communicating key audit matters. (RTP Nov '18)

Answer 4

Purpose of communicating key audit matters

As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", the purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended user's in understanding the entity and areas of significant management judgment in the audited financial statements.

Question 5

Communicating key audit matters in the auditor's report is a separate opinion on individual matters. (PYP 2 Marks May '23)

Answer 5

Incorrect: Communicating key audit matters in the auditor's report are in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not a separate opinion on individual matters.

Alternative solution

Incorrect: Communicating key audit matters in the auditor's report is not a separate opinion on individual matters. The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters".

MULTIPLE CHOICE QUESTIONS (MCQS)

1. Which of the following is incorrect: (MTP 2 Marks April '19)

(a) Communicating key audit matters in the auditor's report is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;

(b) Communicating key audit matters in the auditor's report is not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

(c) Communicating key audit matters in the auditor's report is not a substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern;

(d) Communicating key audit matters in the auditor's report is a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

Ans: (d)

SA 710- Comparative Information—Corresponding Figures and Comparative Financial Statements

Question 1

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in some circumstances. Explain those circumstances. (MTP 5 Marks Aug '18, Sep 22, PYP 4 Marks Nov '19)

OR

The senior member of the firm Kaur & Associates, Chartered Accountants, informed to its auditing staff that at the time of audit reporting regarding corresponding figures, when corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in specified circumstances. What are those exceptional circumstances? (PYP 4 Marks May'22)

Answer 1

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances.

1. If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

(a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

(b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

2. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified.

3. Prior Period Financial Statements Not Audited- If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements

Question 2

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 stating the essential audit reporting differences between the approaches. Also define comparative information and audit procedures regarding comparative information. (RTP May '19)

Answer 2

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 the 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 3

NG Ltd. appointed CA N as the statutory auditor for the F.Y. 2021 -2022. Previous year's auditor gave a qualified opinion on the Comparative Financial Statements for the year ended 31.03.2021. What will be the reporting responsibility casted on CA N when he forms an opinion and prepares audit report on the Comparative Financial Statements for the F.Y. 2021-2022? (PYP 4 Marks Nov 22)

Answer 3

Prior Period Financial Statements Audited by a Predecessor Auditor: As per SA 710, if the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, CA. N, the auditor of NG Limited shall state in an Other Matter paragraph:

(a) That the financial statements of the prior period were audited by a predecessor auditor;

(b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and

(c) The date of that report, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

Audit of Branch Office Accounts 128(1)

Question 1

ABC Ltd is a company incorporated in India. It has branches within and outside India. Explain who can be appointed as an auditor of these branches within and outside India. Also explain to whom branch auditor is required to report. (RTP May'20, Old & New SM)

Answer 1

Sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company' s auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per rule 12 of the Companies (Audit and Auditors) Rules, 2014, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

Question 2

When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole. Explain. (MTP 4 Marks Oct 20, RTP Nov'18)

Answer 2

Using the Work of another Auditor: When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered

Accountants of India has dealt with these issues in SA 600, "Using the Work of another Auditor". It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

(a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit.

The principal auditor would inform the other auditor of matters such as are as requiring special consideration, procedures for the identification of inter -component transactions that may require disclosure and the time-table for completion of audit; and

(b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

Question 1

The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Explain stating the advantages of the joint audit. (MTP 4 Marks April '23, RTP Nov '19, Old & New SM)

Answer 1

Joint Audit: The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the to tal work. This is by itself a great advantage.

In specific terms the advantages that flow may be the following:

(i) Sharing of expertise.

(ii) Advantage of mutual consultation.

(iii) Lower workload.

(iv) Better quality of performance.

(v) Improved service to the client.

(vi) Displacement of the auditor of the company taken over in a takeover often obviated.

(vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.

(viii) Lower staff development costs.

(ix) Lower costs to carry out the work.

(x) A sense of healthy competition towards a better performance

Question 2

Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard. (RTP May '20, PYP 4 Marks, Nov '19)

Answer 2

Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:

(a) identify division of audit areas and common audit areas;

(b) ascertain the reporting objectives of the engagement;

(c) consider and communicate among all joint auditors the factors that are significant

(d) in directing the engagement team's efforts;

(e) consider the results of preliminary engagement activities, or similar engagements performed earlier.

(f) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

Question 3

Examine with reasons whether the following statements are correct or incorrect.

Joint auditor is always bound by the views of majority of the joint auditors regarding matters to be covered in report. (PYP 2 Marks, May '19)

Answer 3

Incorrect- Where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s). Therefore, joint auditor is not bound by the views of the majority of the joint auditors regarding the matters to be covered in the audit report.

Question 4

HMB 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? (PYP 4 Marks Nov 22)

Answer 4

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.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. Which of the following is not an advantage of Joint Audit:

(a) Sharing of expertise.

(b) General superiority complexes of some auditors.

(c) Lower workload.

(d) Displacement of the auditor of the company taken over in a take - over often obviated. (MTP 1 Mark Oct 19)

Ans: (b)

2. Which of the following is correct, in case of joint audit, where there is disagreement with regard to the opinion or any matters to be covered by the audit report.

(a) The auditors shall express their opinion in separate audit report.

(b) The audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s).

(c) Both (a) and (b) are correct

(d) The auditor who is having a separate opinion is bound by the opinion of the majority of the auditors and needs to issue a common audit report. (MTP 2 Marks March '21)

Ans: (c)

3. To jointly audit books of accounts of WZ Limited for the financial year 2020-21 two different firms of Chartered Accountants namely MH and Associates and NR and Associates were appointed. MH and Associates and NR and Associates can together be called as:

(a) Principal Auditors of WZ Limited.

(b) Branch Auditors of WZ Limited.

(c) Individual Auditors of WZ Limited.

(d) Joint Auditors of WZ Limited. (RTP Nov '21)

Ans: (d)

Reporting Requirements under Companies Act

Question 1

The auditor is not required to report on the matters specified in sub-section (1) of Section 143 unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. Explain clearly stating the matters for which the auditor has to perform his duty of inquiry under this section. (MTP 5 Marks Aug '18)

Answer 1

Sections 143 of the Companies Act, 2013 specifies the duties of an auditor of a company in a quite comprehensive manner. It is noteworthy that scope of duties of an auditor has generally been extending over all these years.

Section 143(1) - Duty of Auditor to Inquire on certain matters: It is the duty of auditor to inquire into the following matters-

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 143(1) is reproduced below:

"The auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor's Report will remain exactly the same as the auditor has to inquire and apply his mind to

the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our opinion, it is in this light that the auditor has to consider his duties under section 143(1)." Therefore, it could be said that the auditor should make a report to the members in case he finds answer to any of these matters in adverse.

Question 2

During the audit of PQR Ltd. you as an auditor requested officers of the company to have access to secretarial records and correspondence which they refused to provide. Comment. (MTP 4 Marks April 19, RTP May '21)

Answer 2

Right of Access to secretarial records and correspondence:

1. Section 143(1) of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books of account and vouchers of the company kept at Registered or Head Office, branches and subsidiaries in the case of a Holding Company for conducting the audit.
2. Further, he is also entitled to require from the officers of the company such information and explanations which he considers necessary for the proper performance of his duties as Auditor.

   Therefore, he has a statutory right to inspect the secretarial records and correspondence.
3. In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company. It is, therefore, essential for the auditor to refer to the secretarial records and correspondence which also includes Minute book. In the absence of the same, the auditor may not be able to vouch/verify certain transactions of the company.
4. The refusal to provide access to secretarial records and correspondence shall constitute limitation of scope as far as the auditor's duties are concerned.
5. The auditor may examine whether by performing alternative procedures, the auditor can substantiate the assertions or else he shall have to either qualify the report or give a disclaimer of opinion.

Question 3

Examine with reasons (in short) whether the following statement is correct or incorrect :

The auditor has to report under section 143 of companies act, 2013 whether company has adequate internal controls in place and overall effectiveness of such internal controls. (MTP 2 Marks Oct 20)

Answer 3

Incorrect: Under provisions of Section 143 of the companies Act, 2013, auditor has to report whether the company has adequate internal financial controls with reference to financial statements in place and operating effectiveness of such controls. The auditor has to report on adequacy and effectiveness of internal financial controls only and not internal controls.

Question 4

The auditor has to make inquires on certain matters under section 143(1) of Companies Act, 2013. Discuss those matters. (MTP 6 Marks Oct 20, RTP Nov'18, Old SM)

Answer 4

The auditor has to make inquires on following matters under section 143(1) of Companies Act, 2013:-

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Question 5

The auditor's reporting on internal financial control will be applicable with respect to interim financial statements. Discuss (MTP 3 Marks April '21 & April '23, PYP 2 Marks,Nov '19)

Answer 5

Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

It may be noted that auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.

Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

In view of above, the given statement is incorrect.

Question 6

Examine with reasons (in short) whether the following statements are correct or incorrect: An auditor has to report on the matters specified in section 143(1) of the Companies Act, 2013. (MTP 2 Marks March 22, RTP Nov '22)

Answer 6

Incorrect: The auditor is not required to report on the matters specified in section 143(1) of the Companies Act, 2013 unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. However, the auditor should make a report to the members in case he finds answer to any of these matters in adverse.

Question 7

Under provisions of Section 143(2), the auditor shall make a report to the members of the company on the accounts examined by him. Explain along with relevant rule of The Companies (Audit and Auditors) Rules, 2014 (MTP 4 Marks March 22)

Answer 7

Under provisions of Section 143(2), the auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made thereunder or under any order made under sub-section (11).

Further, auditor has to report whether to best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and following matters as prescribed under relevant rules (Rule 11):-

(i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

(iv) (1) Whether the management has represented that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

(2) Whether the management has represented, that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

(3) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.

(v) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013

(vi) Whether the company has used any accounting software for maintaining books of accounts which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail features have not been tampered with and the audit trail has been preserved by the company as per statutory requirements for record retention. (As per amendment Nov23)

Question 8

The auditor shall make a report to the members of the company on the accounts examined by him.

Explain with reference to relevant provisions of the Companies Act, 2013. (MTP 3 Marks March '23, RTP Nov '19, Old SM)

Answer 8

Right to report to the members of the company on the accounts examined by him – The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under this section and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company' s affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

Question 9

CA E was appointed statutory auditor of XYZ Private Limited in AGM held in the month of August, 2023 for the first time for audit of financial statements of the company from year 2023-24 onwards.

Since he is new to the company, he wants to be sure about integrity of accounting records. In this regard, he wants to ensure that software used by company for maintenance of its books of accounts is capable of tracking user activities and changes made to entries in books of accounts, if any, during the course of year.

What CA E is looking for in the given situation? Discuss the reporting requirements for CA E in this matter to be included in audit report to be issued under the Companies Act, 2013. (MTP 3 Marks Oct'23)

Answer 9

In the given situation, the auditor is looking for a feature of "audit trail" in software used by company for maintenance of books of accounts. Under section 143(3) of Companies Act, 2013, it has to be reported by the auditor as under: -

Whether the company has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the

year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.

Question 10

Discuss significance of a company auditor's right/power to obtain information and explanation from officers of the company. (RTP Nov '21)

Answer 10

The right of the auditor to obtain from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor is a wide and important power. In the absence of such power, the auditor would not be able to obtain details of amount collected by the directors, etc. from any other company, firm or person as well as of any benefits in kind derived by the directors from the company, which may not be known from an examination of the books. It is for the auditor to decide the matters in respect of which information and explanations are required by him.

Therefore, such a right/power is quite significant for discharge of duty of an auditor of a company to report to the members of the company on accounts examined by him.

Question 11

Explain Auditor's right to-

Report to the members of the company on the accounts examined by him Obtain information and explanation from officers. (RTP Nov 18)

Answer 11

Right to report to the members of the company on the accounts examined by him - The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under this section and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

Right to obtain information and explanation from officers - This right of the auditor to obtain from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor is a wide and important power. In the absence of such power, the auditor would not be able to obtain details of amount collected by the directors, etc. from any other company, firm or person as well as of any benefits in kind derived by the directors from the company, which may not be known from an examination of the books. It is for the auditor to decide the matters in respect of which information and explanations are required by him. When the auditor is not provided the information required by him or is denied access to books, etc., his only remedy would be to report to the members that he could not obtain all the information and explanations he had required or considered necessary for the performance of his duties as auditors.

Question 12

As per Sec 143(3)(j) of the Companies Act, 2013, the auditor's report shall also include such other matters as may be prescribed by Rule 11 of the Companies (Audit and Auditors) Rule, 2014. Discuss those matters on which views and comments of the auditor are required. (RTP Nov '23, PYP 3 Marks Dec '21)

Answer 12

Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:

(i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

(iv) (1) Whether the management has represented that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

(2) Whether the management has represented, that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

(3) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (1) and (2) contain any material misstatement.

(v) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

(vi) Whether the company has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention

Question 13

RJ Limited is in the business of trading of cycles having Head Office at Delhi and branch at Mumbai. Statutory audit of Head Office was to be done by CA D and statutory audit of branch at Mumbai was to be done by CA M. During the course of audit by CA D at head office, CA D Wanted to visit branch at Mumbai and verify the inventory records at Mumbai. The management of RJ Limited did not allow CA D to visit Mumbai office and verify the inventory records as the branch audit of Mumbai was already being undertaken by another CA M.

In the above situation, discuss the rights available with CA D in terms of the Companies Act, 2013. (PYP 3 Marks, Nov'20)

Answer 13

Section 143(1) of the Act provides that the auditor of a company, at all times, shall have a right of access to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and he is entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor.

(a) The right of access is not limited to those books and records maintained at the registered or head office so that in the case of a company with branches, the right also extends to the branch records, if the auditor considers it necessary to have access thereto as per Section143(8).

(b) In the given case where CA D was appointed as Statutory Auditor of Head office of RJ Ltd and CA M was appointed to conduct Statutory Audit of Branch office of RJ Ltd., CA D wanted to visit Mumbai Branch to verify the inventory records at Mumbai but management of RJ Ltd did not allow CA D to verify the inventory records at its Mumbai Branch on the ground that branch audit was already being undertaken by another CA M.

(c) Keeping in view the above provisions of the Companies Act and facts of the case, it can be concluded that CA D has a right to visit the branch for verifying inventory records at Mumbai even if the branch accounts are audited by another auditor CA M, if he considers it necessary to do so for the performance of his duties as an auditor.

Question 14

Examine with reasons (in short) whether the following statements are correct or incorrect:

Management of the organization is solely responsible for the compliance of auditing standards while preparing financial statements. (PYP 2 Marks, Nov 2018)

Answer 14

Incorrect: As per Section 143(9) of the Companies Act, 2013, every auditor shall comply with the auditing standards

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Question 15

During the course of audit of PQR Ltd, the statutory auditor CA G came across payments made to various creditors aggregating to ₹ 75 lakhs. On verifying the same it is found that the accounts manager had accounted for fake invoices of credit purchases for ₹ 25 lakhs in the books of account in the name of one bogus creditor Mr. X.

Discuss the duties of auditor with reference to the provisions of Companies Act, 2013 and also the disclosure requirements in the Board's Report. (PYP 4 Marks May '23)

Answer 15

The auditor shall report under clause (xi) of the CARO, 2020 that:

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;

Reporting to the Audit Committee or Board: Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than ₹ 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub- rule (1) [i.e. less than ` 1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

(i) Nature of Fraud with description;

(ii) Approximate amount involved; and

(iii) Parties involved.

Disclosure in the Board's Report: Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.

In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in the Board's Report the following details of each of the fraud reported to the Audit Committee or the Board under sub- rule (3) during the year:

(i) Nature of Fraud with description;

(ii) Approximate Amount involved;

(iii) Parties involved, if remedial action not taken; and

(iv) Remedial actions taken.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. Which of the following is correct as per section 143(10) of the Companies Act, 2013:

(a) IFAC may prescribe the standards of auditing as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

(b) the International Auditing Standards Board may prescribe the standards of auditing as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

(c) the MCA may prescribe the standards of auditing as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

(d) the Central Government may prescribe the standards of auditing as recommended by the Institute of Chartered Accountants of India, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority. (MTP 1 Mark Oct 19)

Ans: (d)

2. Which of the following is not a duty of auditor to report under section 143 (1)

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(d) whether the report on the accounts of any branch office of the company audited under subsection (8) by a person other than the company's auditors has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report; (MTP 1 Mark Oct 19)

Ans: (d)

3. Which of the following is FALSE regarding UDIN? (Unique document identification number)

(a) It is to be generated on UDIN portal.

(b) Its basic objective is to help ICAI in keeping and maintaining an online registry of different services provided by all of its members.

(c) It has to be generated and stated for each audit report signed by a Chartered Accountant.

(d) It has to be generated and stated for each certificate signed by a Chartered Accountant. (MTP 1 Marks Oct'22)

Ans: (b)

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4. UDIN (Unique Document Identification Number) is required to be stated by practising Chartered Accountant on: -

(a) Each audit report only

(b) Each audit report and each cerGficate

(c) Each audit report issued under Companies Act, 2013 only

(d) Each audit report issued under Companies Act, 2013 only and each cerGficate (MTP 1 Mark Oct '23)

Ans: (b)

CARO

Question 1

Discuss the reporting requirements under CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares. (New SM, MTP 4 Marks April 19, PYP 2 Marks May '18, PYP 4 Marks Dec'21)

Answer 1

The following are the disclosure requirements as per CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.

(a) whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year were applied for the purposes for which those are raised, if not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;

(b) whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of noncompliance;

Question 2

Discuss which class of companies are specifically exempt from the applicability of CARO 2016 (CARO 2020). (MTP 3 Marks Oct 19, New SM)

Answer 2

CARO 2016 (CARO 2020) specifically exempts the following class of companies:

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

(ii) An insurance company as defined under the Insurance Act,1938;

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

(iv) A One Person Company as defined under clause (62) of section 2 of the Companies Act;

(v) A small company as defined under clause (85) of section 2 of the Companies Act; and

(vi) 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 rupees one crore as on the balance

sheet date and which does not have total borrowings exceeding rupees one crore 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, 2013 (including revenue from discontinuing operations) exceeding rupees ten crores during the financial year asper the financial statements.

Question 3

M Ltd. has given certain loans to related parties and also has accepted certain deposits. As an auditor, how will you include the above items in paragraph 3 of CARO, 2016 (CARO 2020)? (MTP 3 Marks March '21, PYP 4 Marks, Nov '19)

Answer 3

Clause (iii) of paragraph 3 of CARO, 2016 (CARO 2020) states

Whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013. If so,

(i) As follows-

A) Aggregate amount during the year, outstanding at the balance sheet date with respect to such loans and advances to subsidiaries, joint ventures and associates.

B) Aggregate amount during the year, outstanding at the balance sheet date with respect to such loans and advances to parties other than subsidiaries, joint ventures and associates.

(ii) Whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;

(iii) Whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;

(iv) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;

(v) Specify the amount of any Renew or Extension or Fresh Loan granted to settle the overdues of existing loans given to same parties.

(vi) Reporting of any loan granted which are repayable on demand or without specifying any terms or period of payment.

Further, Clause (v) of paragraph 3 of CARO, 2016 (CARO 2020) states in case the company has accepted deposits,

(i) whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any: ether relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated;

(ii) If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?

In the given situation, M Ltd. has given certain loans to related parties and also has accepted certain deposits. Thus, the auditor is required to report the same as per clause (iii) and (v) of Paragraph 3 of CARO, 2016 (CARO 2020).

Question 4

Provision of CARO, 2016 (CARO 2020) is not applicable to ABC Pvt. Ltd., a subsidiary of XYZ Ltd. (a public company) having fully paid up Capital and Reserves & Surplus of Rs. 50 lakhs, Secured loan from bank of Rs. 90 Lakhs and Turnover of Rs. 5 Crore, for the financial year 2018-19. (MTP 3 Marks April '21, PYP 2 Marks, Nov '19)

Answer 4

The CARO specifically exempts 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 rupees 1 crore as on the balance sheet date and which does not have total borrowings exceeding rupees 1 crore 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, 2013 (including revenue from discontinuing operations) exceeding rupees 10 crore during the financial year as per the financial statements. From the above, it is clear that ABC Pvt. Ltd. is a subsidiary of XYZ Ltd. and hence not exempt from CARO, 2016 (CARO 2020) although it is satisfying the conditions that allow exemption to private limited company which is not a subsidiary or holding company of a public company.

Question 5

State the matters to be included in auditor's report as per CARO, 2020 regarding "Default in repayment of loan or borrowing to a financial institution, bank etc." (MTP 3 Marks March 22, MTP March'19, 4 Marks, MTP-March'18, 4 Marks, MTP-Nov 21, 3 Marks, MTP 4 Marks April '21, RTP May'18)

OR

ABC Ltd. is a public company, which has availed various loans and cash credit facilities from Banks and other financial institutions. The company has defaulted in repayments of such borrowings during the year under audit. What are the reporting requirements in this regard under the Companies (Auditor's Report) Order, 2020? (PYP 4 Marks May '23)

Answer 5

The auditor is required to report as per clause (ix) of paragraph 3 of CARO 2020

(a) whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported as per the format below:-

Nature of borrowing, including debt securities	Name of lender	Amount not paid On due date	Whether principal or interest	No. of days delay or unpaid	Remarks, if any
	lender wise details to be provided in case of defaults to banks, financial institutions and Government.				

(a) whether the company is a declared wilful defaulter by any bank or financial institution or other lender;

(b) whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported;

(c) whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated;

(d) whether the company has taken any funds from any entity or person on account of or to meet the obligations of its subsidiaries, associates or joint ventures, if so, details thereof with nature of such transactions and the amount in each case;

(e) whether the company has raised loans during the year on the pledge of securities held in its subsidiaries, joint ventures or associate companies, if so, give details thereof and also report if the company has defaulted in repayment of such loans raised;

Question 6

State the matters to be included in auditor's report as per CARO, 2020 regarding - Verification of inventory and working capital limits. (MTP 3 Marks April 22)

Answer 6

Matters to be included in Auditor's report as per CARO 2020:

(i) Clause (ii) of Para 3 of CARO, 2020, requires the auditor to report

(a) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;

(b) whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

Question 7

Discuss the reporting requirements as per CARO, 2020, regarding:

(i) Inventory and

(ii) Deposits accepted by company or amounts which are deemed to be deposits. (MTP 4 Marks Oct'22)

Answer 7

Matters to be included as per CARO, 2020:

Inventory

Clause (ii)

(a) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;

(b) whether during any point of time of the year, the company has been sanctioned working capital

limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

Deposits accepted by company or amounts which are deemed to be deposits

Clause (v)

In respect of deposits accepted by the company or amounts which are deemed to be deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act and the rules made thereunder, where applicable, have been complied with, if not, the nature of such contraventions be stated; if an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not;

Question 8

Discuss the reporting requirements as per CARO, 2020, regarding:

(i) disputed and undisputed statutory dues (MTP 2 Marks March '23, MTP 2 Marks Sep'22, RTP May'18, MTP 2.5 Marks Aug '18, MTP 2 Marks May 20) and

(ii) internal audit system of the company (MTP 2 Marks March '23, MTP 2 Marks Sep'22)

Answer 8

Matters to be included as per CARO, 2020:

Undisputed and Disputed Statutory dues Clause (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).

Internal audit system

Clause (xiv)

(a) whether the company has an internal audit system commensurate with the size and nature of its business;

(b) whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor.

Question 9

The head accountant of a company entered fake invoices of credit purchases in the books of account aggregate of ` 50 lakh and cleared all the payments to such bogus creditor. How will you deal as an auditor? (RTP May '20)

Answer 9

Here, the auditor of the company is required to report the fraudulent activity to the Board or Audit Committee (as the case may be) within 2 days of his knowledge of fraud. Further, the company is also required to disclose the same in Board's Report. It may be noted that the auditor need not to report the central government as the amount of fraud involved is less than ` 1 crore, however, reporting under CARO, 2016 (CARO 2020) is required.

Question 10

State with reason (in short) whether the following statements are true or false:(RTP May '22)

According to Para 3(1)(d) of CARO, 2020, an auditor needs to report whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 5% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets.

Answer 10

Incorrect: According to Para 3(1)(d) of CARO, 2020, an auditor needs to report whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets

Question 11

Explain the Reporting requirements the auditor should ensure under CARO 2020 related to PPE and Intangible assets. (RTP May '22, MTP 2.5 Marks Aug '18, MTP 3 Marks Oct'18, MTP 2 Marks May 20, PYP 3 Marks May '19, RTP Nov '21)

Answer 11

Reporting for PPE and Intangible assets - Clause (i) of Para 3 of CARO ,2020, requires the auditor to include a statement in the auditor's report on the following matters, namely -

(a) (A) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Property, Plant and Equipment;

(B) whether the company is maintaining proper records showing full particulars of intangible assets;

(b) whether these Property, Plant and Equipment have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

(c) whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company, if not, provide the details thereof in the format below:-

Description of property	Gross carrying value	Held in name of	Whether promoter, director or their relative or employee	Period held –indicate range, where appropriate	Reason for not being held in name of company*
					*also indicate if in dispute

(d) whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets;

(e) whether any proceedings have been initiated or are pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, if so, whether the company has appropriately disclosed the details in its financial statements.

Question 12

State the matters to be included in the auditor's report as per CARO, 2020 regarding:

(i) Nidhi Company.

(ii) Transactions with related parties. (RTP Nov '23)

Answer 12

As per clause (xii) of CARO, 2020, the following matters are required to be included in the auditor's report relating to Nidhi Company

(a) whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability;

(b) whether the Nidhi Company is maintaining ten per cent. unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;

(c) whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof;

As per clause (xiii) of CARO, 2020, the following matter is required to be included in the auditor's report relating to transactions with the related parties:

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 13

The auditor's requirement to report under clause (X) of paragraph 3 of the Companies (Auditor's Report) Order, 2016 is restricted to frauds noticed or reported during the year. Explain what auditors may consider for reporting under this clause? (PYP 3 Marks, Nov'20, RTP May'18, MTP-March'19, 4 Marks, MTP-March'18, 4 Marks,MTP-Nov 21, 3 Marks, MTP 4 Marks April '21)

Answer 13

The auditor is required to report under clause (x) (Clause xi) of paragraph 3 of Companies (Auditor's Report) Order,2016 (CARO 2020), Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:

(i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified, the fraud by the company or on the company by its officers or employees are only covered.

(ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.

(iii) While reporting under this clause

(a) report whether any fraud by the company or any fraud on the Company by its officers or employees 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, 2013 has been filed by the auditors in Form ADT-4.

(c) Whether auditor has considered whistle-blower complaints, if any

Question 14

State with reasons whether the following statements are correct or incorrect

According to CARO 2020, the company auditor is required to state that whether the title deeds of all immovable properties held in the name of the company are disclosed in its financial statements. (PYP 2 Marks May'22)

Answer 14

Incorrect: According to CARO, 2020, the company auditor is required to state whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company.

Question 15

G Pvt. Ltd. had fully paid up Capital and Reserves of ₹ 1.20 crore as at the end of F.Y. 2020-2021. During the F.Y 2021-2022, business was interrupted due to Covid restrictions and therefore the company incurred losses to the tune of ₹ 25 lacs. During the year, the company also borrowed ₹ 55 lakh each from a bank and a financial institution independently. It had a turnover of ₹ 850 lakh (other than revenue of ₹ 250 lakh from discontinuing operations). Ascertain whether CARO, 2020 is applicable to the company. (PYP 4 Marks May'22)

Answer 15

Applicability of CARO, 2020 in case of Private Ltd. Company: CARO, 2020 shall apply to every company including a foreign company except– a private limited company, not being a subsidiary or holding company of a public company,

(i) having a paid-up capital and reserves and surplus not more than one crore rupees as on the balance sheet date; and

(ii) 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

(iii) 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.

Applying the above to the given case, G Pvt. Ltd., its paid-up capital and reserves are ₹ 95 Lakh (₹ 120 Lakh - ₹ 25 Lakh), borrowings from a Bank and financial institution are (₹ 55 Lakh + ₹ 55 Lakh) i.e., ₹ 1.10 Crore, turnover {including discontinuing operations (₹ 850 lakh + ₹ 250 Lakh)} ₹ 1100 Lakh i.e., ₹ 11 Crore. Since its borrowings and turnover are exceeding the specified limit and therefore it is not exempt from the applicability of CARO, 2020.

Question 16

State with reasons whether the following statements are correct or incorrect:

Mr. T, the director of A Ltd., has purchased an old car belonging to the company against the cooling equipment belonging to the director, which is given to the company as consideration for the car. The auditor is not required to include this in his CARO report. (PYP 2 Marks Nov 22)

Answer 16

Incorrect: The auditor is required to report the same as per clause (xv) of Paragraph 3 of CARO, 2020, "whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with".

Question 17

TS Ltd. has raised funds by issuing fully convertible debentures. These funds were raised for the expansion and diversification of the business. However, the company utilised these funds for repayment of long-term loans and advances. What are the reporting requirements under CARO 2020 in this case? (PYP 4 Marks Nov 22, MTP 3 Marks Oct '21, PYP 4 Marks Nov '18)

Answer 17

Reporting Requirements under CARO 2020 for raising funds: As per clause (x)(b) of Para 3 of CARO, 2020, the auditor of a company has to report whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance.

In the present case, TS Ltd. has raised funds by issuing fully convertible debentures for expansion and diversification of the business. However, the company used the funds for repayment of long-term loans and advances instead of utilization of the same for the purpose for which the funds were raised i.e. expansion and diversification of business.

Here, the auditor should report the fact in his report that the funds were used for the purpose other than the purpose for which the funds were raised, as per cl ause (x)(b) of Para 3 of CARO, 2020.

MULTIPLE CHOICE QUESTIONS (MCQS)

1. In case of a fraud involving less than ₹ 1 crore, the auditor shall

(a) report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed.

(b) report the matter to the audit committee constituted under section 177 within such time and in such manner as prescribed.

(c) report the matter to the Board within such time and in such manner as prescribed.

(d) report the matter to the audit committee constituted under section 177 and also to the Board within such time and in such manner as prescribed. (MTP 1 Mark March '19)

Ans: (a)

2. During the course of audit of a listed company, CA P finds that solar power generating plant capitalized in books for ₹5.00 crore during the year does not exist. It became known that only bills were arranged and no assets were actually procured. Besides, financial statements also reflect depreciation of ₹1.50 core on above.

The bills of capitalized asset were approved by procurement head. The matter was reported to audit committee by CA P. However, no response was received. Considering above, choose the most appropriate option: -

(a) The matter needs to be reported to MCA in ADT-4. It also requires reporting under CARO,2020.

(b) The matter needs to be reported to MCA in ADT-4. It does not require reporting under CARO,2020.

(c) The matter need not be reported to MCA. However, it requires reporting under CARO,2020.

(d) The matter needs neither reporting to MCA nor under CARO,2020 (MTP 1 Marks Oct'22)

Ans: (a)

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3. For which of following company, provisions of CARO,2020 would be applicable?

(a) Boost Up Training (OPC) Private Limited

(b) RCI Bank Limited

(c) PST Industries Limited

(d) Moon Insurance Limited (MTP 1 Mark Oct '23)

Ans: (c)

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4. While reporting under CARO, 2020, it is duty of statutory auditor of company to report: -

(a) Fraud of less than ` 1 crore commiSed by officers or employees of company during the year

(b) Fraud of `1 crore or more commiSed by officers or employees of company during the year

(c) Fraud of `5 crore or more commiSed by officers or employees of company during the year

(d) Any fraud by the company or on the company noTced or reported during the year (MTP 1 Mark Oct '23)

Ans: (d)

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5. Eeyore Pvt. Ltd. is incorporated on 1st July, 2017. During the Financial Year ending on 31set March, 2018, the company did not opt for any borrowing at any point of time and have a total revenue of ` 60 Lakh. At the year end, it provides the following information regarding its paid-up capital and reserve & surplus-

Particulars	Amount (in `)
Paid-up Capital	
- Consideration received in cash for equity shares (including unpaid calls of ` 5,00,000)	40,00,000
- Consideration received in cash for preference shares	25,00,000
- Bonus shares allotted	7,00,000
- Share application money received pending allotment	10,00,000
Sub-Total	82,00,000
Reserve & Surplus	
- Balance in Statement of Profit and Loss	15,00,000
- Capital Reserves	10,00,000
Sub-Total	25,00,000
GRAND TOTAL	**1,07,00,000**

You are provided with the provisions regarding applicability of Companies (Auditor' s Report) Order, 2016, (CARO, 2020) issued under section 143(11) of the Companies Act, 2013 to a private limited company that it specifically exempts a private limited company having a paid up capital and reserves and surplus not more than ₹ 1 crore as on the Balance Sheet date and which does not have total borrowings exceeding ₹ 1 crore from any bank 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, 2013 exceeding ₹ 10 crore during the financial year.

Considering the information given above, which of the following shall be considered as a reason regarding applicability or non-applicability of CARO, 2016 (CARO 2020)?

(a) Reporting under CARO, 2016 (CARO 2020) shall be applicable as the company is having a paid up capital and reserves and surplus of ₹ 1.07 crore i.e. more than ₹ 1 crore as on the Balance Sheet date.

(b) Reporting under CARO, 2016 (CARO 2020) shall be applicable as the company is having a paid up capital and reserves and surplus of ₹ 1.02 crore i.e. more than ₹ 1 crore as on the Balance Sheet date.

(c) Reporting under CARO, 2016 (CARO 2020) shall not be applicable as the company is having a paid up capital and reserves and surplus of ₹ 0.92 crore i.e. not more than ₹ 1 crore as on the Balance Sheet date.

(d) Reporting under CARO, 2016 (CARO 2020) shall not be applicable as the company is having a paid up capital and reserves and surplus of ` 0.82 crore i.e. not more than ₹ 1 crore as on the Balance Sheet data (RTP May '19).

Ans: (c)

CASE STUDY

M/s AB & Company is a firm of Chartered Accountants based in Mumbai. Mr. A and Mr. B are the Partners of the Firm. The Firm is engaged in various assignments including Audits. The partners are taking a summary of their work in order to prepare themselves to finalize the Audit and issue the audit report to various clients. You are requested to go through the following and answer the questions that follow:

- **During the audit of M/s Persistent & Co, Mr. A found that the firm has changed the method of Depreciation from WDV to SLM but has not given the retrospective effect. Mr. A has calculated the difference of depreciation but M/s Persistent & Co. has stated that they don't want to change the financial statements and if auditor persists they may give the effect in the next financial year.**
- **During the audit of M/s Dubious Brothers, Mr B observed that the firm had a very large amount of cash sales and there were no details of the customers to whom the sales were made. Further, cash generated was not even deposited into bank regularly. When Mr. B asked the firm to give him an opportunity to count cash, the manager of the firm said that the cash is with the owner and it cannot be made available to the auditor for the checking purpose. The manager also declined to give an opportunity for stock verification to Mr B.**
- **During the audit of M/s Honest & Associates, Mr. A came to know that the firm has changed its method of valuation of stock. This change has a material impact on the financial statement of the firm. The firm has made relevant disclosures in the financial statements and has given proper accounting treatment to this exercise.**

MULTIPLE CHOICE QUESTIONS (MCQS)

Based on above, answer the following questions: -

1. In case of M/s Persistent & Company, what would be an ideal Audit Opinion?

(a) Unmodified

(b) Qualified

(c) Mention the fact in Emphasis of Matter Paragraph

(d) Disclaimer

Ans: (b)

2. In case of M/s Dubious Brothers, what Audit Opinion should the Auditor give?

(a) Qualified

(b) Adverse

(c) Disclaimer

(d) Unmodified

Ans: (c)

3. According to you, what would be appropriate course to take in case of M/s Honest & Associates?

(a) Issue Qualified Opinion

(b) Issue Adverse Opinion

(c) Mention the fact of change in method in Emphasis of Matter Paragraph

(d) Issue Disclaimer of Opinion

Ans: (c)

4. When the Auditor, after conclusion of an Audit exercise, is of the opinion that there are material misstatements in the Financial Statements, but they are not pervasive, then what should an Auditor do?

(a) Issue Unmodified Opinion

(b) Issue Qualified Opinion

(c) Issue Disclaimer of Opinion

(d) Mention it in Emphasis of Matter Paragraph

Ans: (b)

5. When the Auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, Auditor shall give:

(a) Modified Opinion

(b) Qualified Opinion

(c) Disclaimer of Opinion

(d) Unmodified Opinion

Ans: (d)

TEST YOUR KNOWLEDGE

6. While expressing an unmodified opinion on financial statements, the auditor shall not use which of the following phrases?

(a) present fairly in all material respects

(b) give a true and fair view

(c) with the foregoing explanation

(d) All of the above

Ans: (c)

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7. ..... is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to the user's understanding of the financial statements.

(a) Emphasis of Matter Paragraph

(b) Other Matter Paragraph

(c) Key Audit Matter

(d) Management Responsibility Paragraph.

Ans: (a)

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8. Statement 1: Communicating key audit matter in the auditor's report constitutes a substitute for disclosure in the financial statements.

Statement 2: Instead of modifying an opinion in accordance with SA 705, the statutory auditor can use Key Audit Matter paragraph in the audit report with an unmodified opinion.

(a) Only Statement 1 is correct

(b) Only Statement 2 is correct

(c) Both the statements are correct

(d) None of the statement is correct

Ans: (d)

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9. Which of the following is not correct?

(a) SA 700 - Forming an Opinion and Reporting on the Financial Statements

(b) SA 701- Key Audit Matters in the Independent Auditor's Report

(c) SA 705- Comparative Information- Corresponding figures and Comparative Financial Statements

(d) SA 706- Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

Ans: (c)

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10. Responsibilities of Joint Auditors are governed by:

(a) SA 200

(b) SA 229

(c) SA 299

(d) SA 230

Ans: (c)

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

Question 1

The auditor shall express a qualified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Answer 1

Incorrect: The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Question 2

There is no need of addressee in the Auditor's report.

Answer 2

Incorrect: The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's

report is to be addressed. The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

Question 3

The auditor shall modify the opinion in the auditor's report only when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.

Answer 3

Incorrect: The auditor shall modify the opinion in the auditor's report when:

(a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Question 4

The auditor shall express a disclaimer of 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.

Answer 4

Incorrect: 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.

Question 5

Communicating key audit matter in the auditor's report constitutes a substitute for disclosure in the financial statements.

Answer 5

Incorrect: Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation.

Question 6

When the auditor has to express an adverse opinion, he need not communicate with those charged with governance as this may have an impact on payment of his audit fees.

Answer 6

Incorrect: When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification.

Question 7

Instead of modifying an opinion in accordance with SA 705, the statutory auditor can use Key Audit Matter paragraph in the audit report with an unmodified opinion.

Answer 7

Incorrect: Communicating key audit matters in the auditor's report is not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised).

Question 8

The concept of "joint audit" has legal foothold under the Companies Act, 2013.

Answer 8

Correct: Under provisions of section 139(3), the members of a company may resolve to provide that audit shall be conducted by more than one auditor. Hence, the concept of "joint audit" has legal foothold also under Companies Act, 2013.

THEORETICAL QUESTIONS ANSWER

Question 1

"The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework." Explain

Answer 1

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable

assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

That conclusion shall take into account:

(a) Whether sufficient appropriate audit evidence has been obtained;

(b) Whether uncorrected misstatements are material, individually or in aggregate;

(c) The evaluations.

Question 2

"The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements." Discuss stating clearly qualitative aspects of the entity's accounting practices.

Answer 2

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

Question 3

Discuss the factors affecting the decision of the auditor regarding which type of modified opinion is appropriate.

Answer 3

The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(b) The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

The table below illustrates how the auditor's judgement about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	Auditor's Judgement about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but not Pervasive	Material and Pervasive
Financial statements are misstated materially	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Question 4

Discuss the objective of the auditor as per Standard on Auditing (SA) 705 "Modifications to The Opinion in The Independent Auditor's Report".

Answer 4

As per Standard on Auditing (SA) 705 "Modifications To The Opinion In The Independent Auditor's Report", the objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

(a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Question 5

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated.

Explain and analyse the indicators of lack of neutrality with examples, wherever required.

Answer 5

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:

(i) The selective correction of misstatements brought to management's attention during the audit.

Example

• Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.

The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgement and involvement of audit executives.

(ii) Possible management bias in the making of accounting estimates.

Question 6

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section.

Answer 6

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

(a) Identify the entity whose financial statements have been audited;

(b) State that the financial statements have been audited;

(c) Identify the title of each statement comprising the financial statements;

(d) Refer to the notes, including the summary of significant accounting policies; and

(e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

Question 7

Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?

Answer 7

Emphasis of Matter paragraph: A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(i) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(ii) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

(iii) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Question 8

"An auditor is required to make specific evaluations while forming an opinion in an audit report." State those evaluations.

Answer 8

Specific Evaluations by the auditor: In particular, the auditor shall evaluate whether :

(i) The financial statements adequately disclose the significant accounting policies selected and applied;

(ii) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(iii) The accounting estimates made by management are reasonable;

(iv) The information presented in the financial statements is relevant, reliable, comparable, and understandable;

(v) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(vi) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Question 9

The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Explain

Answer 9

Responsibilities for the Financial Statements: The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

This section of the auditor's report shall describe management's responsibility for:

a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;[because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] and

b) Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

Question 10

Communicating Key Audit Matter is not a substitute for disclosure in the Financial Statements rather Communicating key audit matters in the auditor's report is in the context of the Auditor having formed an opinion on the financial statements as a whole. Analyse.

Answer 10

Communicating key audit matters in the auditor's report is not:

(i) A substitute for disclosures in the financial statements that the applicable Financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;

(ii) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

(iii) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or

(iv) A separate opinion on individual matters

Question 11

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section.

Answer 11

Basis for Opinion: The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

(a) States that the audit was conducted in accordance with Standards on Auditing;

(b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;

(c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

(d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Question 12

Distinguish between an adverse opinion and a qualified opinion. Also draft an opinion paragraph for both types of opinion.

Answer 12

An auditor shall express an adverse opinion, when the auditor having obtained sufficient and appropriate audit evidence, concludes that misstatements, individually or in aggregate are both material and pervasive.

Whereas, when the auditor, having obtained sufficient and appropriate audit evidence, concludes that misstatements are material but not pervasive, shall express a qualified opinion.

SA705 – "Modifications To The Opinion In The Independent Auditor's Report" deals with the form and content of both types of report. The following are the draft of the opinion paragraphs of the reports.

(a) Adverse Opinion

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2021, the consolidated statement of profit

and Loss, (consolidated statement of changes in equity) and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "consolidated financial statements"). In our opinion and to the best of our information and according to the explanations given to us, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 2021, of its consolidated profit/ loss, (consolidated position of changes in equity) and the consolidated cash flows for the year then ended.

(b) Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 2021, and the statement of Profit and Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)) . In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2021 and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

Question 13

ABC Ltd is a company incorporated in India. It has branches within and outside India. Explain who can be appointed as an auditor of these branches within and outside India. Also explain to whom branch auditor is required to report.

Answer 13

Sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified

to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company' s auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per rule 12 of the Companies (Audit and Auditors) Rules, 2014, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

Question 14

Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan.

In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard.

Answer 14

Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan.

In developing the joint audit plan, the joint auditors should:

(a) identify division of audit areas and common audit areas;

(b) ascertain the reporting objectives of the engagement;

(c) consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;

(d) consider the results of preliminary engagement activities, or similar engagements performed earlier.

(e) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

Question 15

The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Explain stating the advantages of the joint audit.

Answer 15

Joint Audit: The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and

expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the advantages that flow may be the following:

(i) Sharing of expertise.

(ii) Advantage of mutual consultation.

(iii) Lower workload.

(iv) Better quality of performance.

(v) Improved service to the client.

(vi) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.

(vii) Lower staff development costs.

(viii) Lower costs to carry out the work.

(ix) A sense of healthy competition towards a better performance

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Question 16

Discuss the reporting requirements under CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.

Answer 16

The following are the disclosure requirements as per CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.

(a) whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year were applied for the purposes for which those are raised, if not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;

(b) whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of noncompliance;

Question 17

Discuss which class of companies are specifically exempt from the applicability of CARO 2020?

Answer 17

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 18 Illustration

M/s Smart & Associates are the statutory auditors of Hotmeals Ltd. for the FY 2021-22. How will the auditor address the audit report issued on the financial statements for the FY 2021-22? Also give a title to the report.

Answer 18

INDEPENDENT AUDITOR'S REPORT

To the Members of Hotmeals Ltd.

Question 19 Illustration

Richa International is a partnership firm dealing in export of blankets. The partners of the firm are Richa and Ashish. Explain how the statutory auditor of the firm will address the auditor's report.

Answer 19

INDEPENDENT AUDITOR'S REPORT

To the Partners of Richa International

Question 20 Illustration

M/s Amitabh & Associates are the statutory auditors of Ringston Ltd. which is a company engaged in the business of manufacture of pen drives. The auditor has started drafting the audit report for the FY 2021-22. CA Amitabh, the engagement partner is of the view that the financial statements of Ringston Ltd. represent a true and fair view. Give the draft of the opinion paragraph of the audit report.

Answer 20

Opinion

We have audited the financial statements of Ringston Limited which comprise the Balance Sheet as at 31.03.2022 and the statement of Profit and Loss Account and the notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the company as at 31.03.2022 and the Profit & Loss for the year ending on that date.

Question 21 Illustration

M/s Kite Rite & Associates are the statutory auditors of Prime Deluxe Limited, for the FY 2021-22. At the time of finalising the audit report, one of the engagement team members, Mr. Robin, asked the engagement partner, CA Kite as to what all should be included in the Basis of Opinion Paragraph. The engagement partner CA Kite, explained the team in detail and asked Mr. Robin to draft such section for the auditor's report of Prime Deluxe Limited. Help Mr. Robin to draft the Basis for opinion section.

Answer 21

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described

in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Question 22 Illustration

Diamond Shine Ltd. is a company engaged in the manufacture of detergent. M/s Bright & Associates are the statutory auditors of the company. Explain how the paragraph related to the management's responsibility will come in the auditor's report.

Answer 22

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity) and cash flows of the Company in accordance with the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgements and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error. In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so. Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

Question 23 Illustration

M/s Ajay Vijay & Associates are the statutory auditors of Sarovar Ltd. for the FY 2021- 22. The company is engaged in the business of manufacture of water bottles. At the time of finalising the auditor's report, one of the audit team members asked CA Ajay, the engagement partner to advise as to how the auditor's responsibilities can be shown in an appendix to the auditor's report. Draft the auditor's responsibility paragraph so as to advise the audit team member.

Answer 23

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists.

Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor's report. This description, which is located at [indicate page number or other specific reference to the location of the description], forms part of our auditor's report.

Question 24 Illustration

M/s TUV & Associates are the statutory auditors of Venus Ltd. for the FY 2021-22. At the time of finalising the auditor's report, one of the audit team members asked the engagement partner, CA Tarun, to explain as to how the auditor's report will be signed. Help CA Tarun in explaining the same.

Answer 24

The following is the correct way of signing an audit report.

M/s TUV & Associates Chartered

Accountants (Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

(Membership No. XXXXX)

Place of Signature: UDIN: 20037320AAAAAH1111

Date:

Question 25 Illustration

Auditor's Report on Financial Statements of a Listed Entity Prepared in Accordance with a Fair Presentation Framework For purposes of this illustrative auditor's report, the following circumstances are assumed:

- **Audit of a complete set of financial statements of a listed company (registered under the Companies Act, 2013) using a fair presentation framework. The audit is not a group audit (i.e., SA 600 does not apply).**
- **The financial statements are prepared by management of the entity in accordance with the accounting Standards prescribed under section 133 of the Companies Act, 2013.**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.**
- **The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.**
- **The relevant ethical requirements that apply to the audit comprise the Code of Ethics issued by ICAI together with the other relevant ethical requirements relating to the audit and the auditor refers to both.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).**
- **Key audit matters have been communicated in accordance with SA 701.**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013.**

Question 26 Illustration

Super Duper Ltd. is a company engaged in the manufacture of office furniture. M/s Young Old & Associates are the statutory auditors of the company for the FY 2021- 22. During the year under audit, the engagement partner CA Young noticed that the company has not bifurcated its loans into long term and short term. CA Young understands that such misstatement is not pervasive though the same is material. Explain the type of opinion that should be given by M/s Young Old & Associates in this case.

Answer 26

M/s Young Old & Associates should give a qualified opinion as the effect of the misstatement on account of the non-bifurcation of loans into long term and short term loans, is material but not pervasive.

Question 27 Illustration

M/s Taj Raj & Associates are the statutory auditors of Polex Ltd. engaged in the manufacture of premium watches, for the FY 2021-22. During the course of audit, CA Taj, the engagement partner found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Both the facts are not reflected in the financial statements for the year ending 31.03.2022.

Accordingly, CA Taj is of the view that the impact of both the situations on the financial statements is material and pervasive and thus, the financial statements represent a distorted view of the state of affairs of the company. Explain the reporting requirements of CA Taj.

Answer 27

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.

In the case Polex Ltd., CA Taj found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Such situations are not reflected in the financial statements of the company despite having a material and pervasive impact on the financial statements. As such, CA Taj should give an adverse opinion.

Further, CA Taj should also consider the reporting responsibilities under CARO 2020 and section 143(12) of the Companies Act, 2013.

Disclaimer of Opinion The auditor shall disclaim an opinion when the auditor is unable to obtain

sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Question 28 Illustration

Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2021-22 the company transferred its accounts to computerised system (SAP) from manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such the statutory auditors of the company were not able to extract correct data and reports from the system. Such data was not available manually also.

Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. Explain the kind of audit report that the statutory auditor of the company should issue in this case.

Answer 28

When the statutory auditor of the company is unable to obtain sufficient and appropriate audit evidence, the auditor should give disclaimer of opinion as per SA 705.

In the present case, the statutory auditor of the company is unable to extract correct data and reports from the SAP system for conduct of audit. Also, such data and reports are not available manually. As such, the statutory auditor of Delightful Ltd. should give a disclaimer of opinion.

Question 29 Illustration

M/s Daisy & Associates are the statutory auditors of Zebra Ltd. for the FY 2021-22. CA Daisy, the engagement partner wants to verify the cash in hand as on 31.03.2022. The cash balance of the company as on 31.03.2022 is ` 1,00,000/- and the turnover of the company for the year is ` 6 crores. The management of the company informs CA Daisy that such cash verification is not possible as the cashier is on leave for his marriage and no other employee of the company is available as all are busy in year ending activities. Explain the relevant provisions to deal with such a situation.

Answer 29

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers is likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

In the present case CA Daisy, the statutory auditor is unable to verify the cash in hand of Zebra Ltd. as on 31.03.2022. The same is due to a limitation imposed by the management of Zebra Ltd. which is due to the non availability of the cashier. In such situation, CA Daisy should perform alternate procedures to verify the cash on hand of the company. Further, CA Daisy should consider the impact on the auditor's report and may consider issuing a qualified opinion in this case.

Question 30 Illustration

M/s Sun Moon & Associates are the statutory auditors of Venus Ltd. for the FY 2021-22. Owing to the pervasive nature of material misstatements in the financial statements of the company, CA Moon, the engagement partner decided to give an adverse opinion. Explain the responsibility of CA Moon with respect to communication with those charged with governance.

Answer 30

CA Moon, being the statutory auditor of Venus Ltd. should communicate with those charged with governance about the circumstances that led to the expected modification i.e. an adverse opinion. Further the wording of such modification also needs to be discussed.

Question 31 Illustration

Lomaxe Ltd. is a company engaged in the business of manufacture of candles. CA Kamalnath is the statutory auditor of the company for the FY 2021-22. During the year under audit, there was a fire in the company's factory as a result of which, some of the company's plant and machinery was destroyed.

The same was disclosed by the company in the notes to accounts annexed to the financial statements for the year ending 31.03.2022. CA Kamalnath decided to communicate this matter in the auditor's report as he is of the view that the matter is of such importance that it is fundamental to the user's understanding of the financial statements. Help CA Kamalnath to deal with this situation in the auditor's report.

Answer 31

In the present case there is a need to add Emphasis on Matter Paragraph in the Auditor's Report. The draft of the same is as under:

Emphasis of Matter – Effects of Fire in Company's Factory

We draw attention to Note Y of the financial statements, which describes the effects of a fire in the Company's factory. Our opinion is not modified in respect of this matter.

Test Your Understanding

Question 1

Maithili Thakur, a CA student, was perusing audit report of a company. Her eyes fell on an 18-digit alpha numeric number stated at end of audit report below the signatures of auditor and membership number.

Make her understand objective and significance of such a randomly generated number. Is it required to be stated in case of audit reports only?

Answer 1

The 18-digit alpha numeric number noticed by her at end of audit report is Unique Document

Identification number (UDIN). It is a system generated unique number. Its basic objective is to curb the malpractices of non-CAs impersonating themselves as CAs. It helps in securing reports and documents issued by practising CAs.

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

Question 2

CA. Maya Memani has conducted audit of a company. She has asked Sana, a CA student undergoing training in her office, to prepare draft audit report. Sana was part of engagement team conducting the audit. She has been further told to prepare draft report expressing unmodified opinion. After drafting para comprising unmodified opinion, Sana feels no need to provide basis for opinion. Discuss why her thinking is not proper.

Answer 2

"Basis for Opinion" is one of basic elements of an audit report in accordance with SA-700. Even in cases where unmodified opinion is expressed by auditor, "Basis for opinion" has to be provided by auditor. Basis for opinion section provides context about auditor's opinion.

Therefore, Sana's thinking is not proper.

Question 3

CA. Sarasbhai Patel, while conducting audit of an entity, feels that there is an atmosphere of noncooperation all around. He has not been provided with necessary support for attending inventory count process of entity as at year end. Besides, CFO is not providing him present addresses of customers as well as suppliers for sending external confirmations. Even mail ids have not been provided on the pretext of business confidentiality.

He was not able to verify revenues of entity due to lack of complete details. For verifying expenses, he has been asking for bills on a sample basis, but staff has been making lame excuses. The matter was brought to knowledge of higher echelons of management, but of no avail. The auditor feels that there could be misstatements and their possible effects would be material and affecting many aspects of financial statements.

Assuming it is not possible to withdraw from engagement, what type of opinion should be expressed by auditor?

Answer 3

In the given case, auditor has not been able to obtain sufficient appropriate audit evidence relating to inventories, debtors, creditors, revenues and expenses. The matter has brought to knowledge of management but no result has been achieved. Besides, auditor opines that there could be misstatements and their possible effects could be both material and pervasive.

In such circumstances, he should make disclaimer of opinion in accordance with SA 705.

Question 4

CA. Dicky Yadav is auditor of a company having four branches. The four branches are audited by another auditor CA. Yamini Jain. The reports in respect of accounts of branches examined by her have already been sent to company auditor. During the course of audit, CA Dicky Yadav asks the branch auditor to share with her summary of audit procedures and findings in respect of accounts of branches examined.

CA. Yamini Jain feels it as encroachment of her domain. Discuss the issue.

Answer 4

As per SA 600 - "Using the Work of Another Auditor", the principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. Such review of audit procedures and findings can be undertaken if principal auditor feels that it is necessary to apply such procedures to obtain sufficient appropriate audit evidence. It is not an encroachment of another auditor's domain.

Question 5

CA. Ravi Patnaik is conducting audit of a company for which reporting requirements under CARO, 2020 are applicable. He finds that cash credit facilities amounting to ₹ 4 crores were released to the company by branch of a bank for meeting its working capital requirements. He finds that out of above funds, ₹ 1 crore have been used by company for installing effluent treatment plant to meet State pollution control Board requirements. Is there any reporting obligation upon him under CARO,2020?

Answer 5

Clause (ix) (d) of CARO, 2020 whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated.

In the given situation, funds have been raised for meeting working capital requirements for ` 4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings. Out of above, `1 crore have been used by the company for investment in effluent treatment plant which is ostensibly for a long-term purpose.

Hence, the matter needs to be reported in accordance with requirements of Clause (ix) (d) of CARO, 2020.

CHAPTER 9
AUDIT OF DIFFERENT TYPES OF ENTITIES

Question 1

An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations. (MTP 5 Marks March '18 March '19, Oct'18, Old & New SM)

Answer 1

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.

(v) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.

(vi) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.

Question 2

Advise any five special points in an audit of hospital. (MTP 5 Marks March '18, March '19, Aug'18, Oct'18)

OR

You have been appointed auditor of Dr. Prem Ratan Hospital. Discuss any eight important points that would attract your attention while audit. (MTP 4 Marks Oct '21)

OR

You have been appointed auditor of M/s. BLK Hospital. Discuss important points that would attract your attention while audit. (MTP 6 Marks March 22, PYP 4 Marks Nov '19)

OR

The general transactions of a hospital include patient treatment, collection of receipts, donations, capital expenditures. You are required to mention special points of consideration while auditing such transactions of a hospital? (MTP 4 Marks Oct 19, RTP Nov 18, Old SM)

OR

A muti-speciality hospital has come up in your city. You are appointed as auditor for first year. Discuss, any four, broad areas to be kept in mind while conducting audit of accounts of such a newly opened multi-speciality hospital. (Old & New SM)

OR

The general transactions of a hospital include patient treatment, collection of receipts, donations, capital expenditures. You are required to mention special points of consideration while auditing such transactions of a hospital? (Old & New SM)

Answer 2

Audit of Hospital: The special steps involved in such an audit are stated below-

(1) **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(2) **Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

(3) **Income from Investments, Rent etc.:** See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities have been collected.

(4) **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(5) **Reconciliation of Subscriptions:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(6) **Authorisation and Sanctions:** Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.

(7) **Grants and TDS:** Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

(8) **Budgets:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.

(9) **Internal Check:** Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorization.

(10) **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.

(11) **Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

(12) Inventories: Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.

(13) Management Representation and Certificate: Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Question 3

BPL Ltd. is running a "RAGHU PALACE CINEMA." Your firm of Chartered Accountants has been appointed to get its accounts audited. Assistant appointed on the job to conduct audit asks the audit in charge as to how to go about conducting an audit and seeks your guidance on it. Keeping in view the above you are required to explain to the assistant special steps (any five) involved in the Audit of Cinema. (MTP 5 Marks Aug '18)

OR

You are auditing the Books of accounts of Karla Multiplex which runs 15 Film shows everyday. One of the major issues which are of concern to you as an auditor is the Agreement entered into the Multiplex owners with the Film Distributors. State what points would you check as an auditor in this respect. (Old & New SM)

Answer 3

The special steps involved in the audit of Cinema are stated below-

(1) Verify the internal control mechanism-

(a) that entrance to the cinema-hall during show is only through printed tickets;

(b) that they are serially numbered and bound into books;

(c) that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;

(d) that for advance booking a separate series of tickets is issued; and

(e) that the inventory of tickets is kept in the custody of a responsible official.

(2) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.

(3) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.

(4) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class and vouch and verify the entertainment tax returns filed each month.

(5) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different

shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

(6) Verify the charges collected for advertisement slides and shorts by reference to the Register of Slides and Shorts Exhibited kept at the cinema as well with the agreements, entered into with advertisers in this regard.

(7) Vouch the expenditure incurred on advertisement, repairs and maintenance. No part of such expenditure should be capitalized.

(8) Confirm that depreciation on machinery and furniture has been charged at an appropriate rate.

(9) Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.

(10) Examine unadjusted balance out of advance paid to the distributors against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.

(11) The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, etc. as in the case of club.

Question 4

State six important advantages of audit of accounts of a Partnership firm. (MTP Marks April 19)

Answer 4

Advantages of Audit of Accounts of a Partnership: On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows:

(1) Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated. On this consideration, it is usually provided in and accepted by the partners, shall be binding upon them, unless some manifest error is brought to light within a specified period subsequent to the accounts having been signed.

(2) On the retirement or death of a partner, audited accounts, which have been accepted by the partners, constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.

(3) The accounts of a partnership, which have been audited, are generally accepted by the Income Tax Department as the basis for computing the assessable income of the partners.

(4) Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.

(5) Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.

(6) An audit is an effective safeguard against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

Question 5

Audit against the propriety seeks to ensure that expenditure confirms to certain principles. Explain (MTP 4 Marks Oct 19)

Answer 5

Audit against propriety: Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

(1) The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

(2) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

(3) Public moneys should not be utilized for the benefit of a particular person or section of the community unless:

(i) The amount of expenditure involved is insignificant; or

(ii) A claim for the amount could be enforced in a Court of law; or

(iii) The expenditure is in pursuance of a recognized policy or custom; and

(iv) The amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

Question 6

LLP need not file a "Statement of Accounts and Solvency". . (MTP 2 Marks May 20, Apr'21)

Answer 6

Incorrect: A LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. A "Statement of Accounts and Solvency" in prescribed form shall be filed by every LLP with the Registrar every year.

Question 7

The C&AG Act gives powers to the C&AG in connection with the performance of his duties. Explain. (MTP 4 Marks May 20, Nov'21, April '23, Oct'23, PYP 3 Marks May '19)

Answer 7

Powers of C&AG: The C&AG Act gives the following powers to the C&AG in connection with the performance of his duties

i. To inspect any office of accounts under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.

ii. To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

iii. To put such questions or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which is his duty to prepare.

In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transactions as he may determine.

Question 8

Cinescreen Multiplex Ltd. is operating cinemas in different locations in Mumbai and has appointed you as an internal auditor. What are the areas that need to be verified in relation to receipts from sale of Tickets? (MTP 4 Marks May 20, Apr'21, RTP Nov '22)

OR

M/s PQ & Co., Chartered Accountants have been appointed as statutory auditor of CBD Multiplex Cinema Ltd. The audit team started the audit and verified the ledger and other books of accounts for the F.Y 2021-2022. However, one of the team members is of the view that the

internal control mechanism of the company should also be verified. Can you guide the audit team about the areas that will be covered in verifying the internal control mechanism? (PYP 4 Marks Nov 22)

Answer 8

Audit of Cinema: The special steps involved in its audit are stated below-

(i) Verify that entrance to the cinema-hall during show is only through printed tickets;

(ii) Verify that they are serially numbered and bound into books;

(iii) Verify that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;

(iv) Verify that for advance booking a separate series of tickets is issued;

(v) Verify that the inventory of tickets is kept in the custody of a responsible official.

(vi) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.

(vii) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.

(viii) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class.

(ix) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

Question 9

The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. Explain. (MTP 4 Marks Oct 20)

Answer 9

Compile and submit Accounts of Union and States - The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. The Comptroller and Auditor General shall, from the accounts compiled by him or [by the Government or any other person responsible in that behalf] prepare in each accounts (including, in the case of accounts compiled by him, appropriation

accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union Territory having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

The C&AG Act of 1971 has provisions for relieving him of this responsibility to give information and render assistance to the Union and States: The Comptroller and Auditor General shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

Question 10

GSR & Co. has been appointed as an auditor of Tagore School. Engagement team wants to verify Fees from students in detail. Advise the audit procedure to be followed by the engagement team.(MTP 3 Marks March '21)

OR

Explain and also state the role of auditor with respect to the following in case of a school: The fees from the students. (MTP 4 Marks Oct'22)

Answer 10

Fee from Students :-

1. Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.
2. Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
3. Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
4. Check admission fees with admission slips signed by the head of the institution and confirm

that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.

5. See that free studentship and concessions have been granted by a person authorised to do so, having regard to the Rules prepared by the Managing Committee.
6. Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
7. Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

Question 11

The audit programme of NGO should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted. Explain. (MTP 3 Marks March '21)

Answer 11

The audit programme should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted.

(i) **Corpus Fund:** The contributions / grants received towards corpus be vouched with special reference to the letters from the donor(s). The interest income be checked with Investment Register and Physical Investments in hand.

(ii) **Reserves:** Vouch transfers from projects / programmes with donors letters and board resolutions of NGO. Also check transfer of gross value of asset sold from capital reserve to general reserve and adjustments during the year.

(iii) **Ear-marked Funds:** Check requirements of donors institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.

(iv) **Project / Agency Balances:** Vouch disbursements and expenditure as per agreements with donors for each of the balances.

(v) **Loans:** Vouch loans with loan agreements, counterfoil of receipt issued.

(vi) **Fixed Assets:** Vouch all acquisitions / sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/ agreements for the grant. In the case of immovable property check title, etc.

(vii) **Investments:** Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis - investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.

(viii) **Cash in Hand:** Physically verify the cash in hand and imprest balances, at the close of the year and whether it tallies with the books of account.

(ix) **Bank Balance:** Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.

(x) **Inventory:** Verify inventory in hand and obtain certificate from the management for the quantities and valuation of the same.

(xi) **Programme and Project Expenses:** Verify agreement with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.

(xii) **Establishment Expenses:** Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

Question 12

Examine with reasons (in short) whether the following statement is correct or incorrect :

Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the Finance Minister may on the advice of the C&AG prescribe. (MTP 2 Marks April '21 & May '20, Old SM)

Answer 12

Incorrect: Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.

Question 13

Briefly explain the provisions for qualification and appointment of Auditors under the Multi-State Cooperative Societies Act, 2002. (MTP 4 Marks April '21) (PYP 5 Marks, Nov '18)

OR

Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of Multi- State co-operative society. Explain stating also the persons who are not eligible for appointment as auditors of a Multi-State co-operative society. (MTP 5 Marks Aug '18)

OR

CA. Z. a Chartered Accountant is the Senior manager of a Multi-State Co-operative Society in Mumbai. He is proposed to be appointed as an auditor of the said Multi-State Cooperative Society. Analyse the provisions of the Multi-State Co-operative Societies Act, 2002 and comment on validity of proposed appointment. (PYP 4 Marks May '23)

Answer 13

Qualification of Auditors -Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of Multi-State co-operative society.

However, the following persons are not eligible for appointment as auditors of a Multi-State co-operative society-

(i) A body corporate.

(ii) An officer or employee of the Multi-State co-operative society.

(iii) A person who is a member or who is in the employment, of an officer or employee of the Multi-State co-operative society.

(iv) A person who is indebted to the Multi-State co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the Multi-State co-operative society for an amount exceeding one thousand rupees.

If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be deemed to have vacated his office as such.

Appointment of Auditors - Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this sub-section, the Multi-State co-operative society in the general meeting may appoint the first auditor or auditors.

The subsequent auditor or auditors are appointed by Multi-State co-operative society, at each annual general meeting. The auditor or auditors so appointed shall hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

Question 14

All Non-Governmental Organisations (NGOs) registered under the Companies Act, 2013 are allowed to maintain accounts either on accrual basis or cash basis. (MTP 2 Marks Oct '21 & March '21)

Answer 14

Incorrect: NGOs registered under the Companies Act, 2013 must maintain their books of account under the accrual basis as required by the provisions of section 128 of the said Act. If the accounts are not maintained on accrual basis, it would amount to non-compliance of the provision of the Companies Act, 2013. The NGOs which are not registered under the Companies Act, 2013 are allowed to maintain accounts either an accrual basis or cash basis.

Question 15

"Public moneys should not be utilised for the benefit of a particular person or section of the community". List out the exceptions to this rule while audit against propriety. (MTP 3 Marks Oct '21, RTP Nov '23)

Answer 15

Exceptions to the rule – Audit Against Propriety: Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

(i) the amount of expenditure involved is insignificant; or

(ii) a claim for the amount could be enforced in a Court of law; or

(iii) the expenditure is in pursuance of a recognised policy or custom; and

(iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

Question 16

(I) List out the types of Revenue Grants received by local bodies from the State. (MTP 2 Marks Nov '21)

(II) PQR Ltd., a government company, constructed a building in conformity with rules and regulations for installing a telephone exchange but not used for the same purpose resulting in the infructuous expenditure.

Considering the above case, explain the type of expenditure audit to be performed to curb the situation. (MTP 2 Marks Nov '21)

Answer 16

(i) Revenue grants received by Local Bodies:

Local bodies may receive different types of grants from the state administration. Broadly the revenue grants are of three types:

(1) General purpose grants: These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.

(2) Specific purpose grants: These grants which are tied to the provision of certain services or performance of certain tasks.

(3) Statutory and compensatory grants: These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

(ii) Propriety audit: According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Further, it may so happen that a transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned but may still be highly wasteful.

In the given situation, PQR Ltd. being a government company, constructed a building in conformity with rules and regulations for installing a telephone exchange but not used for the same purpose resulting in an infructuous expenditure.

Thus, propriety audit should be done for PQR Ltd. to bring out improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations to the notice of the proper authorities of wastefulness in public administration.

Question 17

Audit of government expenditure is one of the major components of government audit conducted by the office of C & AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Explain those standards. (MTP 4 Marks March 22, RTP Nov'19)

OR

The audit of government expenditure is one of the major components of government audit. Explain the basic standards set for such audit of expenditure. (MTP 4 Marks March '21, RTP

May '23, PYP 5 Marks , Nov '18)

OR

An audit of Expenditure is one of the major components of Government Audit. In the context of 'Government Expenditure Audit', write in brief, what do you understand by:

(i) Audit against Rules and Orders

(ii) Audit of Sanctions

(iii) Audit against Provision of Funds

(iv) Propriety Audit

(v) Performance Audit. (RTP May '18)

Answer 17

Government Expenditure Audit: Audit of government expenditure is one of the major components of government audit conducted by the office of C&AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorized by competent authority fixing the limits within which expenditure can be incurred. Briefly, these standards are explained below:

(i) Audit against Rules & Orders: The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority.

(ii) Audit of Sanctions: The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorizing such expenditure.

(iii) Audit against Provision of Funds: It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made.

(iv) Propriety Audit: It is required to be seen that the expenditure is incurred with due regard to broad and general principles of financial propriety. The auditor aims to bring out cases of improper, avoidable, or in fructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Audit aims to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions.

(v) Performance Audit: This involves that the various programmers, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Efficiency-cum- performance audit, wherever used, is an objective examination of the financial and operational performance of an organization, programmer, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

Question 18

The Constitution of India contains no specific provisions regarding the appointment, salary and duties and powers of the C&AG. Moreover, the constitution does not guarantee the independence of the C&AG of India. (MTP 2 Marks April 22, RTP Nov '20)

Answer 18

Incorrect: The Constitution of India contains specific provisions regarding the appointment, salary and duties and powers of the C&AG. The constitution guarantees the independence of the C&AG of India by prescribing that he shall be appointed by the President of India and shall not be removed from office except on the ground of proven mis-behaviour or incapacity.

Question 19

In carrying out audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertained to the bank, there is no unrecorded income and the income is recorded at appropriate amount. Explain the Audit Approach and Procedures regarding following points in the above context :

(i) RBI's Directions

(ii) Materiality

(iii) Revenue Certainty

(iv) Revenue Uncertainty (MTP 4 Marks April 22)

Answer 19

Audit Approach and Procedures

- **Auditor's Concern:** In carrying out audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertained to the bank, there is no unrecorded income and the income is recorded at appropriate amount.
- **RBI's Directions:** RBI has advised that in respect of any income which exceeds one percent of the total income of the bank if the income is reckoned on a gross basis or one percent of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per Accounting Standard 9.
- **Materiality:** If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify their report in that situation.

- **Revenue Certainty:** Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In modern day banking, the entries for interest income on advances are automatically generated through a batch process in the CBS system.
- **Revenue Uncertainty:** In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also.

Question 20

Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. Analyse and Explain (MTP 4 Marks April 22, RTP Nov '20)

OR

What is the function of audit while examining various rules, regulations and orders with regard Audit against Rules & Orders by C&AG? (MTP 4 Marks Nov '21, PYP 3 Marks Nov'20)

OR

Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. These rules, regulations and orders against which regularity audit is conducted fall under various categories. Explain (MTP Sep'22 4 Marks)

Answer 20

Audit against Rules & Orders - Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

(i) Rules and orders regulating the powers to incur and sanction expenditure from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);

(ii) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and

(iii) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulat ions and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

(a) they are not inconsistent with any provisions of the Constitution or any laws made thereunder;

(b) they are consistent with the essential requirements of audit and accounts as determined by the C&AG;

(c) they do not come in conflict with the orders of, or rules made by, any higher authority; and

(d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C&AG.

Question 21

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession. Explain stating clearly the definition of Government auditing as discussed in U.N. Handbook on Govt Auditing and Developing Countries and also state Objectives of Govt audit. (MTP 4 Marks April 22, RTP May '21, PYP 4 Marks July '21, Old SM)

Answer 21

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession.

The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:

Government auditing is

- the objective, systematic, professional and independent examination
- of financial, administrative and other operations
- of a public entity
- made subsequently to their execution
- for the purpose of evaluating and verifying them,
- presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions
- by the responsible officials
- and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

OBJECTIVES: -

(a) Accounting for Public Funds:-Government audit serves as a mechanism or process for public accounting of government funds.

(b) Appraisal of Government policies:-It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.

(c) Base for Corrective actions:-Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.

(d) Administrative Accountability: The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration

Question 22

What are the special steps involved in conducting the audit of an Educational Institution? (Write any 12 points) (MTP 6 Marks April 22, RTP Nov '19 & May '18)

Answer 22

The Special Steps Involved in the Audit of an Educational Institution are the following:

(i) Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.

(ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.

(iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

(v) Total up the various columns of the Fees Register for each month or term to ascertain t hat fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

(vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.

(vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.

(viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.

(ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.

(x) Verify rental income from landed property with the rent rolls, etc.

(xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

(xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.

(xiii) Report any old heavy arrears on account of fees, dormitory rents, etc, to the Managing Committee.

(xiv) Confirm that caution money and other deposits paid by students on admission have been shown as liability in the balance sheet and not transferred to revenue.

(xv) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.

(xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.

(xvii) Vouch donations, if any, with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.

(xviii) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

(xix) Vouch in the usual manner all establishment expenses and enquire into any unduly heavy expenditure under any head.

(xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.

(xxii) Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. These should be checked by reference to Inventory Register and values applied to various items should be test checked.

(xxiii) Confirm that the refund of taxes deducted from the income from investment (intere st on securities, etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.

(xxiv) Verify the annual statements of accounts and while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of Staff, etc.

Question 23

Explain and also state the role of auditor with respect to the following in case of a hotel: Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. (MTP 3 Marks Sep'22, Oct '23, RTP May '22)

Answer 23

Internal control: Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will

minimise the leakage as far as possible. Evidence of their success i s provided by the preparation of regular perhaps weekly, trading accounts for each sales point and a detailed scrutiny of the resulting profit percentages, with any deviation from the anticipated form being investigated. The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.

The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order. The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities. If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts.

As a result, the scope of his audit tests will necessarily be increased and, in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.

Question 24

Explain and also state the role of auditor with respect to the following in case of a school:

Other Receipts/Grants & Donations (MTP 3 Marks Oct'22)

Answer 24

Other Receipts/Grants & Donations :-

1. Verify rental income from landed property with the rent rolls, etc.
2. Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
3. Verify any Government or local authority grant with the memo of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons thereof.

Question 25

Explain the meaning of Government Audit and also discuss its objectives. (MTP 4 Marks Oct'22, New SM)

Answer 25

The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:

Government Audit is the objective, systematic, professional and independent examination of financial, administrative and other operations of a public entity ,made subsequently to their execution for the purpose of evaluating and verifying them, presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future action by the responsible officials and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

OBJECTIVES of the Govt Audit are :

1. **Accounting for Public Funds:** It serves as a mechanism or process for public accounting of government funds.
2. **Appraisal of Govt. Policies:** It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.
3. **Corrective Actions:** Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.
4. **Administrative Accountability:** The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration

Question 26

Explain and also state the role of auditor with respect to the following in case of a hotel:

(i) Inventories (MTP 4 Marks March '23 & Sep '22)

(ii) Travel agents & shops (MTP 3 Marks March '23)

OR

CA Irfan Zaidi is auditor of a prestigious five-star hotel in Jaipur. He notices that there is a gift shop doing brisk business inside the hotel premises. On further enquiries, he comes to know that stocks in gift shop belong to gift shop owner and hotel receives rent for letting out this space. Discuss, how, auditor can verify payment of common amenities used by gift shop owner to the hotel. (Old & New SM)

Answer 26

(i) Inventories

The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores areas

and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed.

Areas where large quantities of inventory are held should be kept locked, the key being retained by the departmental manager. The key should be released only to trusted personnel and unauthorised persons should not be permitted in the stores areas except under constant supervision. In particular, any movement of goods in or out of the stores should be checked. Many hotels use specialised professional valuers to take and value the inventories on a continuous basis throughout the year.

Such a valuation is then almost invariably used as the basis of the balance sheet inventory figure at the year end. Although such valuers are independent of the audit client, it is important that the auditor satisfies himself that the amounts included for such inventories are reasonable. In order to satisfy himself of this, the auditor should consider attending the physical inventory taking and carrying out certain pricing and calculation tests. The extent of such tests could well be limited since the figures will have been prepared independently of the hotel.

(ii) Travel agents & shops:

(i) For ledgers coming through travel agents or other booking agencies the bills are usually made on the travel agents or booking agencies. The auditor should ensure that money are recovered from the travel agents or booking agencies as per the terms of credit allowed.

(ii) Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.

Question 27

State the points which merit consideration in the audit of a CLUB w.r.t its members. (MTP 4 Marks March '23, Old & New SM)

OR

You have been appointed as internal auditor of 'City Club' in Delhi. The receipts of the club were 50 lakhs during the previous year ending 2019-20. You are required to mention special points of consideration while auditing such receipts of the club. (PYP 4 Marks, Jan21)

OR

Sporting Club of India is a private club engaged in promotion of sports in the country. As an auditor of this leading club, discuss any two points to ensure that expenditure incurred by club during the year is properly authorised (Old & New SM)

Answer 27

The points which merit consideration in the audit of a CLUB w.r.t its members:

(1) Entrance Fee: Vouch the receipt on account of entrance fees with –

- members' applications and counterfoils issued to them,
- on a reference to minutes of the Managing Committee.

(2) Member 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) Subscription Arrears/in Advance: Ensure that –

- arrears of subscriptions for the previous year have been correctly brought over,
- arrears for the year under audit and subscriptions received in advance have been correctly adjusted.
- Subscriptions received in advance should have been properly accounted for.

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

(5) Register of Members: 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) 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.

Question 28

As an auditor, explain the areas of consideration while auditing the element of ROOM SALES during the audit of a 5-Star Hotel. (MTP 4 Marks April '23, Old & New SM)

Answer 28

Following points merit consideration while auditing the element of ROOM SALES during the audit of a Hotel:-

(1) The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor.

(2) The source of these entries is the guest register and audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period.

(3) Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.

(4) In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room. This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill.

(5) Ensure compliance with the provisions of FEMA and RBI if receipts are in foreign currency. Ensure application of proper Conversion rate.

(6) Special emphasis to be laid on receipts through Credit Cards.

(7) The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.

Question 29

As an Auditor of NGO, how do you check/verify at least four receipts of income during the year? (MTP 4 Marks April '23 & Sep '23, PYP 4 Marks Jan 21)

Answer 29

The receipt of income of NGO may be checked on the following lines:

(i) Contributions and Grants for projects and programmes: Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.

(ii) Receipts from fund raising programmes: Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

(iii) Membership Fees: Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.

(i) Subscriptions: Check with subscription register and receipts issued. Reconcile subscription

received with printing and dispatch of corresponding magazine/ circulars/periodicals. Check the receipts with subscription rate schedule.

(ii) Interest and Dividends: Check the interest and dividends received and receivable with investments held during the year.

Question 30

Central Govt. holds 55% of the paid up share Capital in Kisan Credit Co-operative Society, which is incurring huge losses. Advise when the Central Government can direct Special Audit under Section 77 of the Multi State Co-operative Society Act. (MTP 3 Marks April '23, PYP 3 Marks ,May '19, Old SM)

Answer 30

Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi-State co-operative society. Under section 77 of the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:

i. 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

ii. 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

iii. that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

Thus, in the given case since Central Govt is holding 55% shares and financial position of Kisan Credit co- operative society is in danger, Central government can direct for special audit.

Question 31

Before commencing the Audit of Local Bodies, a Chartered Accountant employee in firm of XYZ & Co., firm of Chartered Accountants seeks assistance of Mr. X, partner, in preparation of audit programme for local bodies. How Mr. X should advise to him in this connection? (MTP 4 Marks Sep '23)

Answer 31

Audit Programme for local bodies

(i) The Local Fund Audit Wing of the State Government is generally in-charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure his appointment.

(ii) The auditor while auditing the local bodies should report on the fairness of the contents and presentation of financial statements, the strengths and weaknesses of system of financial control, the adherence to legal and/or administrative requirements; whether value is being fully received on money spent. His objective should be to detect errors and fraud and misuse of resources.

(iii) The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.

(iv) He should ensure that all types of sanctions, either special or general, accorded by the competent authority.

(v) He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.

(vi) The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

Question 32

You have been appointed as an auditor of ABC Hotel, a three-star hotel, for Financial Year 2022-23. As an auditor, what are the special points that need to be considered in verifying the Inventories in the nature of food and beverages? (MTP 4 Marks Oct'23, RTP Nov '22)

Answer 32

Verification of inventories in the nature of food and beverages:

The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores' areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed. Therefore, following points may be noted in this regard:

(i) All movement and transfer of inventories must be properly documented.

(ii) Areas where inventories are kept must be kept locked and the key retained by the departmental manager.

(iii) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.

(iv) Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.

(v) The auditor should ensure that all inventories are valued at the year end and that he should himself be present at the year-end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories.

Question 33

Explain in detail the duties of Comptroller and Auditor General of India (RTP Nov '19, May '18, May'19, Old & New SM)

Answer 33

Duties of C&AG: The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under-

(i) Compile and submit Accounts of Union and States - The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.

(ii) General Provisions Relating to Audit - It shall be the duty of the C&AG –

(a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

(b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

(c) to audit and report on all trading, manufacturing profit and loss accounts and balance sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) Audit of Receipts and Expenditure - Where anybody or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

(iv) **Audit of Grants or Loans -** Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organization, the Comptroller and Auditor General shall scrutinize the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

(v) **Audit of Receipts of Union or States -** It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.

(vi) **Audit of Accounts of Stores and Inventory -** The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

(vii) **Audit of Government Companies and Corporations -** The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The comptroller and Auditor - General of India shall appoint the auditor under sub-section (5) or subsection (7) of section 139 (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

Question 34

State with reason (in short) whether the following statements are true or false:

Government audit does not serve as a mechanism or process for public accounting of government funds. (RTP May '20)

Answer 34

Incorrect: Government audit serves as a mechanism or process for public accounting of government funds. It also provides public accounting of the operational, management, programmer and policy aspects of public administration as well as accountability of the officials administering them.

Question 35

a) As per Multi-State Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account. Explain (RTP May '20)

b) Explain the powers and duties of auditors under the Multi-State Co-operative Societies Act, 2002. (RTP May '20)

Answer 35

a) As per sub-section (3) & (4) of section 73 of Multi- state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co- operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

(a) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and

(b) In the case of the profit and loss account, of the profit or loss for its financial year. The auditor's report shall also state:

(i) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.

(ii) Whether, in his opinion, proper books of account have been kept by the Multi- State cooperative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State co-operative society not visited by him.

(iii) Whether the report on the accounts of any branch office audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.

(iv) Whether the Multi-State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.

Where any of the matters referred to in sub-section (3) or (4) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

b) Section 73 of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors. According to this, every auditor of a Multi-State co-operative society shall have a right of access at all times to the books accounts and vouchers of the Multi-State co-operative society, whether kept at the head office of the Multi- State co-operative society or elsewhere, and shall be entitled to require from the officers or other employees of the Multi- State co-operative society such information and explanation as the auditor may think necessary for the performance of his duties as an auditor.

As per section 73(2), the auditor shall make following inquiries:

(a) Whether loans and advances made by the Multi-State co-operative society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State co-operative society or its members,

(b) Whether transactions of the Multi-State co-operative society which are represented merely by book entries are not prejudicial to the interests of the Multi-State co-operative society,

(c) Whether personal expenses have been charged to revenue account, and

(d) Where it is Stated in the books and papers of the Multi-State co-operative society that any shares have been allotted for cash, whether cash has actually, been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet as correct regular and not misleading.

Question 36

The auditor of a Govt Company has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. Explain (RTP Nov'20)

Answer 36

Audit of sanctions - The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. The audit of sanctions is directed both in respect of ensuring that the expenditure is properly covered by a sanction, and also to satisfy that the authority sanctioning it is competent for the purpose by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made thereunder, or by the rules of delegation of financial powers made by an authority competent to do so.

Question 37

State with reason (in short) whether the following statements are true or false:

Article 151 of the Constitution provides that the accounts of the Union and of the States shall

be kept in such form as the President may on the advice of the C&AG prescribe. (RTP May '21, New SM)

Answer 37

Incorrect: Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.

Article 151 requires that the reports of the C&AG relating to the accounts of the Union/State shall be submitted to the President/Governor who shall cause them to be laid before House of Parliament/ State Legislature.

Question 38

Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanor to its logical end. Explain (RTP May '21)

Answer 38

Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanor to its logical end. The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration. In India, the function of Government Audit is discharged by the independent statutory authority of the Comptroller and Auditor General through the agency of the Indian Audit and Accounts Department.

Audit is a necessary function to ensure accountability of the executive to Parliament, and within the executives of the spending agencies to the sanctioning or controlling authorities. The purpose or objectives of audit need to be tested at the touchstone of public accountability. The Comptroller and Auditor General (C&AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.

Question 39

State with reason (in short) whether the following statements are true or false:

The first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society (RTP Nov '21, New SM, PYP 2 Marks July '21)

Answer 39

Correct: Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor

or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this subsection, the Multi-State co-operative society in the general meeting may appoint the first auditor or auditors.

Question 40

While planning the audit of an NGO, the auditor may focus on Knowledge of the NGO's work, its mission and vision, Updating knowledge of relevant statutes especially with regard to recent amendments, circulars etc. Explain the other relevant points the auditor needs to focus while planning the audit of NGO. (RTP Nov '21, Nov'18, Old & New SM)

Answer 40

While planning the audit, the auditor may concentrate on the following:

(i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operates.

(ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 1976, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.

(iii) Reviewing the legal form of the Organization and its Memorandum of Association, Articles of Association, Rules and Regulations.

(iv) Reviewing the NGO's Organization chart, then Financial and Administrative Manuals, Project and Programmed Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.

(v) Examination of minutes of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.

(vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

(vii) Setting of materiality levels for audit purposes.

(viii) The nature and timing of reports or other communications.

(ix) The involvement of experts and their reports.

(x) Review the previous year's Audit Report.

Question 41

State with reason (in short) whether the following statements are true or false:

If LLP (Limited Liability Partnership Firm) is appointed as an auditor of a company, every partner of a firm shall be authorized to act as an auditor. (RTP May '18)

Answer 41

Incorrect: As per section 141(2) of the Companies Act, 2013, where a firm including a limited liability partnership (LLP) is appointed as an auditor of a company, only the partners who are Chartered Accountants shall be authorized to act and sign on behalf of the firm.

Question 42

Discuss the matters which should be specially considered in the audit of accounts of a partnership (RTP May '19, PYP 3 Marks , Nov '19)

Answer 42

Matters which should be specially considered in the audit of accounts of a partnership:

(i) Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.

(ii) Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans; purchase of assets, extraordinary contracts entered into and other such matters as are not of a routine nature.

(iii) Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.

(iv) Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.

(v) Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.

(vi) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.

(vii) Verifying that the profits and losses have been divided among the partners in their agreed profitsharing ratio.

Question 43

State with reason (in short) whether the following statements are true or false:

The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 (RTP May '22)

Answer 43

Incorrect The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013

Question 44

Before holding inquiry by the Central Registrar thirty days' notice must be given to the Multi-State co-operative society. (RTP May '22)

Answer 44

Incorrect: Before holding inquiry by the Central Registrar fifteen days' notice must be given to the Multi- State co-operative society.

Question 45

No inspection under Section 79 of Multi-State Co-operative Societies Act, 2002 shall be made unless a notice has been given to the multi-state co-operative society. Explain stating clearly when and how such inspection can be made. Also state the powers available with the Central Registrar in this regard along with provisions relating to communication of the inspection report under the said section. (RTP May '22)

OR

Discuss, in what circumstances, Central Registrar can hold an inquiry into working and financial condition of a multi-state cooperative society. (Old & New SM)

Answer 45

(a) Inspection of Multi-State Co-operative societies under Section 79

1. When: The Central Registrar may, on a request from

(i) federal co-operative to which a Multi-State Co-operative society is affiliated or a creditor or

(ii) not less than one-third of the members of the board or

(iii) not less than one-fifth of the total number of members of a Multi-State co-operative society

2. **How:** By general or special order in writing in this behalf inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into the constitution, working and financial condition of a Multi-State co-operative society.

3. **Opportunity of Being heard:** No inspection shall be made unless a notice of not less than fifteen days has been given to the multi-state co-operative society.

4. **Powers available:** The Central Registrar or the person authorized by him shall have the following powers:

(a) He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, take them into custody and shall have power to verify the cash balance of the society and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary.

(b) Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.

5. **Inspection Report:** A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection.

Question 46

State six important advantages of audit of accounts of a Partnership firm. (RTP Nov '23)

Answer 46

Advantages of Audit of Accounts of a Partnership: On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows:

(1) Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated. On this consideration, it is usually provided in and accepted by the partners, shall be binding upon them, unless some manifest error is brought to light within a specified period subsequent to the accounts having been signed.

(2) On the retirement or death of a partner, audited accounts, which have been accepted by the partners, constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.

(3) The accounts of a partnership, which have been audited, are generally accepted by the Income Tax Department as the basis for computing the assessable income of the partners.

(4) Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.

(5) Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.

(6) An audit is an effective safeguard against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

Question 47

Mr. M, has served as an auditor in the Co-Operative Department of a Government, is appointed as a statutory auditor by a Co-Operative Society that has receipts over ` 3 crores during the financial year.

He is not a Chartered Accountant. Mr. D, Chartered Accountant is appointed to conduct tax audit of the society under section 44AB of the Income Tax Act, 1961. Comment. (PYP 5 Marks, May 18)

Answer 47

Qualifications and Appointment of Auditors - Apart from a chartered accountant within the meaning of the Chartered Accountants Act, 1949, some of the State Co-operative Acts have permitted persons holding a government diploma in co-operative accounts or in co- operation and accountancy and also a person who has served as an auditor in the co- operative department of a government to act as an auditor.

An auditor of a co-operative society is appointed by the Registrar of Co-operative Societies and the auditor so appointed conducts the audit on behalf of the Registrar and submits his report to him as also to the society.

Thus, in view of above provisions, appointment of Mr. M as statutory auditor and Mr. D as tax auditor under Section 44 AB is in order.

Question 48

State the objectives of audit of Local Bodies. (PYP 5 Marks, May '18, RTP May '23)

OR

The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. Explain stating important objectives of audit of such bodies. (RTP Nov '21)

OR

Local Fund Audit Wing of a State of a State Government has appointed you to audit the accounts of one of the Local body governed by it. As an auditor, what will be your reporting areas? (PYP 4 Marks Dec '21, Old & New SM)

Answer 48

Objective of Audit of Local Bodies: The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. The municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit. The important objectives of audit are:

(i) reporting on the fairness of the content and presentation of financial statements;

(ii) reporting upon the strengths and weaknesses of systems of financial control;

(iii) reporting on the adherence to legal and/or administrative requirements;

(iv) reporting upon whether value is being fully received on money spent; and

(v) detection and prevention of error, fraud and misuse of resources.

Question 49

Examine with reasons whether the following statements are correct or incorrect. The accounts of every LLP shall be audited in accordance with rule 24 of LLP Rules 2009. (PYP 2 Marks, May 19, New SM)

Answer 49

Incorrect- Rule 24 of LLP Rules 2009 provides that any LLP, whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty-five lakh rupees, is not required to get its accounts audited. However, if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rules.

Question 50

Examine with reasons whether the following statements are correct or incorrect.

All entities that are under common control by a state (i.e., national, regional or local government) are considered related party. (PYP 2 Marks, Nov'19)

Answer 50

Incorrect: Entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

Question 51

In the case of audit of a charitable institution, what attentions should be paid by the auditor regarding audit of expenditure items? (PYP 4 Marks, Nov'19)

OR

CA B is appointed as the auditor of a Public Charitable Trust. Guide him the focus area of attention relating to the vouching and verification of expenditure of charitable institution. (PYP 3 Marks May '23)

Answer 51

Audit of Expenditure of Charitable Institution:

(i) Vouching payment of grants also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and that no trustee, director or member of the management committee has benefited there from either directly or indirectly.

(ii) Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test basis.

(iii) Check payment along with supporting documents in regard to salary and other expenses. Verify that all payments are made after proper sanction by appropriate authority.

(iv) Ascertaining that any funds contributed for a special purpose have been utilized for the purpose.

(v) Verifying the cash and bank balances/payments.

Question 52

Examine with reasons whether the following statements are correct or incorrect.

Every LLP is required to submit Statement of Account and Solvency in Form 8, which shall be filed within a period of sixty days from the end of three months of the financial year to which the Statement of Account and Solvency relates. (PYP 2 Marks, Nov'20)

Answer 52

Incorrect: Every LLP is required to submit Statement of Account and Solvency in Form 8 which shall be filed within a period of thirty days from the end of six months of the financial year to which the Statement of Account and Solvency relates.

Question 53

The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger. The auditor should 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. The other provisions for expenses should be examined vis-à-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

You are appointed as an auditor of co-operative society. State the special features of the cooperative audit to be borne in mind by the auditor, concerning:

(1) Audit classification of society.

(2) Discussion of draft audit report with the management committee. (PYP 4 Marks, Nov20)

Answer 53

1. **Audit classification of society -** After a judgement of an overall performance of the society, the auditor has to award a class to the society. This judgement is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.

2. **Discussion of draft audit report with managing committee –** On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit draft report. The audit report should never be finalised without discussion with the managing committee. Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

Question 54

The audit of receipts of government is not as old as audit of expenditure but with the rapid growth of public enterprises audit of receipts tax or non-tax has come to stay. Discuss audit of receipts with respect to Government Audit. (PYP 4 Marks Nov '20)

Answer 54

Government auditing in India as elsewhere was primarily expenditure- oriented. Gradually, audit of receipts-tax and non-tax was taken up.

The audit of receipts is neither all pervasive nor as old as audit of expenditure but has come to stay in some countries. Such an audit provides for checking;

(i) whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities;

(ii) whether adequate regulations and procedures have been framed by the department/agency concerned to secure an effective check on assessment, collection and proper allocation of cases;

(iii) whether such regulations and procedures are actually being carried out;

(iv) whether adequate checks are imposed to ensure the prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or willful omission or negligence to levy or collect taxes or to issue refunds; and

(v) review of systems and procedures to see that the internal procedures adequately secure correct and regular accounting of demands collection and refunds and pursuant of dues up to final settlement and to suggest improvement. The basic principle of audit of receipts is that it is more important to look at the general than on the particular, though individual cases of assessment, demand, collection, refund, etc. Are important within the area of test check. A review of the judicial decisions taken by tax authorities is done to judge the effectiveness of the assessment procedure.

(vi) The extent and quantum of audit required to be done under each category of audit are determined by the C&AG. These are neither negotiable nor questioned. The prescribed extent and quantum of audit are structured in accordance with the design of test check, random sampling, general review, in-depth study of specified areas, etc. .as may be warranted by the nature of transactions, its importance in the scheme of activities of a department and the totality of its transactions, the frequency of check and total plan of audit to be executed during a period.

(vii) Institutional mechanism provides for primary check by the auditor, test check by the supervisor and control and direction by the group leader. Planning, executing and reporting of work is directed and monitored at middle and top levels of the audit hierarchy. There are built –in arrangements within the C&AG to ensure that the work assigned to each employee is carried out as prescribed.

(viii) The audit is conducted both centrally where accounts and original vouchers are kept and locally where the drawing and disbursing functions are performed depending on the organizational and institutional arrangements obtaining.

Question 55

Explain the different types of revenue grants which local bodies may receive. (PYP 3 Marks, Nov'20)

Answer 55

Local bodies may receive different types of grants from the state administration as well. Broadly, the revenue grants are of three categories:

(a) **General purpose grants:** These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.

(b) **Specific purpose grants:** These grants which are tied to the provision of certain services or performance of certain tasks.

(c) **Statutory and compensatory grants:** These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

Question 56

What is the function of audit while examining various rules, regulations and orders with regard to Audit against Rules & Orders by C&AG? (3 Marks, Nov 20)

Answer 56

Audit against Rules & Orders – Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made there under. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

(a) they are not inconsistent with any provisions of the Constitution or any laws made there under;

(b) they are consistent with the essential requirements of audit and accounts as determined by the C&AG;

(c) they do not come in conflict with the orders of, or rules made by, any higher authority; and

(d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Question 57

You have been appointed as an auditor of VJM Schools. Discuss the points which merit your consideration as an auditor while verifying Assets and Liabilities of VJM Schools. (PYP 4 Marks, July21, Old & New SM)

Answer 57

Verification of Assets & Liabilities of VJM Schools:

1. Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.
2. Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet and not transferred to revenue, unless they are not refundable.
3. See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus. Ascertain that the system ordering inspection on receipt and issue of provisions, food stuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
4. Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.

Question 58

Tomo Construction Engineering LLP approached CA K to understand various returns to be maintained and filed by them. Guide/Discuss the various returns to be maintained and filed by them. (PYP 3 Marks July '21, Old & New SM)

Answer 58

Returns to be maintained and filed by an LLP:

- Every LLP would be required to file annual return in Form 11 with ROC within 60 days of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.

- Every LLP is also required to submit Statement of Account and Solvency in Form 8 which shall be filed within a period of thirty days from the end of six months or the financial year to which the Statement of Account and Solvency relates.

Question 59

In case of Government entities, audit of accounts of stores and inventories has been developed as a part of expenditure audit. Discuss about the duties and responsibilities entrusted to C&AG. (PYP 3 Marks Dec '21, Old & New SM)

Answer 59

Audit of Accounts of Stores and Inventories in Government Companies:

Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted:-

(i) to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.

(ii) to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.

(iii) to verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.

(iv) to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.

(v) to check the accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding. Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence.

When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

Question 60

CA A is appointed as the auditor of a charitable institutions. Discuss the audit procedure undertaken by him while auditing the Subscription and Donation received by the charitable institution. (PYP 3 Marks Dec '21, Old & New SM)

Answer 60

Audit Procedure in audit of Subscriptions & donations:

Audit Procedure to be undertaken by CA A in respect of Subscriptions and donations received by a Charitable Institution is:

(i) Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.

(ii) Whether official receipts are issued;

(a) confirming that adequate control is imposed over unused receipt books;

(b) obtaining all receipt books covering the period under review;

(c) test checking the counterfoils with the cash book; any cancelled receipts being specially looked into;

(d) obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;

(e) examining the system of internal check regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and

(f) verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

Question 61

M/s T & Co. Chartered Accountants, a partnership firm, is appointed as an auditor of Treatment Hospital run by Smile Foundation, a charitable trust. Over and above the receipts of treatment of patients, during the year trust has received donations from various donors to treat COVID-19 patients and also incurred some capital expenditure for further development of the hospital. On some of the investment income, income tax has been deducted. What are the special points to be considered by M/s T & Co. while auditing such transactions of Treatment Hospital? (PYP 3 Marks May'22)

Answer 61

Audit of a Hospital:

(A) Receipts from treatment of patients

1. **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.
2. **Collection of Cash from patients:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patient's bills.

(B) Donations from donors to treat the patients: Ascertain those legacies and donation received for a specific purpose have been applied in the manner agreed upon.

(C) Capital Expenditure Incurred: Verify the Capital Expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee.

(D) Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax.

This involves:

(i) vouching the Income-tax refund with the correspondence with the Income-tax Department; and

(ii) checking the calculation of the repayment of claims/refund claim.

Question 62

CA Sevak is appointed as an auditor of a Municipal Corporation of a big smart city. He wants to verify various expenditures of the Municipality. Define the term "Municipality" and state what are the heads under which expenditures incurred by the Municipalities and Corporations can be broadly classified? (PYP 3 Marks Nov 22)

Answer 62

Definition of Municipality & Expenditure incurred by it: Definition: A Municipality can be defined as a unit of local self-government in an urban area. By the term 'local self- government' is ordinarily understood the administration of a locality – a village, a town, a city or any other area smaller than a state – by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.

Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads:

(a) general administration and revenue collection,

(b) public health,

(c) public safety,

(d) education,

(e) public works, and

(f) others such as interest payments, etc.

Question 63

Ban LLP is formed during the year 2021-22. They are not sure about the type of books of accounts to be maintained. What are the books of accounts that the LLP is required to maintain? (PYP 3 Marks Nov 22)

Answer 63

Books of Accounts Ban LLP is required to maintain: An LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. LLPs are required to maintain books of accounts which shall contain-

1. Particulars of all sums of money received and expended by the LLP and the matters in respect of which the receipt and expenditure takes place,
2. A record of the assets and liabilities of the LLP,
3. Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,
4. Any other particulars which the partners may decide.

Question 64

In the case of Co-operative societies, contribution to Education fund is a charge on profits and not an appropriation. (PYP 2 Marks May '23)

Answer 64

Correct: Some of the State Acts provide that every society shall contribute annually towards the Education Fund of the State Federal Society, at the appropriate rate as per the class of the society. Therefore, contribution to Education Fund is a charge on profits and not an appropriation.

Question 65

SK & Co, a Chartered Accountant firm has been appointed an auditor of Metro Rail project in City A. Since the project is on large scale, it involves a high volume of resources (financial, human and physical resources). The appointing authority C&AG requires an objective examination of the financial and operational performance of the Metro Rail project. Explain the nature and scope of audit that SK & Co will undertake. (PYP 4 Marks May '23)

Answer 65

Performance audit - The scope of the audit has been extended to cover efficiency, economy and effectiveness audit or performance audit, or full scope audit.

Efficiency audit looks into whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them, i.e., the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner.

Economy audit looks into whether the government has acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy.

Effectiveness audit is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives.

Efficiency- cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

Question 66

State with reasons (in short) whether the following statements are correct or incorrect:

According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.(Old & New SM, MTP 2 Marks Mar'23, Oct'23)

Answer 66

Correct- According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations i.e. the expenditure is incurred with due regard to broad and general principles of financial propriety.

CASE STUDY

Consider the following five descriptions: -

(A) Audit of "Implementation of Nagpur Metro Rail Project" was conducted by the Comptroller and Auditor General of India.

Following is extract of few audit findings placed on website cag.gov.in.

"The location of New Airport station was not ideal from the viewpoint of ridership due to sparse population in and around the station and also from the accessibility point of view.

Cotton Market station, the second additional station was projected to have high peak hour peak direction trips but the work was kept on hold midway citing fund crunch due to non-release of pending contribution from stakeholders. However, the situation could have been managed through prioritization of works."

(B) Another set of audit findings in respect of audit of Haryana Power Generation Corporation Limited, a wholly owned government company responsible for operation of power generation plants in state of Haryana is as under: -

"The main reason for low generation was higher variable cost of thermal power stations which resulted in backing down of plants."

(C) A report was tabled in Parliament highlighting main features of direct taxes administration of country as mandated in Constitution of India. This report primarily discussed compliance to the provisions of the Income Tax Act, 1961 and the associated rules and procedures etc. as applied to administration of direct taxes including irregularities noticed in finalizing assessments etc.

(D) Radial finance corporation Limited is a government company. The audit of the company is conducted by statutory auditors appointed by Comptroller and Auditor General of India.

(E) Bharat Insurance Company Limited is a general insurance government owned company. The statutory auditor is appointed by Comptroller and Auditor General of India.

The annual report for a particular year also contains comments of statutory auditors on matters such as whether company has carried out reconciliations in respect of its inter-company balances with other government owned insurance companies.

MULTIPLE CHOICE QUESTIONS (MCQS)

Based on above, answer the following questions: -

(1) Based upon plain reading of audit findings stated at Para (A), identify type of audit carried out by office of the Comptroller and Auditor General of India.

(a) Audit against provision of funds

(b) Propriety audit

(c) Performance audit

(d) Compliance audit

Ans: (c)

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(2) Keeping in view audit findings in respect of Haryana Power Generation Corporation Limited, identify type of audit carried out.

(a) Audit of Government Company

(b) Audit against rules and orders

(c) Compliance audit

(d) Performance audit

Ans: (d)

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(3) Which of the following is the most appropriate statement in context of report tabled in Parliament regarding administration of direct taxes?

(a) It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Comptroller and Auditor General of India.

(b) It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by an independent task force of experts.

(c) It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Central Board of Direct Taxes.

(d) It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by Central Board of Direct Taxes.

Ans: (a)

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(4) Who is empowered to conduct "supplementary audit" in case of Radial finance Corporation Limited, a government company?

(a) Central Government

(b) Another independent auditor appointed by CAG

(c) CAG

(d) Another independent auditor appointed by Ministry of Corporate Affairs

Ans: (c)

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(5) As regards comments of auditors specified in respect of audit report of above insurance company, which of the following is likely to be most appropriate statement?

(a) Such are likely to be comments of test audit carried out by CAG.

(b) Such are likely to be comments in respect of directions to statutory auditor by CAG for reporting on specific aspect of their audit work.

(c) Such are likely to be comments of supplementary audit carried out by CAG

(d) Such are likely to be comments of statutory auditors in accordance with requirements of Standards on Auditing

Ans: (b)

TEST YOUR KNOWLEDGE

(6) The audit of municipal corporation of a large metro city is in progress. Which of the following is not likely an objective of such as audit?

(a) To report on the adherence to legal and administrative requirements

(b) To report on whether value is being fully received for money spent

(c) To report on the weakness of systems of financial control

(d) To provide better civic amenities to residents of metro city

Ans: (d)

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(7) "Save Democracy" is an NGO working in cause of promoting democracy and democratic institutions in many countries including India. Its Indian counterpart has received funds from a renowned "Flower Trust" of US. As auditor of NGO, which of the following laws/orders would be relevant to you in context of above information?

(a) Income Tax Act, 1961

(b) Foreign Contribution Regulation Act, 2010

(c) Companies Act, 2013

(d) Orders issued by Ministry of Social Justice and Empowerment

Ans: (b)

(8) The appointment of first auditor of a multi-state cooperative society is made by: -

(a) Central Registrar

(b) Board of society

(c) Members of society

(d) Central Government

Ans: (b)

(9) Consider following revenue sources of Union Government.

(a) Revenues from direct taxes

(b) Revenues from Goods and Services Tax

(c) Revenues from Custom Duties

(d) Revenues from Excise Duties

Out of P, Q, R and S, which of the following flow to "Consolidated Fund of India"?

a) P, Q and R

b) P, Q and S

c) P and Q

d) P, Q, R and S

Ans: (b)

(10) An LLP files compliance returns with: -

(a) Registrar of firms & societies

(b) Central Registrar

(c) Registrar of Companies

(d) Local fund audit wing

Ans: (c)

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

Question 1

Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the Finance Minister may on the advice of the C&AG prescribe.

Answer 1

Incorrect- Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.

Question 2

According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.

Answer 2

Correct- According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations i.e. the expenditure is incurred with due regard to broad and general principles of financial propriety.

Question 3

Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads: (a) general administration and revenue collection, (b) public health, (c) public safety, (d) education, (e) public works, and (f) others such as interest payments.

Answer 3

Correct- Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads: (a) general administration and revenue collection, (b) public health, (c) public safety, (d) education, (e) public works, and (f) others such as interest payments, etc., mostly related to civic amenities and local area development and maintenance.

Question 4

The external control of municipal expenditure is exercised by the Central Government through the appointment of auditors to examine municipal accounts.

Answer 4

Incorrect- The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. However, the municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit.

Question 5

NGOs may be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives.

Answer 5

Correct- NGOs can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, managing disasters and emergent situations. These would include religious organisations, voluntary health and welfare agencies, charitable organisations, hospitals, old age homes, research foundations etc. The scope of services rendered by NGOs is extremely wide.

Question 6

The accounts of every LLP shall be audited in accordance with rule 24 of LLP Rules 2009.

Answer 6

Incorrect- Rule 24 of LLP Rules 2009 provides that any LLP, whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty five lakh rupees, is not required to get its accounts audited. However, if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rules.

Question 7

The auditor of an LLP may be appointed by the Designated Partners or other Partners whosoever is available at the time of appointment.

Answer 7

Incorrect- The auditor is to be appointed by the designated partners of the LLP. However, the Partners may appoint the auditors only if the Designated Partners have failed to appoint them.

Question 8

The Comptroller and Auditor General does not have any authority to audit the accounts of stores and inventory kept in any ofice or department of the Union or of a State.

Answer 8

Incorrect- The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State. Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG.

Question 9

An Operating Lease is a kind of Financing arrangement.

Answer 9

Incorrect- A Finance Lease is a Financing arrangement. An Operating lease, on the other hand, is a simple arrangement where, in return for rent, the lessor allows the lessee to use the asset for a certain period.

Question 10

An auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts in the case of audit of a Hotel.

Answer 10

Correct- The auditor should ensure that proper valuation of occupancy-in- progress at the balance sheet date is made and included in the accounts for proper recording of closing and opening entries and maintenance of accounts on Accrual basis as per the Matching concept.

Question 11

The first auditor of a Multi-State co-operative Society will be appointed in Annual General Meeting.

Answer 11

Incorrect- Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers

under this subsection, the Multi-State Co-operative Society in the general meeting may appoint the first auditor or auditors.

Question 12

Small LLPs are mandatorily required to get their Books of account audited.

Answer 12

Incorrect- The accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009, which provide that any LLP whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty-five lakh rupees, is not required to get its accounts audited. Further, a Small LLP is any LLP the Contribution of which, does not exceed twenty-five lakh rupees (INR 25,00,000) or such higher amount, not exceeding five crore rupees, as may be prescribed; and the Turnover of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed forty lakh rupees (INR 40,00,000) or such higher amount, not exceeding fifty crore rupees, as may be prescribed; Hence, the provisions of audit are not applicable on Small LLP's. Therefore, the Small LLPs can prepare its financial statement merely with the signatures of the Designated Partners.

THEORETICAL QUESTIONS ANSWER

Question 1

Discuss, in what circumstances, Central Registrar can hold an inquiry into working and financial condition of a multi-state cooperative society.

Answer 1

When:- The Central Registrar may, on a request from :-

• a federal co-operative to which a Multi- State Co-operative society is affiliated or

• a creditor or not less than one-third of the members of the board or

• not less than one-fifth of the total number of members of a Multi-state co-operative society,

Question 2

Sporting Club of India is a private club engaged in promotion of sports in the country. As an auditor of this leading club, discuss any two points to ensure that expenditure incurred by club during the year is properly authorised.

Answer 2

(1) **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.

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

(3) **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.

(4) **Inventories :-** Check the inventory of furniture, sports material and other assets physically with the respective inventory registers or inventories prepared at the end of the year.

(5) **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.

(6) **Inventories :-** Check the inventory of furniture, sports material and other assets physically with the respective inventory registers or inventories prepared at the end of the year.

Question 3

Tomo Construction Engineering LLP approached CA K to understand various returns to be filed by them as part of statutory compliance. Discuss, how, CA K should advise them.

Answer 3

Returns to be maintained and filed by an LLP :-

- Every LLP would be required to file annual return in Form 11 with ROC within 60 days of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.
- Every LLP is also required to submit Statement of Account and Solvency in Form 8 which shall be filed within a period of thirty days from the end of six months the financial year to which the Statement of Account and Solvency relates.

Question 4

CA Irfan Zaidi is auditor of a prestigious five-star hotel in Jaipur. He notices that there is a gift shop doing brisk business inside the hotel premises. On further enquiries, he comes to know that stocks in gift shop belong to gift shop owner and hotel receives rent for letting out this space. Discuss, how, auditor can verify payment of common amenities used by gift shop owner to the hotel.

Answer 4

Travel Agents & Shops -

(i) For ledgers coming through travel agents or other booking agencies the bills are usually made on the travel agents or booking agencies. The auditor should ensure that money are recovered from the travel agents or booking agencies as per the terms of credit allowed.

(ii) Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.

Question 5

A muti-speciality hospital has come up in your city. You are appointed as auditor for first year. Discuss, any four, broad areas to be kept in mind while conducting audit of accounts of such a newly opened multi-speciality hospital.

Answer 5

The special steps involved in such an audit are stated below-

1. **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

2. **Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

3. **Income from Investments, Rent etc:** See with reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities have been collected.

4. **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

5. **Reconciliation of Subscriptions:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

6. **Authorisation and Sanctions:** Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.

7. **Grants and TDS:** Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

8. **Budgets:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.

9. **Internal Check:** Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.

10. **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.

11. **Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

12. **Inventories:** Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.

13. **Management Representation and Certificate**: Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Question 6

You have been appointed as an auditor of an NGO, briefly state the points on which you would concentrate while planning the audit of such an organisation?

Answer 6

While planning the audit, the auditor may concentrate on the following:

(i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.

(ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 2010, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.

(iii) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.

(iv) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.

(v) Examination of minutes of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.

(vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

(vii) Setting of materiality levels for audit purposes.

(viii) The nature and timing of reports or other communications.

(ix) The involvement of experts and their reports.

(x) Review the previous year's Audit Report.

Question 7

The general transactions of a hospital include patient treatment, collection of receipts, donations, capital expenditures. You are required to mention special points of consideration while auditing such transactions of a hospital?

Answer 7

1. **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.
2. **Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.
3. **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
4. **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.

Question 8

Mention the special points to be examined by the auditor in the audit of a charitable institution running hostel for students pursuing the Chartered Accountancy Course and which charges only INR 500 per month from a student for their lodging/boarding.

Answer 8

The auditor has to ascertain :-

(a) whether accounts are maintained regularly and in accordance with the provisions of the applicable Act and the rules;

(b) whether receipts and disbursements are properly and correctly shown in the accounts and money received in the form of donations is being applied as per the objects of the trust and as per the specific direction by the donor, if any.

(c) whether the cash balance and vouchers in the custody of the manager or trustee on the date of audit were in agreement with the accounts;

(d) whether all books, deeds, accounts, vouchers or other documents or records required by the auditor were produced before him;

(e) whether a register of movable and immovable properties is maintained, the changes therein are communicated from time to time to the regional office, and the defects and inaccuracies mentioned in the previous audit report have been duly complied with and rectified.

(f) whether the manager or trustee or any other person required by the auditor to appear before him did so and furnished the necessary information required by him;

(g) whether any property or funds of the Trust were applied for any object or purpose other than the object or purpose of the Trust;

(h) the amounts of outstanding for more than one year and the amounts written off, if any;

(i) whether any money of the public trust has been invested contrary to the provisions of applicable Act which have come to the notice of the Auditor

(j) all cases of irregular, illegal or improper expenditure, or failure or omission to recover monies or other property belonging to the public trust or of loss or waste of money or other property thereof, and whether such expenditure, failure, omission, loss or waste was caused in consequence of breach of trust or misapplication or any other misconduct on the part of the trustees or any other person while in the management of the trust (k) whether the maximum and minimum number of the trustees is maintained;

(l) whether the meeting are held regularly as provided in such instrument

(m) whether the minute books of the proceedings of the meeting is maintained

(n) whether any of the trustees has any interest in the investment of the trust

(o) whether any of the trustees is a debtor or creditor of the trust.

(p) whether anonymous donations received are properly accounted for and donations in cash are not received by the Trust over and above the prescribed limit of accepting cash donations.

(q) whether the irregularities pointed out by the auditors in the accounts of the previous year have been duly complied with by the trustees during the period of audit

(r) any special matter which the auditor may think fit or necessary to bring to the notice of the Deputy or Assistant Charity Commissioner

Question 9

Explain in detail the duties of Comptroller and Auditor General of India

Answer 9

Duties of the C&AG:

(i) Compile and submit Accounts of Union and States - The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. The Comptroller and Auditor General shall, from the accounts compiled by him or [by the Government or any other person responsible in that behalf] prepare in each accounts (including, in the case of accounts compiled by him, appropriation accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union Territory having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

NOTE :- The C&AG Act of 1971 has provisions for relieving him of this responsibility to give information and render assistance to the Union and States: The Comptroller and Auditor

General shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

(ii) General Provisions Relating to Audit - It shall be the duty of the Comptroller and Auditor General—

(a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governsit;

(b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

(c) to audit and report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) Audit of Receipts and Expenditure - Where anybody or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

Meaning of Substantially financed :- Where the grant or loan to a body or authority from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly in a financial year is not less than ` 25 lakhs and the amount of such grant or loan is not less than 75% of the total expenditure of that body or authority, such body or authority shall be deemed, for this purpose to be substantially financed by such grants or loans as the case may be.

(iv) Audit of Grants or Loans - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

(v) Audit of Receipts of Union or States - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit and report thereon.

(vi) **Audit of Accounts of Stores and Inventory -** The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

(vii) **Audit of Government Companies and Corporations -** The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The Comptroller and Auditor- General of India shall appoint the auditor under section 139(5) or 139(7) (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

Question 10

An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations.

Answer 10

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.

(v) Donation Utilisation: Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.

(vi) System of NGOs' Selection: System for selecting NGO to whom donations have been sent.

Question 11

As an auditor, what would be your areas of consideration while auditing the element of ROOM SALES during the audit of a 5-Star Hotel.

Answer 11

Room Sales & Hall Bookings - The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor. The source of these entries is invariably the guest register and audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period. Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.

In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room. This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill. The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts. The auditor should ensure that proper records are maintained for booking of halls and other premises for special parties and recovered on the basis of the tariff.

Question 12

You are auditing the Books of accounts of Karla Multiplex which runs 15 Film shows everyday. One of the major issues which are of concern to you as an auditor is the Agreement entered into the Multiplex owners with the Film Distributors. State what points would you check as an auditor in this respect.

Answer 12

(1) Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.

(2) Examine unadjusted balance out of advance paid to the distributors against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.

Question 13

Define Government Audit & explain its objectives.

Answer 13

Government auditing is

- the objective, systematic, professional and independent examination
- of financial, administrative and other operations
- of a public entity
- made subsequently to their execution
- for the purpose of evaluating and verifying them,
- presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions
- by the responsible officials
- and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

OBJECTIVES :-

(a) Accounting for Public Funds:-Government audit serves as a mechanism or process for public accounting of government funds.

(b) Appraisal of Government policies:-It also provides public accounting of the operational,

management, programme and policy aspects of public administration as well as accountability of the officials administering them.

(c) Base for Corrective actions:-Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.

(d) Administrative accountability:-Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration. In India, the function of Government Audit is discharged by the independent statutory authority of the Comptroller and Auditor General through the agency of the Indian Audit and Accounts Department. Audit is a necessary function to ensure accountability of the executive to Parliament, and within the executives of the spending agencies to the sanctioning or controlling authorities. The purpose or objectives of audit need to be tested at the touchstone of public accountability. The Comptroller and Auditor General (C&AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.

Question 14

CA A is appointed as the auditor of a charitable institutions. Discuss the audit procedure undertaken by him while auditing the Subscription and Donation received by the charitable institution.

Answer 14

Subscriptions and donations

(i) Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.

(ii) Whether official receipts are issued;

(a) confirming that adequate control is imposed over unused receipt books;

(b) obtaining all receipt books covering the period under review;

(c) test checking the counterfoils with the cash book; any cancelled receipts being specially looked into;

(d) obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;

(e) examining the system of internal check regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and

(f) verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

Question 15

In case of Government entities, audit of accounts of stores and inventories has been developed as a part of expenditure audit. Discuss about the duties and responsibilities entrusted to C&AG.

Answer 15

Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted :-

- to ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.
- to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.
- to verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.
- to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.
- to check the accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding. Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

Question 16

Local Fund Audit Wing of a State of a State Government has appointed you to audit the accounts of one of the Local body governed by it. As an auditor, what will be your reporting areas?

Answer 16

The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. However, the municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit. The important objectives of audit are:

(a) reporting on the fairness of the content and presentation of financial statements;

(b) reporting upon the strengths and weaknesses of systems of financial control;

(c) reporting on the adherence to legal and/or administrative requirements;

(d) reporting upon whether value is being fully received on money spent; and

(e) detection and prevention of error, fraud and misuse of resources.

Audit is another method of financial control on local governments. This provision is coupled with the privilege of ultra vires. An action of the local authority if it is beyond legal authority can result in 'surcharge' by audit. This procedure is a legacy of colonial days and even in England it is being resorted to less and less. This may well be because of the increasing competence of the local government authorities.

In addition to the external audit, it is also opined by the learned author that there should be a system of internal audit in all municipal institutions. Internal audit should be provided by the institutions' own staff.

It should be performed on a continuous basis according to a well- defined programme. The external auditor should be able to rely upon the work of the internal audit as forming part of a complete system of internal financial control. Where there is no internal audit, as may happen in the case of small or poorly staffed municipalities, the external auditor himself has to do detailed checking. As described under government audit above, increasing attention is being given, to what is described as 'value for money' audit. This kind of audit focuses upon assessment of whether urban institutions are fulfilling their responsibilities with efficiency, economy and effectiveness (sometimes known as 'the three Es').

Question 17

You have been appointed as an auditor of VJM Schools. Discuss the points which merit your consideration as an auditor while verifying Assets and Liabilities of VJM Schools.

Answer 17

Assets & Liabilities :-

1. Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.
2. Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet not transferred to revenue, unless they are not refundable.
3. See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.
4. Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
5. Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.

Question 18

State the points which merit consideration in the audit of a CLUB w.r.t its members.

Answer 18

The special steps involved in such an audit are stated below-

(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) 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.

Test Your Understanding

Question 1

It is the duty of Comptroller and Auditor General of India to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it. Discuss, in above context, what is understood by "Consolidated Fund of India"? What is its importance?

Answer 1

Consolidated Fund of India consists of all the revenue received from direct and indirect taxes, all the loans taken by the Govt. of India and all the amount of repayment of loans received by the Govt. of India. Its importance lies in the fact that all government expenditure is incurred from this fund. No moneys out of the Consolidated Fund of India shall be appropriated except in accordance with law and for the purposes and in the manner provided in the Constitution.

Question 2

CA Akash Virmani is auditor of a partnership firm consisting of 4 partners. During the year, one of the partners has retired and another partner has joined the next day. Discuss, any one point, which shall be considered by you to ensure that financial statements of firm are not misstated due to change of constitution of firm.

Answer 2

The auditor shall consider provisions of retirement deed/partnership deed for date of retiring and joining of partners. It should be ensured that profits are appropriately distributed up to date of retirement.

Further, profits after retirement should have been distributed among partners as per terms of new partnership deed.

Question 3

You are auditor of a school operating in your city. During audit of a year, it is noticed that fees concessions to students have been provided in substantial number of cases. Discuss, how, you as an auditor, would proceed to verify the same?

Answer 3

The fees concessions have to be under proper authority of school management. The auditor would verify internal controls in this regard.

Besides, detailed checking of few cases needs to be undertaken to ensure genuineness of fees concessions and proper management approvals.

Question 4

A society has been formed by pan India employees of a public sector bank. The purpose of society is to promote savings habits of members and to grant loan to them up to a small specified amount. Small savings are promoted amongst members by way of compulsory contribution from monthly salary.

Identify type of society and also discuss nature of books of accounts to be maintained by such a society.

Answer 4

The society is in nature of Multi-state cooperative society as it serves interests of members in more than one state. It accepts small savings from its members and grants loan to members. As per Multi-State Cooperative Society Rules 2002, every Multi- State Co-operative society shall keep books of account with respect to: -

a. all sum of money received and expended and matters in respect of which the receipt and expenditure take place

b. the assets and liabilities

CHAPTER 10
AUDIT OF BANKS

Question 1

Examine with reasons (in short) whether the following statement is correct or incorrect:

The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Central Government. (MTP 2 Marks March '18, Aug'18, Oct'18, Mar'19)

Answer 1

Incorrect: The matters which the banks require their auditors to deal with in the long form audit report have been specified by the Reserve Bank of India.

Question 2

The engagement team of FRN & Co.- Auditors of Bank of Baroda held discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.

The discussion between the members of the engagement team and the audit engagement partner are being done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit.

Analyse and Advise the matters to be discussed in the engagement team discussion. (MTP 5 Marks March '18, March '19)

Answer 2

The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference.

The discussion provides:

- An opportunity for more experienced engagement team members, including the audit engagement partner, to share their insights based on their knowledge of the bank and its environment.
- An opportunity for engagement team members to exchange information about the bank's business risks.

- An understanding amongst the engagement team members about effect of the results of the risk assessment procedures on other aspects of the audit, including decisions about the nature, timing, and extent of further audit procedures.

The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit.

The engagement team discussion ordinarily includes a discussion of the following matters:

- Errors that may be more likely to occur;
- Errors which have been identified in prior years;
- Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
- Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;
- Need to maintain professional skepticism throughout the audit engagement;
- Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

Question 3

In the case of a nationalised bank, the auditor is required to make a report to the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank. Explain what would the auditor state in his report. (MTP 5 Marks Oct 18)

Answer 3

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

(a) whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;

(b) whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;

(c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit;

(d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and

(e) any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalized bank.

Question 4

Your firm of Chartered Accountants has been appointed as the Auditor of two branches of OBC which are located in the Industrial area. Considering that the location of the branches of bank in industrial area, these would be "advances oriented branches and audit of advances would require the major attention of the auditors. Advise how would you proceed to obtain evidence in respect of audit of advances. (MTP 4 Marks Oct 19, RTP May '18)

OR

a) Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors. In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about, among other points, the amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet. Explain. (RTP Nov '23, RTP Nov '19, RTP May 21, RTP Nov'22)

b) The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances. Explain in the context of Audit of Banks (RTP Nov '19)

Answer 4

(a) Audit of Advances: Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors. In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

a. Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.

b. Advances represent amount due to the bank.

c. Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.

d. There are no unrecorded advances.

e. The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.

f. The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.

g. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

(b) The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

• examining the validity of the recorded amounts;

• examining loan documentation;

• reviewing the operation of the accounts;

• examining the existence, enforceability and valuation of the security;

• checking compliance with RBI norms including appropriate classification and provisioning; and

• carrying out appropriate analytical procedures.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts however need to be examined in detail unless the amount involved is insignificant.

Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.

Question 5

Your firm of Chartered Accountants has been appointed as auditor of a Nationalised bank. Explain how will you proceed to carry out audit of provisions and contingencies. (MTP 4 Marks Oct 20, RTP May'22, Old & New SM)

OR

You are appointed as Statutory Auditor of DEF Bank Limited for the year 2019-20. As an Auditor how will you verify Provisions created b DEF Bank Limited? (PYP 4 Marks, Nov'20)

Answer 5

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. The auditor should 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. The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger. The auditor should 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. The other provisions for expenses should be examined 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 6

There are different types of banks prevailing in India. Explain giving examples of such banks. (MTP 3 Marks March '21)

Answer 6

There are different types of banking institutions prevailing in India which are as follows:

Commercial Banks	Regional Rural Banks
Co-operative Banks.	Payment Banks.
Development Banks (more commonly known as 'Term-Lending Institutions').	Small Finance Banks.

1. Commercial banks are the most wide spread banking institutions in India, that provide a number of products and services to general public and other segments of economy. Two of its main functions are:-

   (a) accepting deposits and

   (b) granting advances.

2. Regional Rural Banks known as RRBs are the banks that have been set up in rural areas in different states of the country to cater to the basic banking and financial needs of the rural communities.

   Examples are :- Punjab Gramin Bank , Tripura Gramin Bank , Allahabad UP Gramin Bank , Andhra Pradesh Grameen Vikas Bank, etc.

3. Co-operative Banks function like Commercial Banks only but are set up on the basis of Cooperative Principles and registered under the Cooperative Societies Act of the respective state

or the Multistate Cooperative Societies Act and usually cater to the needs of the agricultural and rural sectors.

Examples are :- The Gujarat State Co-operative Bank Ltd. , Chhatisgarh Rajya Sahakari Bank Maryadit, etc.

4. Payments Banks are a new type of banks which have been recently introduced by RBI. They are allowed to accept restricted deposits but they cannot issue loans and credit cards. However, customers can open Current & Savings accounts and also avail the facility of ATM cum Debit cards, Internet-banking & Mobilebanking. Examples are :- Airtel Payments Bank, India Post Payments Bank, Paytm Payments Bank , etc.
5. Development Banks had been conceptualized to provide funds for infrastructural facilities important for the economic growth of the country. Examples are:- Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI), etc.
6. Small Finance Banks have been set up by RBI to make available basic financial and banking facilities to the unserved and unorganised sectors like small marginal farmers, small & micro business units, etc. Examples are:- Equitas Small Finance Bank, AU Small Finance Bank, etc.

Question 7

In case of a Bank, explain the meaning of Funded loans. Also give examples. (MTP 3 Marks April '21, Oct '21)

Answer 7

Funded loans are those loans where there is an actual transfer of funds from the bank to the borrower. Advances comprise of funded amounts by way of:

- Term loans :-
- Cash credits, Overdrafts, Demand Loans
- Bills Discounted and Purchased
- Participation on Risk Sharing basis
- Interest-bearing Staff Loans

Question 8

Banks ask Security or Collateral while lending to assure that the Borrower will return the money to bank in prescribed time. Explain stating clearly the concept of Primary and Collateral

Security. Also give examples of most common types of securities accepted by banks. (MTP 3 Marks April '21, RTP Nov '20 & Nov '21)

OR

Mr. A approaches a bank for financial assistance for his upcoming project. The Bank Branch Manager, after verifying the proposal, is agreeable to financing Mr. A, but asks for the security to be offered to the bank. Discuss the nature of securities required to be offered to the bank. (PYP 5 Marks May ' 18)

Answer 8

Banks ask Security or Collateral while lending to assure that the Borrower will return the money to bank in prescribed time else the Banks have legal authority to sell the collateral to recover its money.

Nature of Security

A. Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

B. Collateral security is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following:

- Personal Security of Guarantor
- Goods/Stocks/Debtors/Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property
- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Banker's General Lien
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments

Question 9

''There is no difference in provisioning of NPA as regards to categories of NPA, whether the debt is secured or unsecured." Critically evaluate the statement on the basis of provisioning norms of NPA of nationalised bank stating clearly the provision percent required. (MTP 4 Marks Oct '21, RTP May '22, PYP 4 Marks Nov '19)

Answer 9

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. Further, asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.

There are different provisioning requirements as regards to categories of NPA such as Sub- standards assets, Doubtful assets and loss assets which are given below:

Categories of Non-Performing Assets:	Provision required
• **Substandard Assets:** Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
• **Doubtful Assets:** Would be one, which has remained in the substandard category for a period of 12 months.	Secured+ Unsecured
• **Sub-categories:** Doubtful up to 1 Year (D1) Doubtful 1 to 3 Years (D2) Doubtful more than 3 Years (D3)	25% + 100% 40% + 100% 100% + 100%
• **Loss Assets:** Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Question 10

Explain "Advances under Consortium" in the context of Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances. (MTP 4 Marks Nov '21 & MTP 3 Marks Sep '23, PYP 4 Marks Jan '21)

Answer 10

Advances under Consortium: Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

Question 11

Explain the audit approach you would follow to check the Operating Expenses of a Bank. (MTP 4 Marks Sep'22 & April '23, RTP May '23, RTP May'22, Old SM)

Answer 11

Auditing the Operating Expenses of a Bank:

(i) **Internal Controls:** The auditor should study and evaluate the system of internal control relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures.

(ii) **Divergent Trends:** The auditor should examine whether there are any divergent trends in respect of major items of expenses.

(iii) **Substantive analytical Procedures:** The auditor should perform substantive analytical procedures in respect of these expenses. eg. assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.

(iv) **Vouching & Verification:** The auditor should also verify expenses with reference to supporting documents and check the calculations wherever required.

Question 12

What are the general requirements of an effective Risk Management System in Banks?(MTP Sep'22 4 Marks)

OR

Mr Rishikesh, the Bank Manager develops controls to assist in managing key business and financial risks. Discuss the various requirements for an effective risk management system in a bank. (RTP May '23, PYP 4 Marks May '19)

Answer 12

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.

(i) 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.

Question 13

When is an agricultural advance considered as non performing as per the RBI guidelines? (MTP 4 Marks Oct'22, MTP 4 Marks March 22)

Answer 13

As per the guidelines, Agricultural Advances are of two types:

(1) Agricultural Advances for "long duration" crops; and

(2) Agricultural Advances for "short duration" crops.

The "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons; and
- A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

Question 14

Explain hypothecation and assignment as the modes of creation of security with respect to advance granted by a bank. (MTP 4 Marks Oct'22)

Answer 14

Hypothecation:

The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank. The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

Assignment:

Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favor of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment. An assignment gives the assignee absolute right over the moneys/debts assigned to him.

Question 15

The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. Explain this statement. (MTP 4 Marks March 22, Old SM, MTP 4 Marks April 19, RTP Nov '18 & May '19, PYP 5 Marks Nov '18)

Answer 15

The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, inter alia, the following:

- The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The compliance with the terms of sanction and end use of funds should be ensured.
- Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- The accounts should be kept within both the drawing power and the sanctioned limit.
- All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.
- The operation of each advance account should be reviewed at least once a year and at more frequent intervals in the case of large advances.

Question 16

When are following considered as non performing as per the RBI guidelines?

(i) Government guaranteed advances

(ii) Advances to staff (MTP 4 Marks March '23)

Answer 16

Government Guaranteed advances:

o Central Govt. 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.

Advances to Staff

Interest-bearing staff advances as a banker should be included as part of advances portfolio of the bank.

In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of installment of principal or payment of interest on the respective due dates. The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets.

Question 17

Explain pledge and set off as the modes of creation of security with respect to advance granted by a bank. (MTP 4 Marks March '23)

Answer 17

Pledge: A pledge involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge.

Set-off: Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. The right of set- off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same).

For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

Question 18

Examine with reasons (in short) whether the following statements are correct or incorrect:

Classification as NPA should be based on the availability of security and asset classification would be facility wise and not borrower wise. (PYP 2 Marks, Nov'20, MTP 2 Marks April '23)

Answer 18

Incorrect: 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. Asset classification would be borrower-wise and not facility-wise.

Question 19

In a bank, all accounts should be kept within the drawing power and the sanctioned limit. The accounts which exceed the sanctioned limit or drawing power should be brought to the notice of the management regularly. Analyse the following points to be considered in the computation of drawing power in case of bank audit.

(i) Bank's Duties

(ii) Auditor's concern

(iii) Computation of DP

(iv) Stock audit (MTP 4 Marks April '23, PYP 4 Marks Dec '21)

Answer 19

Computation of Drawing Power:

(i) Bank's Duties: Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets. Drawing power is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.

(ii) Auditor's Concern: The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail. The audited Annual Report submitted by the borrower should be scrutinized properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

(iii) Computation of DP: It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

(iv) Stock Audit: The stock audit should be carried out by the bank for all accounts having funded exposure of more than 15 crores. Auditors can also advise for stock audit in other cases if the situation

warrants the same. Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

Question 20

Examine with reasons (in short) whether the following statements are correct or incorrect:

Banks recognize income on Non-Performing Assets on accrual basis. (MTP 2 Marks Sep '23, PYP 2 Marks Nov'18, New SM)

Answer 20

Incorrect: Income from non-performing assets (NPA) is not recognised on accrual basis due to its uncertainty but is booked as income only when it is actually received.

Question 21

While verifying provisions of advances of a branch of MCO Bank as part of statutory branch audit, CA Z notices that credit facilities consisting of term loan to KRT Enterprises have been classified under doubtful asset (D1) category.

The outstanding balance in above term loan account as on 31.3.2023 is ₹ 50 lakhs. Value of security held in account is ₹ 40 lakhs. The branch has made provision of ₹7.50 lakhs. Is provision made by branch proper? Discuss. (MTP 4 Marks Sep '23)

Answer 21

The provision for advances falling in D1 category is required @ 25% of secured portion and 100% of unsecured portion. Therefore, provision in above case is arrived as under: -

Outstanding balance as on 31.3.23		₹ 50 lakhs
Less: Value of security		₹ 40 lakhs
Unsecured portion		₹ 10 lakhs

Therefore, outstanding balance of ₹50 lakhs is secured to the tune of ₹40 lakhs and balance ₹ 10 lakhs is unsecured. Provision calculation

25% of secured part	i.e., 25% of ₹40 lakhs	₹ 10 lakhs
100% of unsecured part	i.e.,100% of ₹10 lakhs	₹ 10 lakhs
Required provision		₹ 20 lakhs

Therefore, provision made by branch is not proper. It should have made provision of ₹20 lakhs instead of ₹ 7.50 lakhs.

Question 22

Examine with reasons (in short) whether the following statements are correct or incorrect:

Collateral security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. (MTP 2 Marks Oct '23, RTP Nov'20)

Answer 22

Incorrect: Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

Collateral security, on the other hand is an additional security.

Question 23

CA X is acting as concurrent auditor of a branch of KLT Bank (a nationalized bank) located in Delhi during the year 2022-23. The assignment started from 1st October 2022 and is for a period of one year. By virtue of this assignment, he is required to issue monthly reports on different aspects of the functioning of branch including deposits, advances and housekeeping to controlling authorities of Bank.

At the end of March, 2023, he has got an offer to conduct statutory audit of two branches of KLT Bank located in the State of Rajasthan for the year 2022-23. Can he accept the above offer? Discuss. (MTP 3 Marks Oct'23)

Answer 23

In the given situation, CA X has undertaken concurrent audit assignment of KLT Bank which is in the nature of internal assignments.

In accordance with RBI guidelines, statutory audit assignments should not be undertaken by auditors while being associated with internal assignments in bank during the same year like concurrent audits (Internal audits of banks conducted monthly during the year).

As CA X is associated with KLT Bank as concurrent auditor, he should not accept statutory audit assignment of same bank even though it relates to different branches of the bank.

Question 24

While conducting statutory audit of branch of a nationalized bank, it is noticed by CA Z that credit facilities granted to a borrower consisting solely of term loan have been classified as "Sub-standard Asset" during the year 2022-23 due to failure of borrower to pay EMIs on time. Such EMIs were outstanding for more than 90 days and account was, therefore, classified as "Sub-Standard Asset". CA Z has also agreed to above asset classification made by branch management.

What are CA Z's responsibilities regarding verification of compliance with income recognition norms by branch in respect of above credit facilities? (MTP 3 Marks Oct'23)

Answer 24

RBI norms stipulate that if any advance account becomes NPA as at close of any year, the entire interest accrued or credited to income account in past periods should be reversed or provided for, if the same is not realized.

Further, in respect of NPAs, fees, commission and other similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

In the given case, account has turned Sub-standard asset which is a type of NPA. Therefore, auditor should make compliance of above norms relating to income recognition.

Question 25

In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense. Analyse and explain stating the audit approach and procedure in regard to interest expense (RTP May '20 & Nov '21)

Answer 25

In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense by analyzing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. In modern day banking, the entries for interest expenses are automatically generated through a batch process in the CBS system.

- The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.

- The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences. The auditor should obtain general ledger break-up for the interest expense incurred on deposits (savings and term deposits) and borrowing each month/quarter. The auditor should analyse month on month (or quarter on quarter) cost analysis and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger. The auditor should understand the process of computation of the average balance and re-compute the same on sample basis.
- The auditor should, on a test check basis, verify the calculation of interest and ensure that:

(a) Interest has been provided on all deposits up to the date of the balance sheet;

(b) Interest rates are in accordance with the bank's internal regulations, the RBI directives and agreements with the respective deposit holder;

(c) Interest on savings accounts are in accordance with the rules framed by the bank/RBI in this behalf.

(d) Interest on inter–branch balances has been provided at the rates prescribed by the head office/RBI.

The auditor should ascertain whether there are any changes in interest rate on saving accounts and term deposits during the period. The auditor should obtain the interest rate card for various types of deposits and analyze the interest cost for the period accordingly. The auditor should examine the completeness that interest has been accrued on the entire borrowing portfolio and the same should agree with the general ledgers. The auditor should re-compute the interest accrual i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc. from the term sheet, deal ticket, agreements, etc. and ensure that the recomputed amount is tallying with the amount as per books of accounts without any significant difference.

Question 26

In view of the significant uncertainty regarding ultimate collection of income arising in respect of nonperforming assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realized. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also. Analyse and Explain. (RTP May '20, Old & New SM)

Answer 26

Reversal of Income:

If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realized. This will apply to Government guaranteed accounts also. In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected. Further, in case of banks which have wrongly recognized income in the past should reverse the interest if it was recognized as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

Question 27

Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien. Explain with specific reference to Audit of Banks. (RTP Nov'20)

Answer 27

Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien.

(i) **Mortgage:** Mortgage are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage.

• Registered Mortgage can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security.

• Equitable mortgage, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

(ii) **Pledge:** A pledge thus involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge.

(iii) Hypothecation: The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favour of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank.

The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

(iv) Assignment: Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favor of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

An assignment gives the assignee absolute right over the moneys/debts assigned to him.

(v) Set-off Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. The right of setoff enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same).

For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

(vi) Lien: Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

Question 28

State with reason (in short) whether the following statements are true or false:

The policy of income recognition, in case of a Bank, should be subjective (RTP May '21).

Answer 28

Incorrect: The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Income from non-performing assets (NPA) is not recognized on accrual basis but is booked as income only when it is actually received

Question 29

State with reason (in short) whether the following statements are true or false:

The assignment is the creation of an equitable charge which is created in favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower (RTP May '21)

Answer 29

Incorrect: The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower. Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favor of another person.

Question 30

Your firm of auditors, SRG & Co., has been appointed as Statutory Central Auditors of Reliable Bank. Explain the reporting requirements of the Statutory Central Auditors (SCAs) in addition to their main audit report. (RTP May '21)

Answer 30

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

i. Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(I) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.

ii. Long Form Audit Report. (LFAR)

iii. Report on compliance with SLR requirements.

iv. Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.

v. Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.

vi. Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.

vii. Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jelani Committee on internal control and inspection/credit system.

viii. Report on instances of adverse credit-deposit ratio in the rural areas.

Question 31

The engagement team discussion ordinarily includes a discussion of the matters such as - Errors that may be more likely to occur; Errors which have been identified in prior years;

Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures; etc. In the above context, explain the advantages of such a discussion. (RTP Nov '21, PYP 3 Marks July '21)

Answer 31

Advantages of such a discussion: -

- Specific emphasis should be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks.
- It further enables the audit engagement partner to delegate the work to the experienced engagement team members, and to determine the procedures to be followed when fraud is identified.
- Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

Question 32

State with reason (in short) whether the following statements are true or false:

A loan granted for short duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for one crop season. (RTP May '22)

Answer 32

Incorrect: A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

Question 33

State with reason (in short) whether the following statements are true or false:

It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the RBI and agreed upon by the concerned statutory auditors. Special consideration need not be given to proper reporting of sundry creditors for the purposes of calculating drawing power. (RTP May '22)

Answer 33

Incorrect: It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

Question 34

CA. Puranjay is appointed as statutory branch auditor of two branches of a nationalized bank for year 2021-22. During the course of audit, he came across the following:

While verifying advances of one semi-urban branch, he noticed substantial number of accounts categorized as SMA (Special mention accounts). In this context, explain the nature and significance of SMA.(RTP Nov'22)

Answer 34

Special Mention accounts (SMA) are those accounts which are resulting signs of incipient stress leading to the possibility that borrowers may default on debt obligations. These are in the nature of warning system to alert the banks about probable NPAs so that remedial action can be taken before accounts actually turn NPAs. Therefore, their significance lies in the fact that proper and timely identification of SMAs can help in preventing turning potential NPAs into actual NPAs.

Question 35

While verifying interest income of a mid-corporate branch of an urban centre having advances consisting of only cash credit limits for large borrowers, it was noticed that advances of ₹ 300 crores were outstanding as on balance sheet date carrying average interest rate @8% p.a. One articled clerk in audit team makes quick back of the envelope calculations of interest income of ₹ 24 crores on advances. However, schedule of profit & loss a/c shows interest income on advances for ₹ 10 crores. Discuss any two probable reasons for such variation. (RTP Nov'22)

Answer 35

The probable reasons for difference in interest calculation could be due to following:

(i) Cash credit accounts, by their very nature, are running accounts and their utilization depends upon needs of business. Further, interest on cash credit account is charged on the extent of funds utilized by the borrower. It could be possible that all cash credit limits were not fully utilized during the year which resulted in lower interest income.

(ii) Some large accounts may have been sanctioned during later part of the year resulting in lower interest income on advances for whole year.

Question 36

State with reason (in short) whether the following statements are true or false:

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. 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 180 days as on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'. (RTP May '20)

Answer 36

Incorrect: An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. 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 not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

Question 37

TEP Industries Private Limited, a company engaged in obtaining rice from paddy, is enjoying a cash credit facility against hypothecation of paid stocks and book debts (eligible up to 90 days only) from LMV Bank for ₹ 4.00 crore. The letter sanctioning the above credit facility stipulates margin @ 25% on stocks and @ 40% on eligible book debts up to 90 days.

While preparing stock statement as on 30.6.23, accountant of the company calculates value of stocks for ₹ 5 crore (including ₹ 1 crore of rice which was lying in a low lying godown and was completely damaged during recent floods caused by river Yamuna). Debtors outstanding as on 30.6.23 are ₹ 3 crore (including ₹ 50 lacs outstanding for last 6 months). Trade creditors

outstanding as on date are ₹ 2 crore. He calculates DP as on 30.6.23 for ₹ 3.30 crore. Is he correct? Justify with your workings. What does drawing power calculated by you signify to the borrower company? (RTP Nov '23)

Answer 37

The calculation of DP is as under:

Value of stocks as on 30.6.23	₹ 5.00 crore
Less: value of damaged stocks	₹ 1.00 crore
Value of stocks considered as on 30.6.23	₹ 4.00 crore
Less: Trade creditors	₹ 2.00 crore
Paid stocks	₹ 2.00 crore
Less: Margin @ 25%	₹ 0.50 crore
Drawing power for stocks [A]	₹ 1.50 crore
Value of Trade debtors	₹ 3.00 crore
Less: Debtors outstanding for more than 90 days	₹ 0.50 crore
	₹ 2.50 crore
Less: Margin @ 40%	₹ 1.00 crore
Drawing power for Book debts [B]	₹ 1.50 crore
Total drawing power [A+ B]	₹ 3.00 crore

Accountant's DP calculation is not correct. The drawing power of ₹ 3.00 crore signifies that company can utilize funds to the tune of ₹3.00 crore only against sanctioned cash credit limit of ₹ 4.00 crore.

Question 38

Examine with reasons whether the following statements are correct or incorrect.

Auditor of a Nationalised bank is to be appointed at the annual general meeting of the shareholders. (PYP 2 Marks, May'19, Old & New SM)

Answer 38

Incorrect- Auditor of a nationalized bank is to be appointed by the bank concerned acting through its Boards of Directors and approval of the Reserve bank is required before the appointment is made.

Question 39

You are appointed as an auditor of Banking Co., and hold discussions with engagement team. List out matters which you would discuss at the planning stage of an audit to gain better understanding of the bank and its environment. (PYP 4 Marks, May'19)

Answer 39

The engagement team discussion ordinarily includes a discussion of the following matters:

(i) Errors that may be more likely to occur;

(ii) Errors which have been identified in prior years;

(iii) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;

(iv) Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;

(v) Need to maintain professional skepticism throughout the audit engagement;

(vi) Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

Question 40

N Ltd. has been sanctioned a Cash Credit Facility by XYZ Bank Ltd. for INR 1 crore and drawing power as per the stock statements furnished for the last quarter is INR 80 Lakh. Outstanding balance in the account is INR 7 lakhs. Interest charged to the account is INR 3.5 Lakh and total credit into the account for the quarter is INR 2.5 Lakh. As an auditor how will you report this account in your report. (PYP 4 Marks, July'21, Old & New SM)

Answer 40

Out of Order: 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'.

Applying the above to the given case of N Ltd, its Drawing power is ₹ 80 Lakhs, although outstanding balance in the account is ₹ 75 Lakhs, but still the account would be reported as out of order because credits in the account are not sufficient to cover the interest debited during the same period

Question 41

Compute the Drawing Power for Cash Credit A/c of S Limited for the month of March 2022 with following information: (PYP 3 Marks May'22)

	(Amount in ₹)
Stock	50,000
Debtors (Including Debtor of ₹ 5,000 for an invoice dated 17.11.2021)	45,000
Sundry creditors	15,000
Sanctioned Limit	45,000
Margin on stock is 20% and on debtors is 50%.	
Note: Debtors older than 3 months are ineligible for calculation of DP.	

Answer 41

Computation of Drawing Power:

Computation of Drawing Power for CC A/c of S Ltd.

Particulars of current assets		Amount (₹)	DP Amt (₹)
(A) Stocks:			
Stocks at realizable value		50,000	
Less: Unpaid stocks:			
- Sundry creditors	15000	15000	
Paid for stocks		35000	
Margin @ 20%		7000	28000
(B) Debtors:			
Total Debtors		45000	
Less: Ineligible debtors		5000	
Eligible debtors		40000	
Margin @ 50%		20000	20000
Total Drawing Power			48000

The sanctioned limit given in the Question is ₹ 45000 whereas drawing power as per the above working is ₹ 48000. So, drawing power would be restricted to sanctioned limit i.e.,₹ 45000

Question 42

After becoming Chartered Accountant, you have got your first assignment as an auditor of a bank branch dealing in various types of advances. What are the areas which you will be looking for obtaining sufficient appropriate evidence (for advances) besides studying and evaluating internal controls? (PYP 3 Marks May'22)

Answer 42

Audit Procedure in Audit of Advances in case of Bank Audit: The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

(i) examining the validity of the recorded amounts;

(ii) examining loan documentation.

(iii) reviewing the operation of the accounts;

(iv) examining the existence, enforceability and valuation of the security;

(v) checking compliance with RBI norms including appropriate classification and provisioning; and

(vi) carrying out appropriate analytical procedures.

Question 43

"Ramjilal & Co. had been allotted the branch audit of a nationalized bank for the year ended 31st March, 2018. In the audit planning, the partner of Ramjilal & Co., observed that the allotted branches are predominantly based in rural areas and major portion of the advances were for agricultural purpose."

Now he needs your assistance on the following points so as to incorporate them in the audit plan:

(i) for determination of NPA norms for agricultural advances

(ii) for accounts where there is erosion in the value of security/frauds committed by the borrowers. (PYP 5 Marks Nov 2018)

Answer 43

i. **NPA norms for Agricultural Advances:** As per the guidelines, Agricultural Advances are of two types, (1) Agricultural Advances for "long duration" crops and (2) Agricultural Advances for "short duration" crops The "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons and,
- A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

ii. Accounts where there is erosion in the value of security / frauds committed by borrowers Not prudent to follow stages of asset classification. It should be straightaway classified as doubtful or loss asset as appropriate.

(i) Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.

(ii) If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset. It may be either written off or fully provided for by the bank.

Question 44

CARD Ltd. is into the banking business and handles large amount of loans and advances of different kinds. Non-performing assets are on the rise since last two quarters. The management is concerned with correct provisioning for the same. CA R is appointed to check whether correct provisioning of NPA's is being made by the bank or not. What are the aspects that will be verified by CA R for this purpose? (PYP 4 Marks Nov 22)

Answer 44

Provisioning of Non-performing Assets: CA R should verify that the classification of NPAs into sub-standard assets, doubtful assets and loss assets is done depending upon prudential norms as per the RBI Guidelines.

Further he should also ensure that provis ion is being made for the same in accordance with the given table:

Categories of Non-Performing Assets:	Provision required
• **Substandard Assets:** Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
• **Doubtful Assets:** Would be one, which has remained in the substandard category for a period of 12 months.	Secured+ Unsecured
• **Sub-categories:** Doubtful up to 1 Year (D1) Doubtful 1 to 3 Years (D2) Doubtful more than 3 Years (D3)	25% + 100% 40% + 100% 100% + 100%
• **Loss Assets:** Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Alternative Answer 1:

Aspects to be verified by CA R to check correct provisioning of NPAs: CA R should verify following aspects while checking whether correct provisioning of NPAs is being made by bank: -

1. It should be verified whether classification of NPAs is in accordance with RBI guidelines. Such guidelines require classification of NPAs into sub-standard assets, doubtful assets and loss assets depending upon different criteria. Each classification requires different percentage of provisions. Therefore, proper classification of NPAs would ensure that provisioning is correct.
2. It should be verified that doubtful assets have been further properly classified in D1, D2 and D3 categories. These three different categories require provision of 25%, 40% and 100% respectively of secured portions of outstanding amount.
3. It should be verified that secured and unsecured portion in doubtful assets have been arrived at properly. Unsecured portion of liability entails provision of 100%. Therefore, it is important to verify that break-up of doubtful assets into secured and unsecured portions is proper.
4. As different kinds of loans and advances are handled by the bank, it should be ensured that loan classification according to its purpose is properly made in the system. NPA norms vary for cash credit accounts, term loans, bills purchased and agricultural loans. Any wrong classification can lead to incorrect provisioning. For example, if an agricultural loan is wrongly classified, it would lead to incorrect provisions.

Alternative Answer 2:

Aspects to be verified by CA R to check correct provisioning of NPAs:

1. For audit of Provisions, the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
2. The auditor should 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.
3. The auditor may verify the loan classification on a sample basis.
4. The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.

Question 45

A Ltd. has availed Cash Credit facilities against Stock and Book Debt, Term Loan for machineries and Bank Guarantee from Big Bank Ltd. A Ltd. furnishes stock statements and age wise list of debtors to Big Bank Ltd. on regular basis. Concurrent Auditors of Big Bank Ltd. mentioned about wrong calculation of Drawing Power by the Bank Branch along with sanctioned limit, and balances overdrawn due to wrong calculation of Drawing Power (DP) in the monthly report. Explain the meaning of drawing power and how it differs from sanctioned limit? What is to be ensured while computing Drawing Power (DP)? (PYP 3 Marks May '23)

Answer 45

Meaning of Drawing Power generally addressed as "DP" is an important concept for Cash Credit (CC) facility availed from banks and financial institutions. Drawing power is the limit up to which a firm or company can withdraw from the working capital limit sanctioned.

Different from Sanctioned Limit: The Sanctioned limit is the total exposure that a bank can take on a particular client for facilities like cash credit, overdraft, export packing credit, non-funded exposures etc. On the other hand, Drawing Power refers to the amount calculated based on primary security less margin as on a particular date.

Computation of DP: It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

CASE STUDY

CA M is conducting statutory audit of branch of MMC Bank. During the course of audit, it is noticed as under:-

(i) Loans under "Kisan credit card" are given by Bank to farmers to meet their short-term credit needs for cultivation of crops.

In respect of one agricultural advance classified under "Kisan Credit Card" having an outstanding balance of ₹ 20 lacs as at year end, there is no transaction in account since last 90 days. The said loan has been granted for cultivation of paddy which is harvested in a period of 3-4 months from sowing. The branch has classified the said advance as "Standard asset".

(ii) It is also observed that account of one borrower availing cash credit limit of ₹50 lacs was taken over from another bank. The proposal was sanctioned by branch manager instead of immediate next higher authority as required in "Manual of Delegation of Powers" of Bank.

(iii) It is noticed that head office of bank has flagged a savings account maintained in branch in which interest was wrongly paid at higher rate due to wrong data feeding entry. Now, situation has been rectified by debiting excess interest paid in the account. Since there was little balance in savings account, a debit balance of ₹1.50 lac was created in the said savings account due to above reversal. The matter was immediately informed to account holder. However, he has not turned up for payment since matter was informed to him about six months ago.

(iv) There are many cash credit accounts in the branch. Such borrowers are required to submit monthly stock statements to branch showing calculation of drawing power.

(v) One borrower has availed a housing loan and a car loan from the branch. Housing loan EMIs are overdue for 120 days as on date of Balance sheet. Car loan EMIs are overdue for 60 days as on date of Balance sheet.

MULTIPLE CHOICE QUESTIONS (MCQS)

Based on above, answer the following questions: -

(1) As regards description of agricultural advance, which of the following statements is most appropriate in this regard?

(a) The branch has erred in making classification as per RBI norms. It is a "Sub-standard" asset.

(b) The classification made by branch is proper. However, there are no transactions in account since last 90 days, it is SMA.

(c) The classification made by branch is proper.

(d) The branch has erred in making classification as per RBI norms. It is a "doubtful" asset.

Ans: (c)

(2) Regarding taken over account from another bank, which of following statements is most appropriate?

(a) It is an internal issue of Bank and auditor is not concerned with it.

(b) It is an internal issue of Bank. However, the auditor may, at his discretion, report it.

(c) It is a serious violation of laid down procedures of bank for sanction of advances and should be reported by auditor without fail.

(d) There is no issue involved as credit facility was properly sanctioned.

Ans: (c)

(3) As regards debit balance of ₹ 1.50 lacs in Savings account, which of the following is correct from point of view of an auditor?

(a) The situation does not attract RBI norms on asset classification.

(b) The debit balance of ₹1.50 lacs should be classified as NPA.

(c) The situation does not attract RBI norms on asset classification as no credit facility was granted.

(d) The bank cannot demand excess interest paid to account holder.

Ans: (b)

(4) Which of the following statements is not true about "drawing power" (DP)?

(a) Drawing Power refers to the amount calculated based on primary security less margin as on particular date.

(b) It is always less than sanctioned limit.

(c) It can be different from sanctioned limit.

(d) Creditors for goods are reduced for purpose of calculating Drawing Power.

Ans: (b)

(5) Considering housing loan and car loan availed by a borrower, which of the following statements is appropriate?

(a) Both Housing loan as well as car loan should be classified as "Non- Performing Assets" in accordance with RBI norms on asset classification.

(b) Housing Loan should be classified as "Non-Performing Asset" in accordance with RBI norms on asset classification. However, Car loan should be classified as Standard asset.

(c) Car Loan should be classified as "Non-Performing Asset" in accordance with RBI norms on asset classification. However, Housing Loan should be classified as Standard asset.

(d) Both Housing as well as car loans should be classified as Standard assets.

Ans: (a)

TEST YOUR KNOWLEDGE

(6) Which of the following is included in "Interest Earned" in Profit & loss A/c of a bank?

(a) Discount on Bills

(b) Loan Processing fees

(c) Commission on bills for collection

(d) Credit Card Fees

Ans: (a)

(7) While auditing advances of a bank as statutory auditor, which of the following is not a likely concern of auditor?

(a) Appropriate documentation of advances

(b) Ensuring budgeted targets of advances given by bank management

(c) Compliance of sanctioned terms and conditions

(d) Operations in advance accounts

Ans: (b)

(8) Any amount due to the bank under any credit facility is 'overdue' if: -

(a) it is not paid on the due date fixed by the bank

(b) it is not paid within 30 days of due date fixed by the bank

(c) it is not paid within 60 days of due date fixed by the bank

(d) it is not paid within 90 days of due date fixed by the bank

Ans: (a)

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(9) Which of the following statement is true regarding appointment of statutory branch auditor of a nationalized bank?

(a) The appointment is made by bank acting through its board of directors with prior approval of Central govt.

(b) The appointment is made by bank acting through its board of directors with prior approval of RBI

(c) The appointment is made by bank acting through its board of directors with prior approval of ICAI

(d) The appointment is made by shareholders in AGM.

Ans: (b)

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(10) Identify the correct statement: -

(a) Income from non-performing assets is recognized on accrual basis

(b) Income from non-performing assets is never recognized.

(c) Income from non-performing assets is recognized on basis of actual recovery

(d) Income from non-performing assets is recognized only when such assets are upgraded to standard assets

Ans: (c)

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

Question 1

RBI has been entrusted with the responsibility of regulating the activities of commercial banks only.

Answer 1

Incorrect. RBI has been entrusted with the responsibility of regulating the activities of commercial and other banks. All the Banks and even NBFC's fall under the regulatory function of RBI.

Question 2

In the computerised environment, the auditor need not be familiar with latest applicable RBI guidelines.

Answer 2

Incorrect. In the Computerised environment, it is imperative that the auditor is familiar with, and is satisfied that, all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income recognition.

Question 3

The auditor can assume that the system generated information is correct and relied upon.

Answer 3

Incorrect. The auditor should not go by the assumption that the system generated information is correct and can be relied upon without evidence that demonstrates that the system driven information is based on validation of the required parameters for the time being in force and applicable.

Question 4

Collateral security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank.

Answer 4

Incorrect. Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

Collateral security is in addition to the Primary security.

Question 5

Registered mortgage is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof

Answer 5

Incorrect. Registered Mortgage can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security. Equitable mortgage, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

Question 6

Any amount due to the bank under any credit facility is 'overdue' if it is not paid within 90 days of becoming due.

Answer 6

Incorrect. Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank and 90 days of becoming overdue.

Question 7

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

Answer 7

Correct. 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.

Question 8

Banks recognize income on Non-Performing Assets on accrual basis.

Answer 8

Incorrect: Income from non-performing assets (NPA) is not recognised on accrual basis due to its uncertainty but is booked as income only when it is actually received i.e. on actual receipt basis.

Question 9

Auditor of a Nationalised bank is to be appointed at the annual general meeting of the shareholders.

Answer 9

Incorrect- Auditor of a nationalized bank is to be appointed by the bank concerned acting through its Boards of Directors and approval of the Reserve bank is required before the appointment is made.

Question 10

Reporting of fraud of INR 150 Lakhs by auditor will be done within three days of the fraud coming to the knowledge of the auditor to the Board or the Audit Committee along with remedial action taken in case of audit of ABA Bank Ltd.

Answer 10

Incorrect- The auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days.

The Banking Company is bound to disclose remedial action taken in Board's report.

Question 11

Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets.

Answer 11

Correct: Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.

THEORETICAL QUESTIONS ANSWER

Question 1

Discuss outline of audit approach including audit procedures while auditing "provisions and contingencies" in financial statements of a bank.

Answer 1

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 nonperforming 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 2

Discuss importance of implementation of KYC norms by a bank from perspective of an auditor of bank.

Answer 2

Assess the Risk of Fraud including Money Laundering: As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately. The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

The RBI has framed specific guidelines that deal with prevention of money laundering and "Know Your Customer (KYC)" norms. The RBI has from time to time issued guidelines ("Know Your Customer Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

Question 3

List out any four points which highlight peculiarities involved in banking operations.

Answer 3

Peculiarities involved:

• Huge volumes and complexity of transactions;

• Wide geographical spread of banks' network;

• Large range of products and services offered;

• Extensive use of technology;

• Strict vigilance by the banking regulator etc.

Question 4

Is statutory auditor of a bank required to report on the requirements relating to Companies (Auditor's Report) Order, 2020?

Answer 4

It is pertinent to mention that the reporting requirements relating to the Companies (Auditor's Report) Order, 2020 is not applicable to a banking company, as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949.

Question 5

Account of a borrower availing cash credit facility from branch of a bank has become "Out or order." Discuss the term "Out of order".

Answer 5

Out of Order: 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'.

Question 6

The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country. Explain

Answer 6

Reserve Bank of India: Regulating Body

The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country.

RBI is responsible for :-

- development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions)
- determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour.
- regulating the activities of commercial and other banks

Important functions of RBI are :-

- issuance of currency;
- regulation of currency issue;
- acting as banker to the central and state governments; and
- acting as banker to commercial and other types of banks including term- lending institutions. Besides, RBI has also been entrusted with the responsibility of regulating the activities of commercial and other banks.

No bank can commence the business of banking or open new branches without obtaining license from RBI. The RBI also has the power to inspect any bank.

Question 7

"The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference". Explain.

Answer 7

Engagement Team Discussions: All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement are known to be the "Engagement Team". The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference.

The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's branch financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit.

The engagement team discussion ordinarily includes a discussion of the following matters:

(a) Errors that may be more likely to occur;

(b) Errors which have been identified in prior years;

(c) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;

(d) Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;

(e) Need to maintain professional skepticism throughout the audit engagement;

(f) Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

Advantages of such a discussion :-

- Specific emphasis should be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks.
- It further enables the audit engagement partner to delegate the work to the experienced engagement team members, and to determine the procedures to be followed when fraud is identified.
- Further, audit engagement partner may review the need to involve specialists to address the issues relating to fraud.

Question 8

Write a short note on reversal of income under bank audit.

Answer 8

Reversal of Income:

(a) If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

(b) In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

(c) Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

(d) Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

Test Your Understanding

Question 1

The financial statements of a bank are prepared in a specified format. Discuss legal provisions in this regard as applicable to financial statements of a nationalized bank.

Answer 1

Sub-sections (1) and (2) of Section 29 of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their authentication. These provisions are also applicable to nationalised banks. Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

Question 2

Ranjana Ceramic Private Limited is sanctioned a cash credit facility of ₹100 lacs from a branch of LMO Bank. Besides, branch has also sanctioned a one-time bank guarantee of ₹ 10 lacs on behalf of the company in favour of a statutory authority. Discuss, what type of credit facilities have been sanctioned by branch of LMO bank to the company along with probable purpose for each of credit facility.

Answer 2

Cash credit facility sanctioned by bank to company is in nature of funded credit facility. Its purpose is to meet working capital requirements of business. Bank guarantee sanctioned to the company is in nature of non-funded credit facility. Its probable purpose could be requirement of a guarantee by a statutory authority in exchange of company fulfilling some statutory obligations.

Question 3

During course of audit of branch of a nationalized bank, you find that system has generated a report marking ten term loan accounts as SMA. Discuss, meaning of SMA accounts and significance of such a classification.

Answer 3

Special Mention Account (SMA) is an account which is exhibiting signs of incipient stress resulting in the borrower defaulting in timely servicing of debt obligations, though the account has not yet been classified as NPA as per the RBI guidelines. In the given case, ten term loan accounts have been classified as SMA.

It means that there are overdues in the accounts for a period of 0 to 90 days. Since period of 90 days has not been exceeded as on the date, such accounts have not been classified as NPA as per RBI norms.

Such a classification is significant as early recognition of such accounts enables banks to initiate timely remedial actions to prevent potential slippages of such accounts into NPAs.

Question 4

CA P is conducting stock audit of a borrower availing cash credit facility of ₹100 lacs from branch of a bank. The cash credit facility is against security of paid stocks and debtors up to 90 days. Margin stipulated is 25% for stocks and 40% for debtors. Following further information is available as on 31.12.22: -

Answer 4

Value of stocks as on 31.12.22	**₹ 125 lacs**
Less: value of damaged stocks	**₹ 5 lacs**
	₹ 120 lacs
Less: creditors for goods as on 31.12.22	**₹ 50 lacs**
Value of Paid stocks	**₹ 70.00 lacs**
Less: Margin @ 25%	**₹17.50 lacs**
Drawing power (A)	**₹ 52.50 lacs**
Value of debtors as on 31.12.22	**₹ 50 lacs**
Less: debtors exceeding 90 days	**₹ 10 lacs**
	₹40 lacs
Less: Margin @ 40%	**₹ 16 lacs**
Drawing Power (B)	**₹ 24 lacs**
Drawing Power (A+B)	**₹ 76.50 lacs**
The drawing power calculated by CA P is not proper. Drawing Power comes to ₹ 76.50 lacs.	

Question 5

You are verifying interest on deposits paid by branch of a nationalized bank. Discuss, any two "analytical procedures", to verify interest on deposits paid by branch.

Answer 5

The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.

The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyze any material differences.

CHAPTER 11
ETHICS AND TERMS OF AUDIT ENGAGEMENTS

Question 1

The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism. Explain. (RTP Nov'22)

OR

Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. 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. Explain giving examples. (MTP 4 Marks Sep '23, RTP Nov'20, PYP 4 Marks, Nov' 19)

Answer 1

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.

Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
- 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.

Professional skepticism is necessary to the critical assessment of audit evidence. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider t he reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud, the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism.

Question 2

The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements. The Code establishes the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements. Explain. (MTP 3 Marks May 20 & April '19, RTP May 19)

OR

Explain the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements in accordance with Code of Ethics issued by ICAI. (PYP 4 Marks, Jan'21)

Answer 2

Ethical Requirements Relating to an Audit of Financial Statements: The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements :

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality; and

(e) Professional behavior.

Question 3

The IESBA Code establishes the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements. Discuss and also explain the meaning of ethics. (RTP May '22)

Answer 3

The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

First, broadly understand what are ethics? "Ethics" are the principles of conduct governing an individual or group. Professions like law, medicine have their code of ethics. Auditing profession is no exception.

Rather, in profession of auditing, importance of ethics is manifold.

The IESBA Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements. We shall understand broad meaning and intent of these fundamental principles as under:-

(a) Integrity

Integrity requires auditor to be straight forward and honest in all professional and business relationships. It implies fair dealing and truthfulness. It effectively means that he shall not be associated with reports, returns, communications or other information which he believes contains a materially false or misleading statement; contains statements or information provided recklessly or omits required information where such omission could be misleading.

(b) Objectivity

The principle of objectivity requires an auditor not to compromise professional judgment because of bias, conflict of interest or undue influence of others.

(c) Professional competence and due care

It requires that auditor attains and maintains professional knowledge and skill at the level required to render competent professional service based on current technical and professional standards and legislation and also to act diligently and in accordance with technical and professional standards. Diligence includes responsibility to act carefully, thoroughly and on a timely basis in accordance with requirements of an assignment.

(d) Confidentiality

Confidentiality principle requires an auditor to respect the confidentiality of information acquired as a result of professional or business relationships.

(e) Professional behaviour

It requires an auditor to comply with relevant laws and regulations and avoid any conduct that he knows or should know might discredit the profession.

Question 4

The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded as being incompatible with integrity and objectivity. Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist requiring the application of different safeguards. Explain stating clearly the five types of threats as contained in Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC). (MTP 7 Marks Oct 18)

OR

The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. Explain. (MTP 5 Marks Aug '18, RTP May'22, Old SM)

Answer 4

The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded as being incompatible with integrity and objectivity. Many different circumstances, or combination of

circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist requiring the application of different safeguards.

Threats to Independence

The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

1. Self-interest threats, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement, (iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the audit engagement.
2. Self-review threats, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement (Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.), or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.
3. Advocacy threats, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.
4. 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:

   (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.
5. Intimidation threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

Question 5

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 4 Marks April 19)

Answer 5

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:

(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.

Question 6

Examine with reasons (in short) whether the following statement is correct or incorrect :

It is necessary for the auditor to maintain professional skepticism throughout the audit. (MTP 2 Marks Oct 19)

Answer 6

Correct. As per SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. Thus, it is necessary for the auditor to maintain professional skepticism throughout the audit.

Question 7

Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats. Explain the guiding principles in this regard. (MTP 4 Marks May 20)

OR

Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats. Explain the guiding principles in this regard. (MTP 3 Marks April '21, RTP May '21 & RTP Nov '19,RTP May'23, PYP 4 Marks ,Nov '20)

OR

Discuss few guiding principles which are behind safeguards to eliminate threats to auditor's independence. (RTP Nov '21)

Answer 7

The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

The following are the guiding principles in this regard: -

1. For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
2. In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.
3. Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
4. When such threats exist, the auditor should either desist from the task or put in place safeguards that eliminate them.
5. If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

Question 8

There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance. Explain. (4 Marks Oct 20)

Answer 8

There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance. The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term 'Independence' as follows:

"Independence is:

(i) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

(ii)Independence in appearance – the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised."

Question 9

Examine with reasons (in short) whether the following statements are correct or incorrect:

Confidentiality requires an auditor to be straight forward and honest in all professional and business relationships. (MTP 2 Marks Oct'22)

Answer 9

Incorrect: Integrity requires an auditor to be straight forward and honest in all professional and business relationships. It implies fair dealing and truthfulness. Confidentiality principle requires an auditor to respect the confidentiality of information acquired as a result of professional or business relationships.

Question 10

Examine with reasons (in short) whether the following statements are correct or incorrect. Advocacy threat, is the threat which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. (MTP 2 Marks March '23)

Answer 10

Incorrect: Self-interest threat is the threat which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Further, Advocacy threat is the threat which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client' s advocate in litigation and third party disputes.

Question 11

Write a note on "Self-review threats" (RTP Nov '19)

Answer 11

Self-review threats, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement (Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.), or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (I) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.

Question 12

State with reason (in short) whether the following statements are true or false:

Familiarity threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees. (RTP May '21)

Answer 12

Incorrect: Intimidation threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

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.

Question 13

Professional integrity and independence are considered essential characteristics of all the professions. There are two interlinked perspectives of independence of auditors, one, independence of mind and two, independence in appearance. Explain. (RTP May '23)

Answer 13

Professional integrity and independence are considered essential characteristics of all the professions but are more so in the case of accountancy profession. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him. It is not possible to define "independence" precisely. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules themselves cannot create or ensure the existence of independence. Independence is a condition of mind as well as personal character. It should not be confused with the superficial and visible standards of independence which are sometimes imposed by law.

There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance. The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term 'Independence' as follows:

"Independence is:

(i) **Independence of mind –** the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

(ii) **Independence in appearance –** the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised."

Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

Question 14

"Independence of mind and independence in appearance are interlinked perspectives of Independence of auditors." Explain. (PYP 3 Marks, May '19)

Answer 14

a. **Independence"** implies that the judgment of a person is not subordinate to the wishes or direction of another person who might have engaged him. The auditor should be independent of the entity subject to the audit. There are two interlinked perspective of independence of auditors, one independence of mind and two, independence in appearance. The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term "Independence" as comprising both

b. **Independence of mind –** the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

c. **Independence in appearance –** the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised." Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

Question 15

There is a very thin difference between advocacy threats and intimidation threats to an auditor while performing his duty. (PYP 2 Marks July '21)

Answer 15

Incorrect: Advocacy threats, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised. e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.

Intimidation threats, which occur when auditors are deterred from acting objectively with an adequate

degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

So, it can be concluded that there is not very thin difference between the advocacy threats and intimidation threats.

SA 210- Agreeing the Terms of Audit Engagements

Question 1

Examine with reasons (in short) whether the following statement is correct or incorrect:

Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement. (MTP 2 Marks April 19)

Answer 1

Correct. Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

Question 2

Examine with reasons (in short) whether the following statement is correct or incorrect : There is no need to put the nature of engagement to writing. (MTP 2 Marks April 19)

OR

It is important for the auditor that each party should be clear about the nature of the engagement. (MTP 2 Marks May 20)

Answer 2

Incorrect: It is important, both for the auditor and client, that each party should be clear about the nature of the engagement. It must be reduced to writing and should exactly specify the scope of the work.

Question 3

Examine with reasons (in short) whether the following statement is correct or incorrect: The audit engagement letter is sent by the client to auditor. (MTP 2 Marks Oct 20, New SM)

Answer 3

Incorrect: As per SA 210 "Agreeing the Terms of Audit Engagements", the Audit engagement letter is sent by the auditor to his client.

Question 4

Examine with reasons (in short) whether the following statement is correct or incorrect: The terms of audit engagement can restrict the scope of an audit. (MTP 2 Marks April '21)

Answer 4

Incorrect: The scope of an audit of financial statements will be determined by the auditor for having regard to the terms of the engagement, the requirement of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.

Question 5

Preconditions for an audit have not been defined in SA 210 "Agreeing the Terms of Audit Engagements."(RTP Nov '19)

Answer 5

Incorrect: As per SA 210 "Agreeing the Terms of Audit Engagements", preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

Question 6

State with reason (in short) whether the following statements are true or false:

SA 210 does not require the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement. (RTP May '20)

Answer 6

Incorrect: SA 210 requires the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.

Question 7

On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. The auditor may decide not to send a new audit engagement letter or other written agreement each period. Explain the factors an auditor considers to be appropriate to revise the terms of the audit engagement or to remind the entity of existing terms. (RTP May '21, New SM)

Answer 7

On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

Question 8

Discuss preconditions for an audit as per SA 210. Explain how would an auditor proceed to establish the presence of pre-conditions for an audit. (RTP May '21, MTP 4 Marks Sep'22, PYP 4 Marks Dec'21)

Answer 8

As per SA 210 "Agreeing the Terms of Audit Engagements", preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

In order to establish whether the preconditions for an audit are present, the auditor shall:

(a) Determine whether the financial reporting framework is acceptable; and

(b) Obtain the agreement of management that it acknowledges and understands its responsibility:

(i) For the preparation of the financial statements in accordance with the applicable financial reporting framework;

(ii) For the internal control as management considers necessary; and

- To provide the auditor with: Access to all information such as records, documentation and other matters;
- Additional information that the auditor may request from management for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Question 9

"An auditor who before the completion of the engagement is requested to change the engagement to one which provides a lower level of assurance should consider the appropriateness of doing so." Discuss. (RTP May'18 & Nov '23, MTP 4 Marks Mar'22)

Answer 9

Acceptance of a Change in Engagement: An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so. A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications. If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to-

(i) the original engagement; or

(ii) any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report. The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall-

(i) Withdraw from the audit engagement where possible under applicable law or regulation; and

(ii) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Question 10

An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

Explain the circumstances which may contribute towards a request from the client for the auditor to change the engagement. (RTP Nov'22, Nov'19)

Answer 10

An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

A request from the client for the auditor to change the engagement may result from-

1. a change in circumstances affecting the need for the service,
2. a misunderstanding as to the nature of an audit or related service originally requested.
3. a restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

Question 11

The discussion between members of the engagement team members and the audit engagement partner should be done on the susceptibility of the bank's financial statements to material misstatements. Briefly discuss the points ordinarily included in discussion of the engagement team. (PYP 3 Marks, Nov'19)

Answer 11

The engagement team discussion ordinarily includes a discussion of the following matters:

(i) Errors that may be more likely to occur;

(ii) Errors which have been identified in prior years;

(iii) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and / or disclosure;

(iv) Audit responses to engagement risk, pervasive risks and specific risks;

(v) Need to maintain professional skepticism throughout the audit engagement,

(vi) Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g. the bank's application of accounting policies in the given facts and circumstances).

Question 12

Examine with reasons whether the following statements are correct or incorrect.

Even if law or regulation prescribes sufficient details of the terms of the audit engagement the auditor should record them in a written agreement (PYP 2 Marks, Nov'20)

Answer 12

Incorrect: 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.

Question 13

CA P is appointed as an auditor of XYZ Limited for the F.Y. 2021 -22. The management of XYZ Limited has requested the auditor to change the terms of original engagement as the company has diversified its business and few new products have been introduced by the company. Can CA P agree to the request made by the management? Under which circumstances can the client make a request to the auditor for a change in the terms of engagement? (PYP 4 Marks Nov 22)

Answer 13

Acceptance of a Change in Engagement:

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, a significant change in nature or size of the entity's business is one of the factors which may make it appropriate to revise the terms of the audit engagement.

In the given situation, XYZ Limited has diversified its business and few new products have also been introduced by the Company which is indicative of significant change in nature or size of the entity's business. In view of above, CA. P can agree to the request made by the management to change the terms of the audit engagement. Therefore, request of Management to change the terms of audit engagement is appropriate.

A request from the client for the auditor to change the engagement may result from-

1. a change in circumstances affecting the need for the service,

2. a misunderstanding as to the nature of an audit or related service originally requested.
3. a restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

SQC 1- Quality Control for Firms Which Perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Service Engagements

Question 1

The firm's system of quality control should include policies and procedures addressing each and every element of system of quality control. State those elements. (MTP 3 Marks Oct 19, RTP Nov '18)

OR

How does SQC 1 ensure that independence in engagements is not breached by an audit firm? (New SM)

Answer 1

ELEMENTS OF A SYSTEM OF QUALITY CONTROL: The firm's system of quality control should include policies and procedures addressing each of the following elements:

(a) Leadership responsibilities for quality within the firm.

(b) Ethical requirements.

(c) Acceptance and continuance of client relationships and specific engagements.

(d) Human resources.

(e) Engagement performance.

(f) Monitoring.

Question 2

SQC1 requires engagement partner 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 30 days after the date of the auditor's report. (MTP 2 Marks May 20)

Answer 2

Incorrect: SQC1" 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.

Question 3

Discuss the following:

The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Explain the purpose of monitoring compliance with quality control policies and procedures. (MTP 4 Marks Oct'22, RTP Nov '19 & Nov '20)

Answer 3

The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

(1) Adherence to professional standards and regulatory and legal requirements;

(2) Whether the quality control system has been appropriately designed and effectively implemented; and

(3) Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

Question 4

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.

Discuss. (MTP 5 Marks March '18, March'19, PYP 3 Marks, Nov '19, RTP Nov '19)

Answer 4

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 5

Examine with reasons (in short) whether the following statements are correct or incorrect:

Historical financial information relates to financial information based on assumptions about the occurrence of future events and possible actions by an entity. (MTP 2 Marks Oct '23, PYP 2 Marks Nov 22)

Answer 5

Incorrect: Historical financial information relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. Whereas financial information based on assumptions about occurrence of future events and possible actions by an entity relates to prospective financial information.

Question 6

Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Explain the matters to be addressed in this context. (RTP May '21)

Answer 6

The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Matters addressed include the following:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- Processes for complying with applicable engagement standards.
- Processes of engagement supervision, staff training and coaching.
- Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- Appropriate documentation of the work performed and of the timing and extent of the review.
- Processes to keep all policies and procedures current.

Question 7

The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles. Explain stating clearly personnel issues addressed by such policies and procedures. (RTP Nov'22, Nov'21)

Answer 7

The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and

legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

Such policies and procedures address the following personnel issues:

(a) Recruitment.

(b) Performance evaluation.

(c) Capabilities.

(d) Competence.

(e) Career development.

(f) Promotion;

(g) Compensation; and

(h) Estimation of personnel needs.

Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements. The firm's recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm's work.

Question 8

Examine with reasons (in short) whether the following statements are correct or incorrect:

The Audit Engagement documentations should ordinarily be retained by the auditor for minimum of six years from the date of the auditor's report or the date of the group auditor's report, whichever is later (PYP 2 Marks, May'18, New SM).

Answer 8

Incorrect: 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 9

CA Raj, an engagement partner wants to take decision, regarding acceptance and continuance of an audit engagement. Which information's, he should obtain before accepting an engagement? (PYP 3 Marks, May '19)

Answer 9

SQC 1 requires the firm to obtain information before accepting an engagement. Information such as the following assists the engagement partner in determining whether the decisions regarding the acceptance and continuance of audit engagements are appropriate:

(i) The integrity of the principal owners, key management and those charged with governance of the entity

(ii) Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources.

(iii) Whether the firm and the engagement team can comply with relevant ethical requirements; and

(iv) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

Question 10

The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances. Explain. (MTP 4 Marks March '23)

Answer 10

The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.

Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter - specific guidance materials.

Matters addressed include the following:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- Processes for complying with applicable engagement standards.
- Processes of engagement supervision, staff training and coaching.
- Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- Appropriate documentation of the work performed and of the timing and extent of the review.
- Processes to keep all policies and procedures current.

Multiple Choice Questions (MCQs)

1. Standard on Quality Control (SQC) 1 provides that,

(a) unless otherwise specified by law or regulation, audit documentation is the property of the management.

(b) unless otherwise specified by law or regulation, audit documentation is the property of those charged with governance.

(c) unless otherwise specified by law or regulation, audit documentation is the property of the management or those charged with governance.

(d) unless otherwise specified by law or regulation, audit documentation is the property of the auditor. (MTP 1 Mark Oct 19)

Ans: (d)

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2. As per SQC 1 the retention period for audit engagements ordinarily is no shorter than from the date of the auditor's report.

(a) ten years

(b) five years

(c) seven years

(d) four years (MTP 1 Marks March '21)

Ans: (c)

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3. In relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures is known as :

(a) Monitoring

(b) Inspection

(c) Subsequent Audit procedures

(d) Compliance procedures (MTP 1 Marks March '21)

Ans: (b)

4. _____requires firms to establish policies and procedures for the retention of _.

The retention period for audit engagements ordinarily is no shorter than from the date of the auditor's report, or, if later, the date of the group auditor's report (RTP May '22)

(a) SA 220, audit evidence, six years

(b) SA 200, audit documentation, seven years

(c) SQC 1, engagement documentation, seven years

(d) SA 230, documentation, six years

Ans: (c)

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5. In relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures is known as:

(a) Monitoring

(b) Inspection

(c) Subsequent Audit procedures

(d) Compliance procedures. (RTP May '21)

Ans: (b)

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6. Mr. Salman, is an engagement partner of Khan & co. chartered accountants for an audit of Lava Ltd., he died of a stroke on 30.09.2019 after completing the entire routine audit work of Lava Ltd. Mr. Shoji, one of the partners of Khan & Co. will be signing the accounts of Lava Ltd. What is the course of action to be taken by Mr. Shoaib ?

(a) Sign the accounts of Lava Ltd without reviewing the work of his partner

(b) Sign the balance sheet after reviewing the work of his partner

(c) Withdraw the audit as the person who has performed the audit is no more

(d) Issue an adverse report. (RTP Nov'20)

Ans: (b)

SA 220- Quality Control for an Audit of Financial Statements

Question 1

Examine with reasons (in short) whether the following statement is correct or incorrect:

As per SA 220, the engagement partner shall be responsible for the overall quality on each audit engagement assigned to him. (MTP 2 Marks Aug '18)

Answer 1

Correct: As per SA 220 "Quality Control for an Audit of Financial Statements", the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

Question 2

As per SA 220, the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. While taking responsibility for the overall quality on each audit engagement, analyse and explain the emphasis of the actions of the engagement partner and appropriate messages to the other members of the engagement team . Also define engagement partner. (MTP 5-Marks Aug '18, RTP Nov'20 & May '23, PYP 3 Marks Nov'19)

Answer 2

As per SA 220 "Quality Control for an Audit of Financial Statements", the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

(a) The importance to audit quality of:

(i) Performing work that complies with professional standards and regulatory and legal requirements;

(ii) Complying with the firm's quality control policies and procedures as applicable;

(iii) Issuing auditor's reports that are appropriate in the circumstances; and

(iv) The engagement team's ability to raise concerns without fear of reprisals; and

(b) The fact that quality is essential in performing audit engagements.

Engagement partner defined

Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

Question 3

As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new client. Explain stating clearly the information that would assist the auditor in accepting and continuing of relationship with the client. (MTP 4 Marks Nov '21, RTP May'18, Old SM)

Answer 3

Information which assist the Auditor in accepting and continuing of relationship with Client: As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement and when considering acceptance of a new engagement with an existing client. The following information would assist the auditor in accepting and continuing of relationship with the client:

(i) The integrity of the principal owners, key management and those charged with governance of the entity;

(ii) Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;

(iii) Whether the firm and the engagement team can comply with relevant ethical requirements; and

(iv) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

CASE STUDY

Das & Co, a firm of auditors, is offered appointment as auditor of a company, a prospective new client. CA Sukanya, one of partners, is dealing with new client. While meeting with officers of the company, she comes to know that Sushant, CFO of the company, was her class mate. In fact, both of them had started CA together. However, Sushant had left CA mid-way due to repeated failures and tried his luck to pursue MBA (finance) from one of leading institutions.

During initial discussions, it transpires that company is going to launch new services in the field of "weather-forecasting". Such services would be available on web site of company and micro weather information would be available on payment of charges. The company requests audit firm to be visibly associated with their marketing blitz.

Assume that firm choses to accept the offer and writes to previous auditor, Walker & Co., to advise whether there exist any professional reasons for them not to accept the proposed offer. However, Walker & Co. do not reply to the request of Das & Co.

During preliminary discussions, it also became known that the said company has acquired all shares of another company. Under relevant provisions of law, financial statements of both companies needed to be consolidated and audited. Despite this knowledge, Das & Co. failed to advise their client regarding audit of consolidated financial statements.

The company also offers auditors contract for providing IT services pertaining to information system of company.

MULTIPLE CHOICE QUESTIONS (MCQS)

Based on above, answer the following questions: -

1. Considering discussion about Sukanya and Sushant, which of the following statements seems most appropriate?

(a) The above discussion is irrelevant in context of proposed offer.

(b) The proposed offer should be accepted by firm. The engagement team may be headed by CA Sukanya for better coordination and results.

(c) The proposed offer should be accepted by firm. The engagement team may be headed by a different partner of the firm.

(d) The matter is too trivial to be reported by CA Sukanya to other partners of firm.

Ans: (c)

2. Keeping in view request of the company to be visibly associated with company's new services, identify which type of threat is being faced by audit firm.

(a) Self-interest threat

(b) Familiarity threat

(c) Self-review threat

(d) Advocacy threat

Ans: (d)

3. The previous auditors, Walker & Co., have not replied to communication of Das & Co. Which fundamental principle of professional ethics is not followed by them?

(a) Objectivity

(b) Professional behaviour

(c) Professional competence and due care

(d) Integrity

Ans: (b)

4. Das & Co. have failed to advise the company regarding audit of consolidated financial statements. Which fundamental principle of professional ethics is violated by Das & Co.?

(a) Professional behaviour

(b) Integrity

(c) Objectivity

(d) Professional competence and due care

Ans: (d)

5. Which of the following statements is most appropriate regarding providing offer of work of IT services by auditors to the company?

(a) Such offer may create a self-review threat.

(b) Such offer may create an advocacy threat.

(c) Such offer does not constitute any threat.

(d) Such offer may create self-review and advocacy threats.

Ans: (a)

TEST YOUR KNOWLEDGE

6. Identify the most appropriate statement: -

(a) SA 220 applies at the level of firm.

(b) SQC 1 is premised on the basis that firm is subject to SA 220.

(c) SA 220 is premised on the basis that firm is subject to SQC 1.

(d) SA 220 applies to all engagements.

Ans: (c)

7. Professional skepticism includes-

(a) Overlooking unusual circumstances.

(b) Using inappropriate assumptions in determining extent of audit procedures.

(c) Over generalising when drawing conclusions from audit observations.

(d) Being vigilant to conditions that might indicate possibilities of fraud.

Ans: (d)

8. Which of the following is not a fundamental principle governing professional ethics?

(a) Professional competence and due care

(b) Integrity

(c) Objectivity

(d) Safeguards to independence

Ans: (d)

9. Which of the following is not necessary to establish preconditions for an audit?

(a) Acceptability of financial reporting framework.

(b) Acknowledgment of cooperation from management in designing audit procedures.

(c) Acknowledgment from management of providing access to persons within company.

(d) Acknowledgment of management in understanding its responsibility for preparation of financial statements.

Ans: (b)

10. Identify the most appropriate statement in context of SQC 1.

(a) Assembly of engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements.

(b) Engagement files should be completed before date of auditor's report in case of audit engagements.

(c) Engagement files should be completed in not more than 60 days after completion of an engagement.

(d) Engagement files should be completed on date on which audit report is signed in case of audit engagements.

Ans: (a)

Correct/Incorrect

State with reasons (in short) whether the following statements are correct or incorrect:

Question 1

The audit engagement letter is sent by the client to auditor.

Answer 1

Incorrect: As per SA 210 "Agreeing the Terms of Audit Engagements", the Audit engagement letter is sent by the auditor to his client.

Question 2

The Audit Engagement documentations should ordinarily be retained by the auditor for minimum of six years from the date of the auditor's report or the date of the group auditor's report, whichever is later.

Answer 2

Incorrect: 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.

THEORETICAL QUESTIONS ANSWER

Question 1

Briefly outline how principles-based approach differs from rules-based approach to ethics.

Answer 1

Ethical guidance may follow principles-based approach or rules-based approach. The essence of principles-based approach to ethics is that it requires compliance with spirit of ethics. It requires accountants to exercise professional judgment in every situation based upon their professional knowledge, skill and expertise. It requires that accountants should use professional judgment to evaluate every situation to arrive at conclusions.

However, rules-based approach to ethics strictly follows clearly established rules. It may lead to a narrow outlook and spirit of ethics may be overlooked while strictly adhering to rules. Further, rules-based approach is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules.

Therefore, it is necessary that spirit of code is followed.

Question 2

How application of professional skepticism throughout audit is helpful in reducing audit risk?

Answer 2

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.

Professional skepticism is necessary to the critical assessment of audit evidence. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary.

Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud, the

SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism.

Question 3

A Chartered accountant is conducting audit of a client for last two years. Before proceeding to start audit for next year, he notices that there is substantial change in management. Besides, client has ventured into areas of business activity which were not present at time of accepting initial audit engagement. Discuss responsibility of auditor in this regard in context of SA 210.

Answer 3

Recurring audit is an audit which is performed by an auditor over years. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

(i) Any indication that the entity misunderstands the objective and scope of the audit.

(ii) Any revised or special terms of the audit engagement.

(iii) A recent change of senior management.

(iv) A significant change in ownership.

(v) A significant change in nature or size of the entity's business.

(vi) A change in legal or regulatory requirements.

(vii) A change in the financial reporting framework adopted in the preparation of the financial statements.

(viii) A change in other reporting requirements.

Question 4

How does SQC 1 ensure that independence in engagements is not breached by an audit firm?

Answer 4

The firm's system of quality control should include policies and procedures addressing each of the following elements: -

(A) Leadership responsibilities for quality within the firm

(B) Ethical requirements

(C) Acceptance and continuance of client relationships and specific engagements

(D) Human resources

(E) Engagement performance

(F) Monitoring

Quality control policies and procedures should be documented and communicated to the firm's personnel. By communicating, the firm recognizes the importance of obtaining feedback on its quality control system from its personnel. Therefore, the firm encourages its personnel to communicate their views or concerns on quality control matters.

Question 5

An engagement partner takes overall responsibility for maintaining audit quality in an audit engagement in accordance with SA 220. What are his objectives in taking and emphasizing such responsibility?

Answer 5

Leadership responsibility of an engagement partner is to take responsibility for the overall quality on each audit engagement. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise

(a) The importance to audit quality of: -

(i) Performing work that complies with professional standards and regulatory and legal requirements;

(ii) Complying with the firm's quality control policies and procedures as applicable;

(iii) Issuing auditor's reports that are appropriate in the circumstances; and

(iv) The engagement team's ability to raise concerns without fear of reprisals.

(b) The fact that quality is essential in performing audit engagements.

Test Your Understanding

Question 1

CA P. Suryakantam has conducted audit of accounts of an entity for a particular year. ICAI has issued a letter to him relating to certain matters concerning audit. He didn't even bother to reply to the letter despite reminders. Discuss which fundamental principle governing professional ethics is disregarded by him.

Answer 1

Failure to reply to professional body smacks of lack of courtesy and professional responsibility. The principle of "Professional behaviour" is disregarded.

Question 2

A Chartered accountant in practice issued a certificate showing original cost of plant and machinery installed in premises of a client for Rs. 9 crores to save some regulatory fees for his client. However, original cost of plant and machinery was Rs.15 crore as per records of client. Which fundamental principle governing professional ethics is violated in this case?

Answer 2

"Integrity" requires that a professional accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information contains a materially false or misleading statement; contains statements or information provided negligently or omits or obscures required information where such omission or obscurity would be misleading.

In the given case, a false certificate is knowingly issued showing misstated original cost of machinery. Therefore, fundamental principle of "integrity" is violated.

Question 3

CA Raman Gupta is offered appointment as auditor of a company. One of his distant uncles held some shares in the same company. Holding of such shares, by a distant relative, is not prohibited under provisions of law nor does it affect his independence. Before he could accept appointment, he received unfortunate news of death of his uncle who had died without any children. He came to know that he was nominee of these shares having substantial value. It landed him in a tricky situation. What should be proper course of action for him?

Answer 3

When threats to independence 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.

Holding of shares involves financial interest in the company and is in nature of self-interest threat. He has come to hold shares due to nomination made by his distant relative before accepting the appointment.

Considering above, he should take steps to eliminate the threat by selling shares immediately before accepting appointment. Holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence.

Question 4

A Chartered accountant receives about 40% of his total audit fees from a single client. Discuss how it could affect independence of Chartered accountant as auditor of this client. What are such types of threats referred to as?

Answer 4

Undue dependence on fees of a client constitutes a threat as there is fear of losing the client. Such threats are referred to as self-interest threats.

Question 5

CA Murli Madhavan provides accounting and book keeping services to a leading NGO engaged in environmental protection work. He is also offered audit of the accounts of NGO. Identify and discuss what kind of threat to independence may be involved in accepting such an engagement.

Answer 5

In this case, Chartered Accountant is already rendering accounting and book keeping services to an NGO.

If he accepts audit, he would be involved in reviewing own work. Therefore, the same constitutes "selfreview" threat.

Question 6

The auditors of a company have only relied upon management representation letter regarding treatment of certain tax matters under appeal by the company. The auditors have not carried

out any other audit procedures to justify management's treatment of the said tax matters under appeal in the financial statements. What is lacking on part of auditors in such a situation?

Answer 6

In the given case, auditors have relied only upon management representation letter regarding treatment of certain tax matters under appeal by the company. No other audit procedures to verify management's treatment of such matters under appeal have been performed by auditors. It shows lack of "professional skepticism" on part of auditors.

Question 7

Chirag, as part of articled training, is part of an engagement team conducting audit of a company. He has read somewhere that engagement letter issued by auditor to client also includes expected form and content of the auditor's report. He was at a loss to understand how could an auditor include form and content of the report beforehand. Try to help Chirag by making things clear to him.

Answer 7

Engagement letter includes reference to expected form and content of audit report. It merely states that auditor would provide opinion in this form. However, engagement letter also includes statement that the form and content of report may need to be amended in the light of audit findings. Therefore, if in light of audit findings, auditor needs to give a modified opinion, he shall do so.

Question 8

The management of an entity feels that it is not necessary for it to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. Discuss, whether, it is necessary for the management to do so. In case management refuses, why should an auditor not accept the proposed engagement?

Answer 8

It is necessary for management to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. It is a necessary precondition for an audit in accordance with SA 210.

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement: -

(a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable or

(b) If the agreement of management is not obtained on matters relating to understanding of responsibility of management on preparation of financial statements, internal controls for preparation of financial statements, providing access to all information to auditor and unrestricted access to persons within the entity.

Unless required by law or regulation to do so, such a refusal on the part of auditor is necessary as management is not willing to accept its responsibility for preparation of financial statements in accordance with applicable financial reporting framework. An audit is conducted on this basic premise according to SA 210. When basic premise on which audit is conducted is not fulfilled, refusal by auditor is necessary.

Question 9

CA PK Nair is offered appointment as auditor of a company engaged in providing tourism services. While making due diligence of the proposed client, he comes to know that there have been raids on premises of the company and residences of its directors by National Investigation Agency (NIA) on suspicion of links with terror outfits. It has been followed up with searches by Enforcement Directorate hunting for illicit money trail. There is a strong suspicion of tourism services provided by company being façade of terror funds. Should proposed offer be accepted by him?

Answer 9

Integrity of principal owners has to be considered before accepting an audit engagement in accordance with SA 220. In this regard, SA 220 states requirements on lines of SQC 1. SQC 1 clearly states that in cases where there are indications that the client might be involved in money laundering or other criminal activities, appointment should not be accepted.

In the instant case, there have been raids of NIA on suspected links with terror outfits which is a criminal activity. Further, raids by Enforcement Directorate also point towards money laundering. Therefore, proposed offer should not be accepted.

Question 10

CA Arpita has joined a mid-sized CA firm recently. She finds that partners remain too busy and the firm is proposing to accept audit work in areas in which it has no experience or capabilities. The firm is proposing to accept audit of some entities engaged in emerging "fin-tech" sector.

Such audits may be requiring extensive use of technology and data analytics. However, the said firm has no such capabilities and trained personnel. Discuss, whether, firm should accept such audits with reason.

Answer 10

SQC 1 requires that before accepting an engagement, competence (including capabilities, time and resources) to perform engagement have to be considered.

In the given case, the proposed engagements involve use of technology and data analytics. The firm has no prior experience of audits in emerging "fin- tech" sector. The firm does not have trained personnel to carry out these audits. Hence, offer for these audits should not be accepted.

CHAPTER 12
CASE SCENARIOS

Case Scenarios

Case Scenario (MTP May 20)

- **M/s TPR & Associates have been appointed as the auditors of Octopus Ltd. for the Financial Year 2019-20.**
- **During the course of audit, the auditor notices that there is significant change in the number of debtors of the company. The auditor decided to check the debtors account in detail.**
- **Further the company has made various provisions like the provisions for taxation, provision for bad & doubtful debts.**
- **Also during the current Financial Year, the auditor attended the physical verification of the inventory being carried out by the management.**
- **The auditor notices that there is no substantial change in the bifurcation of amount of items representing the liabilities side of the balance sheet of Octopus Ltd. Still the auditor understands that he needs to check the liability side in detail.**
- **Further the company has also recognised various income like interest income and dividend income which auditor understands need to be checked in detail.**
- **The auditor is of the understanding that certain matters need to be reported under Companies Auditors Report Order (CARO).**

Based on the above facts, answer the following:-

1. ..... is a possible obligation that arises from the past events and whose existence will be confirmed only by the occurrence/ non occurrence of one or more uncertain future events not wholly within the control of the entity:-

(a) Provision

(b) Reserve

(c) Contingent Liability

(d) Liability (2 Marks May 20)

Answer : (c)

2. Which of the following is not correct with respect to the inventory held by Octopus Limited:-

(a) All inventory units held by the company should have been recorded and recognized in the financial statements.

(b) Any inventory held by a third party on behalf of the company should not be included as part of the inventory balance.

(c) Inventory should be recognized at cost or net realizable value whichever is lower.

(d) Inventory balance as at the year end does not include any element of next year(2 Marks May 20)

Answer : (b)

3. If the management of Octopus Ltd. refuses to allow the auditor, to send the confirmation request to the debtors, the auditor should:-

(a) Withdraw from the engagement.

(b) Not listen at all to any requests of the management.

(c) Consider the management's request for refusal and assess its validity and decide the nature, timing, extent of his audit procedures accordingly.

(a) Agree to management request and proceed with audit of other items of the financial statements. (2 Marks May 20)

Answer : (c)

4. Which of the following statements is not true so far as the liabilities of a company are concerned:-

(a) Liabilities are the financial obligations of a company including owner's funds.

(b) Liabilities include borrowing, trade payable and other current liabilities and provisions.

(c) Verification of liabilities is an important as that of assets.

(d) All of the above. (2 Marks May 20)

Answer : (a)

5. Statement 1: Confirmations as well as undelivered letters should be given/ returned to the auditor and not to the client

Statement 2: When no reply is received, the auditor should perform alternate procedures regarding the balances:-

(a) Only statement 1 is correct

(b) Only statement 2 is correct

(c) Both 1 & 2 are correct

(d) Both 1 & 2 are incorrect (2 Marks May 20)

Answer : (c)

Case Scenario (MTP May 20) (Chapter 10 The Company Audit)

ABC Ltd. is a company dealing in products namely chocolate and coffee. ABC Ltd. approached audit firm XYZ & Associates for the statutory audit of its financial statements for the year ended 31.03.2019. The Gross turnover of the company is Rs.105 crores, out of which turnover from one of its product namely coffee is of Rs.95 crores during the immediate preceding Financial Year.

During the course of Audit, XYZ & Associates found certain delay in the payment of the Employees Provident Fund by ABC Ltd. They understand that the same need to be reported under the relevant provisions of Companies (Auditors Report) Order 2016.

During the FY 2018-2019, Mrs. X wife of CA Mr. X who is partner in XYZ & Associates acquires certain shares of ABC Ltd. The audit firm is of the opinion that this may call for a disqualification for the firm for being working as the auditor of the company under the relevant provisions of the Companies Act 2013.

Further, ABC Ltd. also approached the auditors to provide them the Investment Banking service to which the auditors denied as per the provisions of Companies Act 2013.

During the course of audit, XYZ & Associates has reason to believe that an offence of fraud involving some amount has been committed in the ABC Ltd. by its General Manager. The auditors understand that there is a requirement for reporting of fraud by the auditors under the Companies Act and the relevant rules.

Based on the above facts, answer the following:-

1. After the appointment of XYZ & Associates, ABC Ltd. should inform the auditor and file a notice of such appointment with registrar within:-

(a) 60 days

(b) 30 days

(c) 15 days

(d) 20 days(2 Marks May 20)

Answer : (c)

2. If Mrs. X acquires security exceeding the prescribed limit in the ABC Ltd., then XYZ & Associates shall take corrective actions within… days. What is the prescribed limit:-

(a) 100 days, Market Value Rs 1,00,000

(b) 60 days, Face value Rs 1,00,000

(c) 90 days, Face value Rs 1,00,000

(d) 15 days, Market Value Rs 1,00,000(2 Marks May 20)

Answer : (b)

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3. Under which section reporting of fraud by an auditor to the Central Government is required and what is the amount of fraud:-

(a) Section 143(12), 1 crore & above

(b) Section 139(12), 1 crore & above

(c) Section 143(12), 2 crore & above

(d) None of the above(2 Marks May 20)

Answer : (a)

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4. What is the requirement for ABC Ltd as per the relevant provisions regarding maintenance of cost records:-

(a) Maintenance of cost records is mandatory, in form CRA 1.

(b) Maintenance of cost records is mandatory, in form CRA 2.

(c) Maintenance of cost records is mandatory, in any general format.

(a) No requirement of maintenance of cost records. (2 Marks May 20)

Answer : (a)

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5. Under relevant clause of CARO,2020, XYZ & Associates is required to report the extent of arrears of Employees Provident Fund as at the balance sheet date:-

(a) Exceeding 9 months

(b) Exceeding 3 months

(c) Exceeding 6 months

(d) Exceeding 12 months(2 Marks May 20)

Answer :(c)

Case Scenario (MTP Oct 20)

Mr. Laxman is appointed as statutory auditor of Best Limited for the Financial Year ended 31st March, 2020.

During the course of audit, it was found that few doubtful transactions had been committed by finance manager who retired in March, 2020.

The fraud was going on since last 4-5 years and the total amount misappropriated is approximately ₹ 75 lacs.

Balance sheet of Best Ltd. reflected a cash balance of ₹ 7 crores. The company has taken a loan of ₹ 2 crores from the bank despite of the huge cash balance with the company.

Also, Companies Act bestows some duties on auditors to report matters to Central Government in case of fraud.

On the basis of above facts answer below questions in relation to Mr. Laxman's role and duties while conducting statutory audit of Best Limited.

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1. Mr. Laxman shall obtain _____ that the financial statements are free from fraud andbmisstatement.

(a) Absolute assurance

(b) Reasonable assurance

(c) Management's assurance

(d) Chief Financial Officer assurance.(2 Marks Oct '20)

Answer : (b)

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2. Mr. Laxman suspects that cash payments were inflated. Out of the below which could be probable reason for such inflated cash payments.

(a) Not accounting for cash sales completely

(b) Making payments against purchase vouchers

(c) Making payments against inflated vouchers

(d) Teeming and Lading .(2 Marks Oct '20)

Answer : (c)

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3. As per Section 143 (12) of Companies Act, 2013 & Rule 13 of CAAR, 2014; Mr. Laxman shall

(a) report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed.

(b) report the matter to the audit committee constituted under section 177 within such time and in such manner as prescribed.

(c) report the matter to the audit committee constituted under section 177 and also to the Board within such time and in such manner as prescribed.

(d) report the matter to the Board within such time and in such manner as prescribed.

Answer : (a)

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4. Owing to the _____ limitations of an audit, there is __ risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

(a) Inherent, unavoidable

(b) Inherit, complete

(c) Management, unavoidable

(d) Regulatory, control.(2 Marks Oct '20)

Answer : (a)

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5. As an auditor what conclusion can Mr Laxman draw looking at the huge cash reserve of the company and corresponding bank loan?

(a) Report this matter to the Central Government u/s 143(12) as there is a possibility of fraud

(b) Obtain sufficient and appropriate audit evidence of existence of fraud

(c) Report the matter under CARO, 2020

(a) There is nothing to report as it's a normal financial decision.(2 Marks Oct '20)

Answer : (b)

Case Scenario (MTP Oct '20)

Roop & Co. are the auditors of Onda group of Hotels. This is the first time the firm is auditing an industry in food and beverages and it is day one of the audit. The engagement partner along with his team wants to make a thorough understanding of the entity and its environment in

order to identify and assess the risks of material misstatements, whether due to fraud or error. The following are some of the points identified by them on Day 1.

1. **The hotel has two banquet halls. The documentation available for verification of banquet hall revenue is only the invoice raised by the hotel and some mail conversations on customer enquiry and finalization of price. In audit trail, it is found that finance approval of the transaction is only after invoice is sent to them for accounting at final settlement. Advance paid by the clients are not vetted through finance team. The auditor suspects a weakness in this system.**
2. **The auditor also finds a control deficiency in the process of procurement of stores. A goods receipt note is not prepared at the time of receipt of goods. On enquiry with management, the auditor finds that there exists a system control wherein goods receipt note is automatically prepared and approved in the system once the quantity and price of goods is entered against specific vendor. This entry is on real -time basis and system does not allow back dated entries.**
3. **The auditor enquires of the management as to what is risk assessment process followed by the entity for prevention and detection of risk of material misstatement due to fraud and error. The auditor finds there is no documented risk assessment process.**

With the help of the above facts, answer the following questions by choosing the correct option.

Questions:

1. What kind of a risk is portrayed in the booking of revenue with respect to Banquet halls?

(a) Inherent risk in the class of transaction

(b) Control risk in the class of transaction

(c) Detection risk in the audit procedures

(d) Audit risk in the opinion on the financial statements. (2 Marks Oct '20)

Answer : (b)

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2. Which among the following statement is incorrect in the context of Audit Risk?

(a) The more extensive the audit procedures performed, the lower is the detection risk

(b) Greater the risk of material misstatement the auditor believes exist, less is the detection risk that can be accepted and accordingly more persuasive evidence is required by the auditor.

(c) Audit risk means the risk that the auditor gives an appropriate audit opinion when the financial statement are materially misstated.

(d) Risk of material misstatement at the assertion level is of two kinds – control risk and inherent risk. (2 Marks Oct '20)(Chapter 4.3 Key concepts)

Answer : (c)

3. In the case of procurement of stores, the auditor has tested more than one control for the same assertion. In that given case, what should be his reliance on the control?

(a) Since compensating controls are identified, if tested and evaluated to be effective , the auditor can rely on the control.

(b) Even though compensating controls are there, since one control is ineffective, the auditor should not rely on control for this assertion and should perform extensive procedures.

(c) Documentation in electronic medium cannot be accepted, hence, he cannot rely only on system control.

(d) Even though compensating controls are there, since one control is ineffective, the auditor should not rely on control for this assertion as well as associated assertions. (2 Marks Oct '20)

Answer : (a)

4. In the context of SA 315, which among the following is NOT a risk assessment procedure?

(a) Inquiries of management, of appropriate individuals within internal audit function and of others within the entity

(b) Analytical Procedures

(c) Observation and Inspection

(d) Audit Planning (2 Marks Oct '20)

Answer : (d)

5. What should be the course of action of the auditor for the entity not having a documented risk assessment process?

(a) The auditor should obtain management written representations on how risks are identified

(b) The auditor shall discuss with management on how risks are identified, addressed and determine whether the absence is appropriate in the circumstances or whether it represents a significant deficiency in internal control.

(c) The auditor should advise the management to document the same immediately and accordingly opine on the same in his audit report too.

(d) The auditor shall discuss with management on how risks are identified by system and place reliance on the same as documentation in this context is immaterial. (2 Marks Oct '20)

Answer : (b)

Case Scenario (MTP March '21)

Ghan Shyam & Associates have been appointed as the statutory auditors of ABC Ltd. for the FY 2019 - 2020. The engagement partner, CA Ghan Shyam established the overall audit strategy and made the detailed plan with respect to the audit assignment of ABC Ltd. after discussing the same with the engagement team.

The strategy adopted by Ghan Shyam & Associates consisted of relying on the internal control system of the company and the audit plan and programme were developed accordingly & executed by the engagement team. During the course of audit, the engagement partner, CA Ghan Shyam found that some internal control system of the company were not in place. So, he decided not to rely on the internal control system of the company and accordingly changed the firm's overall audit strategy, audit plan & audit programme.

While conducting audit, the engagement partner also discussed with his team regarding the audit procedures to be performed to verify the debtors' balances of ABC Ltd. CA Ghan Shyam also asked for the addresses of various debtors from the management of ABC Ltd. to send balance confirmation request to such debtors. The management provided such addresses to the audit team. However, the management of ABC Ltd. asked the debtors to send the responses to such confirmation request to General Manager of accounts department who will in turn provide such responses to the audit team.

Also with respect to five random debtors, CA Ghan Shyam decided to confirm the terms of agreement also along with confirming the balance amount, by seeking responses to confirmation requests from such debtors.

During the course of audit, the auditor found that the inventory of ABC Ltd. is kept at its factories and various other locations including warehouses. The audit team is unable to attend the physical verification activity undertaken by the management at all such locations.

During the course of audit, the audit team found that legal cases have been filed against the company on account of customer complaint. CA Ghan Shyam discussed with his team regarding the audit procedures that can be performed by the audit team in this regard. CA Ghan Shyam also briefed his engagement team regarding the documents to be included in the audit file with respect to the audit assignment of ABC Ltd.

Based on the above facts, answer the following:-

1. Is CA Ghan Shyam right in changing the overall audit strategy and plan after the audit team has started working as per the earlier strategy established & plan so developed?

(a) CA Ghan Shyam is not right as once the audit team has started the audit work, it is not correct to change the audit strategy and plan.

(b) CA Ghan Shyam is not right as once the overall audit strategy has been established the same cannot be changed. Audit plan however can be revised.

(c) CA Ghan Shyam is right in making changes to the overall audit strategy and the audit plan.

(d) CA Ghan Shyam can change the overall audit strategy and audit plan only after discussing the same with the management of ABC Ltd. (2 Marks March '21)

Answer : (c)

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2. Which of the following audit procedures should the audit team perform with respect to verification of debtors balance?

(a) Ghan Shyam & Associates can compare the debtors balance reflected in financial statement with the total balance of ledgers account in the books of ABC Ltd.

(b) Ghan Shyam & Associates can obtain direct balance confirmation from the debtors as this is external evidence which is most reliable and relevant.

(c) Ghan Shyam & Associates can obtain management representations with respect to the debtors balance from the management of ABC Ltd and need not perform other audit procedure as obtaining written representation from management constitutes sufficient and appropriate audit evidence.

(d) Both a & b. (2 Marks March '21)

Answer : (d)

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3. Statement 1: The reliability of information to be used as audit evidence is influenced by its source and its nature, and the circumstances under which it is obtained.

Statement 2: The audit evidence obtained from sources external to the entity are generally more reliable than the audit evidence from internal sources.

(a) Only statement 1 is true

(b) Only statement 2 is true

(c) Both the statements are true

(d) None of the statements is true(2 Marks March '21)

Answer : (c)

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4. With respect to the inventory of ABC Ltd. kept in warehouse, which audit procedures can the audit team perform to obtain sufficient and appropriate audit evidence?

(a) Checking of warehouse receipt with the inventory record of ABC Ltd.

(b) Obtaining direct confirmation with respect to quantity & condition of inventory of ABC Ltd. from the warehouse.

(c) Both a & b

(d) Seeking a management representation regarding inventory valuation and mentioning the fact regarding inventory being kept at the warehouse in the audit report. (2 Marks March '21)

Answer : (c)

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5. Is management correct in asking the debtors to provide the reply of confirmation request of auditor to the General Manager of accounts department of the company?

(a) Yes, the management has correctly asked the debtors to respond directly to the GM of accounts department.

(b) No, management is not correct in asking for a direct response to GM of accounts department as external confirmation is the response obtained directly by the auditor.

(c) Yes, the management is correct in advising direct response to the GM of accounts department as this will ensure that only correct confirmation are provided to the auditors.

(d) No, management is not correct as this is the option of the auditor to see if the response to external confirmation is to be obtained by management or auditor himself. (2 Marks March '21)

Answer (b)

Case Scenario (MTP March '21)

RRM & Associates have been appointed as the statutory auditors of UVW Ltd. for the FY 2019-2020. The engagement partner is CA Raj and his engagement team consists of 2 article assistants. CA Raj briefed his audit team regarding the factors affecting the sample selection and the sample size. The team was also told that the tolerable error should be zero and sample size should be selected accordingly. CA Raj gave a detailed audit programme to his team. The audit programme with respect to the checking of accounts receivable and accounts payable consists of checking the accounts on sample basis. CA Raj asked the engagement team to divide the accounts receivables and account payable balances into separate groups and to take sample from each of them.

During the course of audit, the audit team noticed that certain internal control system with respect to the accounts receivable were not in place at few instances during the FY 2019 -20.

Also while checking the payment transactions on sample basis, the engagement team noticed that on 9th and 10th of every month, the miscellaneous expense vouchers were not signed by the authorised personnel. The engagement team discussed the implications of the same on their audit procedures to be performed in this regard.

Based on the above facts, answer the following:-

1. Which of the following factors should not be considered by CA Raj in deciding the extent of checking while making the sample plan in case of UVW Ltd.?

(a) The size of UVW Ltd.

(b) The state of the internal control system of UVW Ltd.

(c) The tolerable error range decided in case of UVW Ltd.

(d) The competence of the engagement team. (2 Marks March '21)

Answer : (d)

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2. With respect to the weakness in internal control system of accounts receivable during the FY 2019 -20, the audit team:-

(a) Should consider a larger sample size or 100% examination of accounts receivables.

(b) Should consider a smaller sample size of accounts receivables.

(c) Should not consider applying sampling techniques.

(d) Should give a disclaimer of opinion. (2 Marks March '21)

Answer : (a)

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3. Statement 1: While conducting an audit, it is obligatory for the auditor to apply sampling. Statement 2: There may be sometimes where test checking or sampling may not be suitable.

(a) Only statement 1 is true

(b) Only statement 2 is true

(c) Both the statements are true

(d) None of the statements is true(2 Marks March '21)

Answer : (b)

4. With respect to selecting sample for accounts receivable and accounts payable which method of selecting of sample is advised by CA Raj to the engagement team?

(a) Stratified Sampling method

(b) Monetary Unit Sampling method

(c) Haphazard Sampling method

(d) Interval Sampling(2 Marks March '21)

Answer : (a)

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5. With respect to the deviation identified by the auditor occurring on 9 th and 10th of every month, what course of action should the audit firm adopt?

(a) RRM & Associates should ignore such deviation as it exists only on a very few instances during the entire year under audit.

(b) RRM & Associates should extend its audit procedures to such deviated transactions.

(c) RRM & Associates shall investigate the nature and causes of such deviations as such deviations may be intentional and may indicate the possibility of fraud.

(d) Both b & c (2 Marks March '21)

Answer : (d)

Case Scenario (MTP April '21)

- **Mars Ltd is a public company having a turnover exceeding Rs 50 crores in the last 3 financial years including the current financial year which is FY 2019-20**
- **The company comes under the class of companies specified under item (A) Regulated Sectors.**
- **M/s XYZ & Associates have been appointed as the auditors of Mars Ltd for FY 2019-20.**
- **Mars Ltd has a branch office in Dubai for which a separate auditor has been appointed.**
- **M/s XYZ & Associates understand that they need to communicate with the another auditor appointed for the branch office in Dubai.**
- **Further Mars Ltd has taken a loan from a nationalized bank in 2015 amounting to Rs 1 crore payable in 8 equal instalments of Rs. 12.50 lakhs each starting from 31st March 2016 onwards.**

  It has repaid its 4 instalments, however the company has defaulted in the current financial year. Mars Ltd has sought re- scheduling of loan from the bank.

- **The auditors, XYZ & Associates understand that they have certain reporting requirements under Companies (Auditor's Report) Order, 2016.**
- **Further, the auditors also attended the physical verification of inventory conducted by the management at the year end.**

Based on the above facts, answer the following:-

1. With respect to the forms specified by companies (Cost Records & Audit) Rule 2014, which of the following is incorrect combination:-

(a) Form CRA 1- Maintenance of cost records by the Company.

(b) Form CRA 2- Intimation of appointment of another cost auditor to Central Government.

(c) Form CRA 3- Submission of Cost Audit Report to the Board of Directors of the company.

(d) Form CRA 4- Submission of Cost Audit Report by the company to the Registrar. (2 Marks April '21)

Answer : (d)

2. Within how many days of the receipt of the copy of Cost Audit Report. Mars Ltd is required to forward the report to the Central Government:-

(a) 30 days

(b) 60 days

(c) 15 days

(d) 90days(2 Marks April '21)

Answer : (a)

3. Whether reporting about maintenance of cost records required by Companies (Auditors Report) Order, 2016. If yes, then under which clause and which is the relevant section under the Companies Act 2013: -

(a) Yes, Clause vi, Section 148(1)

(b) No, - , Section 148(1)

(c) Yes, clause v, Section 143(1)

(d) No, - , section 143(1) (2 Marks April '21)

Answer : (a)

4. With respect to the branch office of Mars Ltd In Dubai, what is the duty of M/s XYZ & Associates:-

(a) M/s XYZ & Associates might discuss with the branch auditor the audit procedures applied by the branch auditor.

(b) M/s XYZ & Associates may also visit the branch auditor.

(c) M/s XYZ & Associates cannot advise the other auditor of accounting, auditing/ reporting requirement as the other auditor is well versed with such provisions.

(d) Both a & b(2 Marks April '21)

Answer : (d)

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5. Which of the following is incorrect:-

(a) SA 200- Overall objectives of Independent Auditor

(b) SA 230- Audit Documentation

(c) SA 299- Joint Audit of Financial Statements

(d) SA 600- Subsequent Events (2 Marks April '21)

Answer : (d)

Case Scenario (MTP April '21 & Sep '22)

Sun Private Limited is a newly formed private limited company engaged in the manufacturing of solar panels. Company has appointed M&S Associates, a Partnership Firm of Mr Meticulous and Mr Sincere as their First Auditors. M&S Associates accepted the assignment and Mr Meticulous being the engagement Partner, started their Audit.

During the course of Audit, Mr Meticulous asked the Management for name of the companies operating in similar business so that they can compare the Company's Figures. During this procedure, Mr Meticulous found that the Gross Margin of the Company is lower than the Industry Standard / Fellow Companies. He prepared an Interim Report dealing with this matter and asked the Management about the reasons for this deviation. Management asked him to give all the working along with the Working Papers as they believed it is the Company's Property. Mr Meticulous advised them that he can provide working but cannot give them the working papers as they are the property of the Firm.

Management agreed to that and asked Mr Meticulous to go into detail and tell them the reasons for lower Gross Margin to which he agreed. During the detailed audit, Mr Meticulous came to

know about the fact that the company dispatched its solar panels to its Distributors on Delivery Challans and once the goods were accepted, Sales bills were raised. Checking each Challan against Sales Invoices, Mr Meticulous found that there were many challans for which no Invoices were raised and thus Sales was grossly understated and there was no mechanism where unbilled Challans were recorded or tracked. Company employed a person to reconcile all the challans and prepared a list where Bills are yet to be sent to the Customers. In addition, Company was also asked to seek confirmation of balances from all its customers. The Management assured Mr Meticulous that Inventories are physically verified and hence there will be no impact on them.

Multiple Choice Questions:

1. Mr. Meticulous asked about other Companies, he was intending to perform which audit procedure?

(a) Analytical Procedures

(b) Substantive Procedures

(c) Random Sampling

(d) Statistical Sampling (2 Marks)

Answer : (a)

2. What was the initial procedure carried on by Mr Meticulous?

(a) Trend Analysis

(b) Ratio Analysis

(c) Statistical Modelling

(d) Random Sampling(2 Marks)

Answer : (b)

3. Who has the right to retain the working papers of the Company in current case?

(a) Audit Committee

(b) Board of Directors

(c) Auditor

(d) Chairman of the Audit Committee(2 Marks)

Answer : (c)

4. When Mr. Meticulous decided to go in detail checking of Sales, which Audit Procedure he applied to obtain the evidence?

(a) Test of Transactions

(b) Test of Balances

(c) Both (a) and (b)

(d) Analytical Procedures(2 Marks)

Answer : (c)

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5. The impact of the exercise carried on by the Company for unbilled challans will have an impact on

(a) Gross Receipts and Debtors

(b) Gross Receipts and Inventory

(c) Debtors

(d) Inventory (2 Marks)

Answer (a)

Case Scenario (MTP Oct '21)

A Partnership Firm of Chartered Accountants by the name of HS and Associates was appointed to audit books of accounts of WT Limited for financial year 2019-20. HS and Associates consisted of two partners CA H and CA S.

While conducting audit of WT Limited for financial year 2019-20, CA H, one of the partners of HS and Associates used different audit procedures in order to obtain audit evidence.

The different audit procedures used by CA H were as follows:

(1) As WT Limited was engaged in manufacturing business of wooden doors, CA H and his team members carefully watched the whole process of counting of finished wooden doors by employees of WT Limited. The counting of finished wooden doors was necessary for the purpose of verification of stock of finished wooden doors.

(2) In WT Limited the stock of finished wooden doors was valued manually by multiplying number of finished wooden doors with value per finished wooden door. A team member of CA H again did the calculation in order to verify the accuracy regarding valuation of stock of wooden finished doors.

(3) CA H with the help of his team members obtained information from people (who were experienced in manufacturing business of wooden doors) about the purchase price of raw materials required in manufacturing business of wooden doors and also obtained some nonfinancial information.

(4) CA H and his team members while conducting the audit of WT Limited for financial year 2019- 20 in detail checked and evaluated the books of accounts and relevant documents of W Limited.

(5) CA H asked for written confirmations regarding account balances from Debtors and Creditors of WT Limited.

Keeping the basic concepts about various audit procedures in mind, answer the following multiple - choice questions:

1. CA H and his team members carefully watched the whole process of counting of finished wooden doors by employees of WT Limited. This is an example of which audit procedure:

(a) External Confirmation.

(b) Observation.

(c) Inquiry.

(d) Inspection. (2 Marks Oct '21)

Answer : (b)

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2. In order to verify the accuracy regarding valuation of stock of wooden finished doors, a team member of CA H again did the calculation. This is an example of which audit procedure:

(a) Analytical Procedures.

(b) Inquiry.

(c) Inspection.

(d) Recalculation. (2 Marks Oct '21)

Answer : (d)

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3. CA H with the help of his team members obtained information (both financial and non-financial information) from experienced people in manufacturing business of wooden doors. These experienced people provided the required information. This whole method of obtaining information is an example of which audit procedure:

(a) Inspection

(b) Reperformance.

(c) Inquiry.

(d) Investigation. (2 Marks Oct '21)

Answer : (c)

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4. CA H and his team members in detail checked and evaluated the books of accounts and relevant documents of WT Limited. This is an example of which audit procedure:

(a) Inspection.

(b) Reperformance.

(c) Recalculation.

(d) Investigation(2 Marks Oct '21)

Answer : (a)

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5. Asking for written confirmations regarding account balances from Debtors and Creditors of WT Limited by CA H is an example of which audit procedure:

(a) Inquiry

(b) Inspection

(c) Investigation.

(d) External Confirmation. (2 Marks Oct '21)

Answer : (d)

Case Scenario (MTP Oct '21)

RM & Associates have been appointed as Auditors of Techblocks Consulting Ltd. for the year 2020- 21. CA R and CA M were the Engagement partners.

Para 1

The Firm has freshly appointed 2 Article Clerks who had no practical knowledge in the area of Auditing.

They had to work to tight hard-headed factual issues and were baffling to understand the various terms and their objectives in the field of Auditing.

Para 2

To make sure that the Article Clerk do not misplace or mis-handle the Working Papers, CA M also described the relevance of Audit File and clarified that working papers are the property of Auditor.

Such Audit file should be preserved for a period of seven years.

Para 3

CA R while scrutinizing Books of Accounts suspected some fictitious sales as a result of which he anticipated inflated Debtors. Management was reluctant to give the details. As CA R could not gather more evidence from the Management, he sought to obtain details from the third party.

Para 4

On further perusal of Opening Balances, it is essential to perceive that Accounting Policies have been consistently applied in the current period's financial statements and whether any changes have been properly accounted for and disclosed. CA M assigned this duty to his article clerk. The Article clerk explained to CA M about how he had observed that Accounting policies were not consistently applied in relation to opening balances in accordance with the financial reporting framework or a change is not properly accounted or not adequately disclosed.

Para 5

Subsequently, the Auditors gathered from the Management that there was a fire in the Factory premises after the Balance Sheet date, as a result of which the company suffered loss of Inventories.

It did not provide any conditions on the Balance Sheet date. SA 560 deals with such type of transactions.

1. The Auditor explained his Audit team the purpose of Audit Documentation. Which of the following is incorrect with respect to the purpose of Audit Documentation?

(a) It enables the conduct of quality control reviews and inspections in accordance with SQC- 1.

(b) It helps in preparation of Financial Statements.

(c) It retains a record of matters of continuing significance to future audits.

(d) It enables the conduct of external inspections in accordance with applicable legal, regulatory or other requirements. (2 Marks Oct 21)

Answer : (b)

2. An auditor strictly ensured that the audit team should document / assemble all the working papers in Audit file. The completion of assembling the Audit File is an administrative process and should be done in :

(a) It should be within 30 days from the date of Audit Report.

(b) It should be within 60 days from the completion of Audit.

(c) It should not be more than 60 days from the date of Audit Report.

(d) It should be before 90 days from the completion of Audit. (2 Marks Oct 21)

Answer : (c)

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3. With reference to para 3 of Case scenario, this is a case of obtaining External Confirmation by the Auditor. Which of the following is inappropriate with regard to External Confirmation?

(a) External Confirmations are restricted to Account balances only.

(b) It is also used in a case to obtain Audit evidence about the absence of certain conditions say, Side Agreement.

(c) It can be also effective in obtaining Audit evidence about verification of Inventories held by third parties at bonded warehouses for processing or on consignment.

(d) External Confirmation is also functional in case of Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the Balance Sheet date. (2 Marks Oct 21)

Answer : (a)

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4. With reference to para 4, in such a situation CA M shall express a :

(a) A Disclaimer Opinion

(b) A qualified opinion

(c) A qualified opinion or an adverse opinion in accordance with SA 705

(d) An unmodified opinion(2 Marks Oct 21)

Answer : (c)

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5. In respect to subject matter mentioned in Para 5, what procedures should Auditor perform to identify such events?

Statement 1: Obtain an understanding of any procedures management has established as well as Inquiry with Management and those charged with governance procedures for identification of such subsequent events.

Statement 2: Inspection of Minutes of the meetings of the entity's owners, management and those charged with governance that have been held after the date of the financial statements and inquiring about the matters discussed at any such meetings for which minutes are not yet available.

Statement 3: The Auditor should not read the entity's latest subsequent interim financial statements, if any.

(a) Only Statement 1 is correct

(b) Only Statement 2 is correct

(c) Both Statements 1 and 2 are correct

(d) Only Statement 3 is correct (2 Marks Oct 21)

Answer : (c)

Case Scenario (MTP Nov '21)

Mars Ltd. is a public limited Company incorporated during the previous financial year 2019-20. R S Shah & Associates have been appointed as the Auditors of the Company.

Para 1

Its Authorized Capital was Rs. 75 Lacs. Subsequently it increased its Share Capital. They issued Shares at a premium of Rs.25/- per share. The Company has transferred the amount received as premium to the Securities Premium Account.

Para 2

CA R recommended his Engagement Team to prepare an Audit Strategy as well as Audit plan for efficient conduct of audit. He advised to the team that they should include a series of verification procedures to be applied to Financial Statements of the Company for accomplishing the Audit objectives. CA R illustrated to his team the relationship between Audit strategy as well as Audit plan.

Para 3

Encompassed by a huge clientele, one of the Auditee firm was a LLP. It was in the name of Mangaldeep Geotech LLP. They conducted the business in a very efficient way but had allotted only the Audit and the Income Tax work to CA R S Shah & Associates. The Partners of the LLP were capable enough but however inadvertently bypassed the ROC Compliances. They had no knowledge about the Compliances and its related penalties. Thus they approached CA R S Shah and Associates for their guidance. They were completely clueless as to filing of Annual Return with ROC.

Para 4

R S Shah and Associates have been appointed as Auditors of a large Enterprise namely Search Results Ltd. Considering the overhaul required in the Organization's Risk Management, Directors of the listed companies braced the subject of Internal Financial Control with much seriousness and rigor. The dawn of the Financial Year lays down the daunting task of establishing and implementing Internal Financial Control in an Enterprise.

Para 5

The Auditors are performing their Audit work in the Company Search Results Ltd by using CAAT's. The Company is completely automated and all the processes, operations are carried out using the Computer systems. Testing is performed in an automated environment to increase the efficiency and allow for more robust tools to be built. There are four types of testing methods in an Automated environment. They are Inquiry, Observation, Inspection and Re-performance.

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1. Sec. 52 of the Companies Act states that Security Premium Account can be applied by the Company for one of the purpose mentioned below. Which of the following is an INCORRECT option?

(a) To write off preliminary expenses of the Company

(b) To pay dividend to equity shareholders

(c) To provide premium on redemption of Preference share capital

(d) To purchase its own shares or other securities under Sec 68(Buyback) (2 Marks Nov '21)

Answer : (b)

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2. In reference to para 2, which of the following Statement is inappropriate?

(a) Once the overall audit strategy is established, an audit plan can be developed to address the various matters identified in the overall audit strategy.

(b) The establishment of overall audit strategy as well as detailed audit plan is a discrete and sequential process.

(c) Audit Strategy and Audit plan are inter-related as changes in one may result in consequential changes to the other.

(d) The Audit plan is more detailed than the Audit Strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. (2 Marks Nov '21)

Answer : (b)

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3. In reference to para 3, which form from the following should be filed by the Partners to avoid penalty consequences?

(a) Form 11 within 90 day of end of closer of financial year and Form 8 within a period of 60 days from the end of six months of the financial year.

(b) Form 11 within 60 days of end of closer of financial year and Form 8 within a period of 30 days from the end of six months of the financial year.

(c) Form 11 within 30 days of end of closer of financial year and Form 8 within a period of 60 days from the end of three months of the financial year.

(d) Form 11 within 60 day of end of closer of financial year and Form 8 within a period of 90 days from the end of three months of the financial year. (2 Marks Nov '21)

Answer : (b)

4. With reference to para 4, which of the following point ensures implementation of policies and procedures with regard to Internal Financial Control by the Companies?

(a) Reliability of Financial Reporting

(b) Effectiveness and efficiency of operations

(c) Compliance with applicable laws and regulations

(d) All of the above. (2 Marks Nov '21)

Answer : (d)

5. Which of the following statement is inappropriate with regard to testing methods as mentioned in Para 5 above?

(a) Inquiry in combination with Inspection gives the most effective and efficient audit evidence.

(b) Re-performance is the most effective as an audit test and gives the best audit evidence.

(c) Inquiry should always be used in combination with any other testing method.

(d) which audit test to use and in what combination does not require professional judgment. (2 Marks Nov '21)

Answer : (d)

Case Scenario (MTP Nov 21)

A Partnership Firm of Chartered Accountants by the name of S K and Associates were appointed as the Auditors of the Company named Big Box Ltd.

Para 1

Big Box Ltd is a Public Listed Company. The CA Firm comprised of 2 partners namely CA S and CA K. Subsequently, a close relative of CA K, acquired security having face value Rs.495000/- of Big Box Ltd. As per the provisions of Section 141 of the Companies Act 2013, an Auditor will be disqualified from appointment, if the Auditor himself or his relative acquires the security exceeding the prescribed limit in the Company.

Para 2

Further, the Auditors, S K and Associates also had to bank on the policies and procedures adopted by the Company for ensuring the efficient conduct of its business. They have to state about the adequacy of Internal Financial Controls in the Company. The Company had a turnover of Rs. 60 Crores as per the latest Audited Balance Sheet and its Borrowings during the year were Rs. 20 Crores from Banks.

Para 3

The CFO of the Company, Mrs. Darshana felt dubious in the Accounts department of the Company. She entreated the Auditors to perform a thorough investigation of the Accounts department. Mrs. Darshana was also anticipating a fraud in this situation. Both the Auditor as well as the CFO of the Company analyzed the various risk factors. The Auditors observed that the Head Accountant of the Department has inflated the Sales amount to finish his targets. There was collusion between the Head Accountant & Employees of the Company. Employees were presented incentives on accomplishing their targets. This resulted in a fraud by the Head Accountant of amount aggregating to Rs.75 Lacs.

Para 4

Mr. X, an acquaintance of CA S, wanted to form an LLP with his distant relatives. He wanted to possess in- depth knowledge about LLP. CA S explained him that LLP is a separate legal structure and is liable to full extent of its assets but the partners are liable to the extent of their agreed contribution in LLP.

Mr. X additionally wanted to know the criteria for the accounts of LLP to be audited. CA S enlightened him that the accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009.

Para 5

Big Box Ltd. is expanding its business. Consequently it requires many Computers. Purchasing computers may involve paying a huge upfront cost. Cash flow may get disrupted. Hence the

Company came up with an idea of getting the Computers on lease. It will allow the businesses to have access to the latest technology without harming their cash flow.

The Auditors explained to the Directors that leasing Computers shall come under the purview of Operating Lease.

1. With reference to para 1, S K and Associates can take corrective actions within days. The relative may hold security or interest in the company of face value not exceeding _____

(a) 45 days, Face Value Rs.100000/-

(b) 60 days, Market Value Rs.500000/-

(c) 30 days, Face Value Rs. 500000/-

(d) 60 days, Face Value Rs.100000/- (2 Marks Nov '21)

Answer : (d)

2. The Auditors of S K and Associates were doubtful concerning the applicability of Internal Financial Controls in the Company Big Box Ltd. With reference to details provided in Para 2 above, please guide them in this regard.

(a) It will be applicable as Turnover exceeds the threshold limit of Rs.50 Crores.

(b) It is not applicable as the Borrowings are less than 25 Crores during the financial year.

(c) It will be applicable as the Company is a Public Listed Company.

(d) Reporting on Internal Financial Control is not under the scope of Auditors reporting. Hence, Not Applicable. (2 Marks Nov '21)

Answer : (c)

3. With reference to para 3, wherein a fraud was observed by the Auditor, what should be the course of action of the Auditor?

(a) The Auditor should report the fraud details to Central Government.

(b) The Auditor shall report the fraud to the audit Committee or to the Board within the prescribed time.

(c) The Auditor shall disclose it in the Audit Report and report the fraud details to RBI too.

(d) Both a & c above. (2 Marks Nov '21)

Answer : (b)

4. With regard to information provided in Para 4, which of the following is a CORRECT option?

(a) Any LLP whose turnover does not exceed, in any financial year, Rs.40 Lacs or whose contribution does not exceed Rs.25 Lacs is not required to gets its accounts audited.

(b) Any LLP whose turnover does not exceed, in any financial year, Rs.50 Lacs or whose contribution does not exceed Rs.20 Lacs is not required to gets its accounts audited.

(c) Any LLP whose turnover exceeds Rs.25 Lacs in any financial year or whose contribution exceeds Rs.10 Lacs in any financial year is required to gets its accounts audited.

(d) Any LLP whose turnover does not exceed, in any financial year, Rs.40 Lacs and whose contribution does not exceed Rs.25 Lacs is not required to gets its accounts audited. (2 Marks Nov '21)

Answer : (a)

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5. In reference to para 5, which among the following is an INCORRECT trait about the Operating Lease?

(a) The Lessee does not have the option to buy the asset during the lease period.

(b) The Lessee cannot claim Depreciation on the leased asset.

(c) The Lessee generally bears the Insurance, Maintenance and Taxes.

(d) The Lease term generally extends to less than 75% of the projected useful life of the leased asset. (2 Marks Nov '21)

Answer : (c)

Case Scenario (MTP March 22)

Honest Limited is a listed Company engaged in the construction business. The Company constructs residential buildings after purchasing vacant land and then sells ready flats to customers. The Company has not been earning good profits and so no dividend was declared in the last financial year for which the statutory audit is to be conducted.

XYZ & Company has been appointed as the statutory auditor of Honest Limited. The audit firm has seven partners and is a reputed firm with the partners having expert knowledge in various areas.

While conducting the audit, the engagement partner, CA Z suspects some fraudulent activities undertaken by the officers and employees of the Company. CA Z is aware that for the purpose of SAs, the auditor is concerned with fraud that causes a material miss tatement in the financial statements. He understands that misstatements in the financial statements can arise from either fraud or error.

On detailed verification by the audit team, it was observed that accounts were manipulated with a view to presenting a false state of affairs. The fraud was committed to avoid incidence of income-tax and withhold declaration of dividend. There was also an incidence of cash receipts being suppressed which came to the notice of the audit team.

CA Z had enough reasons to believe that the offence of fraud, involved individually an amount of Rs.1 crore, and had been committed against the company by its officers or employees. The audit team discussed the reporting requirements of the fraud committed.

One of the audit team members puts forward his recommendations on reporting which includes disclosure in the Board's Report. He states that sub-section (12) of section 143 of the Companies Act, 2013 prescribes that the companies, whose auditors have reported frauds under this subsection (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.

CA Z discusses the reporting under Companies (Auditor's Report) Order, 2020 [CARO, 2020] wherein the auditor is required to report under clause (xi) of paragraph 3 of Companies (Auditor' s Report) Order,2020, about fraud by the company or any fraud on the Company.

Based on the above information, answer the following questions: (2 Marks)

1. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is:

(a) Fraud causes a material misstatement in the financial statements.

(b) Fraud is an intentional act.

(c) Fraud is easier to detect than error.

(d) Fraud can be committed by only the management, those charged with governance, and the employees.

Answer 1 (b)

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2. Which of the following is not a technique of suppressing cash receipts?

(a) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

(b) Adjusting unauthorized or fictitious rebates, allowances, discounts,etc. to customer' accounts and misappropriating amount paid by them.

(c) Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.

(d) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.

Answer 2 (c)

3. To whom should XYZ & Company report the fraud committed in Honest Limited?

(a) Report the matter only to the Audit Committee constituted under section 177 since the amount of fraud has not exceeded 1 crore.

(b) Report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days and on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations.

(c) Report the matter only to the Board since the amount of fraud is not less than 1 crore.

(d) Report the matter either to the audit committee constituted under section 177 or the Central Government since the amount of fraud is neither less nor more than 1 crore.

Answer 3 (b)

4. Sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules,2014 states that the auditor is required to disclose in the Board's Report details of each of the fraud reported to the Audit Committee or the Board under sub-rule (3) during the year. Which of the following details is not required to be disclosed in the Board's Report?

(a) Nature of Fraud with description.

(b) Parties involved, if remedial action taken.

(c) Approximate Amount involved

(d) Remedial actions taken.

Answer 4 (b)

5. For reporting under clause (xi) of paragraph 3 of Companies (Auditor's Report) Order,2020, which of the following points the auditor may consider?

(a) Fraud by the company or on the company by its officers, employees or third parties to be reported.

(b) Only suspected frauds shall be included here and not the noticed frauds.

(c) Principles of materiality outlined in Standards on Auditing.

(d) The auditor's withdrawal from the engagement and the reasons for the withdrawal.

Answer 5 (c)

Case Scenario (MTP March 22)(RTP Nov '22)

SAM & Company, a Chartered Accountant firm, is in the process of finalizing the audit of Health is Wealth Limited which is a Company listed on the Bombay Stock Exchange. Since the past decade, Health is Wealth Limited has made its presence felt in over 10 countries, including India, making it a leader in the global fitness industry. It runs a chain of fitness centres that offers energetic group workouts and multiple workout formats to choose from. It also offers the best equipment, knowledgeable staff and personal advice in a welcoming environment.

SAM & Company being a very reputed firm, was appointed for the statutory audit of Health is Wealth Limited. The Engagement Partner CA A and her team of 8 members have conducted the audit in an efficient and effective manner. The senior manager in the team, CA K is of the opinion that they have obtained sufficient appropriate audit evidence, which concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements. One of the article clerks, Mr N, is a fresher and this audit is his first experience as an auditor in a limited company. He is a sharp boy and has grasped all the concepts and techniques very well. However, the term "pervasive" confused him so CA K patiently explained to Mr N the pervasive effects on the financial statements as per the auditor's judgement. Mr. N understood the term well and thanked CA K for clearing all his doubts.

CA A disagreed with CA K that they have obtained sufficient appropriate audit evidence, which concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements. So, the entire team held various meetings and discussions, and finally reached to a conclusion. They concluded that they have obtained reasonable assurance that the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion took into account:

(a) Whether sufficient appropriate audit evidence had been obtained;

(b) Whether uncorrected misstatements were material, individually or in aggregate;

(c) The evaluations.

The Auditor's Report was prepared in writing and it was decided that an unmodified opinion would be expressed. The first section of the auditor's report included the auditor's opinion, and had the heading "Opinion". Following the Opinion section, was a sect ion with the heading "Basis for Opinion". When expressing an unmodified opinion on financial statements, the auditor's opinion used the following phrase,

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

During the audit, the audit team had observed that there was uncertainty in Health is Wealth Limited relating to the future outcome of a regulatory action. So, a paragraph was included in the auditor's report that referred to this matter which was appropriately disclosed in the financial statements and that, in the auditor's judgment, was of such importance that it was fundamental to users' understanding of the financial statements.

CA A also determined whether the financial statements included the comparative information required by the applicable financial reporting framework and whether such information was appropriately classified. One team member, Mr R was curious to know whether th e auditor's opinion referred to the corresponding figures or not, whenever the corresponding figures are presented. CA A explained the circumstances to Mr R in which, when the corresponding figures are presented, auditor's opinion referred to the correspondin g figures.

Based on the above information, answer the following questions: (2 Marks)

1. CA K explained to Mr. N the pervasive effects on the financial statements in the auditor's judgement. Pervasive effects on the financial statements are those that, in the auditor's judgement:

(i) Are not confined to specific elements, accounts or items of the financial statements;

(ii) If so confined, represent or could represent a substantial proportion of the financial statements; or

(iii) In relation to disclosures, are fundamental to users' understanding of the financial statements. Which of the following is correct?

(a) (i), (iii)

(b) (ii),(iii)

(c) (i), (ii)

(d) (i), (ii) and (iii)

Answer 1 (d)

2. When expressing an unmodified opinion on financial statements, SAM & Company used the following phrase:

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

Which is the other phrase which is regarded as being equivalent to the above phrase and could also be used by SAM & Company?

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

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

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

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

Answer 2 (c)

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3. Which of the following statements is not included in the section with the heading "Basis for Opinion" in the Auditor's Report?

(a) Audit was conducted in accordance with the Accounting Standards.

(b) Auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

(c) Description of the auditor's responsibilities under the SAs.

(d) States whether the auditor believes that the audit evidence the auditor has obtained, is sufficient and appropriate to provide a basis for the auditor's opinion.

Answer 3 (a)

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4. A paragraph was included in the Auditor's Report of Health is Wealth Limited that referred to a matter which was appropriately disclosed in the financial statements that, in the auditor's judgment, was of such importance that it was fundamental to users' understanding of the financial statements. What is this section of the Auditor's Report called?

(a) Other Matters.

(b) Emphasis of Matters.

(c) Key Audit Matters.

(d) Auditor's Responsibilities for the Audit of the Financial Statements.

Answer 4 (b)

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5. CA A explained the circumstances to Mr. R in which, when the corresponding figures are presented, auditor's opinion referred to the corresponding figures. Which of these circumstances did he mention to Mr. R?

(a) If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which a modified opinion has been previously issued.

(b) If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is resolved.

(c) Prior Period Financial Statements are audited by another auditor.

(d) Prior Period Financial Statements not audited.

Answer 5 (d)

Case Scenario (MTP April 22)

AA & Associates, an audit firm based in New Delhi, was appointed as the Statutory Auditor of Success Ltd ., a listed Company having branches all over India. Success Limited is engaged in the business of manufacturing furniture items from timber which is imported from South Africa. The audit firm has six partners and partner CA A is the engagement partner for Success Ltd.

The audit team consisting of CA A and five more members prepared an audit strategy and audit plan before commencing the audit. CA A was aware of the fact that the understanding of the internal control of the organization would assist the team in various ways. So, it was decided that the team would first obtain an understanding of the internal control relevant to the audit before commencing the audit.

CA A explained to the team that there is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial report ing, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment. CA A educated the team about the factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit. The team then

applied its professional judgment to decide whether a control, individually or in combination with others, is relevant to the audit.

One of the team members, CA P scheduled a meeting with the Director of Success Ltd., Mr. D, to understand the risk assessment process of the entity. The entity's risk assessment process formed the basis for the risk to be managed. CA P, on the basis of his judgment, found the process to be appropriate, and it helped him in in identifying the risks.

Once the risks were identified, CA P had to determine whether any of the risk identified is, in his judgment, a significant risk. CA P considered all the factors which he should have considered to exercise his judgement as to which risks are significant risks. He was aware that significant risks often relate to certain type of transactions and matters.

In the meanwhile, CA A met the CFO of the Company, Mr. C to obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting. Mr. C explained to CA A the various monitoring activities undertaken by the management to monitor the internal control performance of the company.

Based on the above information, answer the following questions:

1. CA A was aware of the fact that the understanding of the internal control of the organization would assist the team in various ways. Which of the following is not achieved by an understanding of the internal control system? (2 Marks for each question)

(a) Identifying breakdown due to human error.

(b) identifying types of potential misstatements.

(c) designing the nature, timing, and extent of further audit procedures.

(d) identifying factors that affect the risks of material misstatement.

Answer 1 (a)

---

2. Which of the following factors is not relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit?

(a) The diversity and complexity of the entity's operations.

(b) Applicable legal and regulatory requirements.

(c) The nature of the entity's business, including its organization and ownership characteristics.

(d) Nature, timing, and extent of further audit procedures.

Answer 2 (d)

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3. CA P obtained an understanding of the risk assessment process of the entity. Which of the following is a risk assessment process to be followed by an entity?

(i) Identifying business risks relevant to financial reporting objectives.

(ii) Estimating the significance of the risks.

(iii) Assessing the likelihood of their occurrence.

(iv) Deciding about actions to address those risks.

(a) (i), (ii), (iii),

(b) (i), (ii)

(c) (i), (ii), (iii), (iv)

(d) (ii), (iii)

Answer 3 (c)

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4. CA P considered all the factors which he should have considered to exercise his judgment as to which risks are significant risks. Which of the following is a factor which he would have considered to determine the same?

(a) Whether the risk is a risk of error.

(b) The complexity of transactions.

(c) Whether the risk involves significant transactions with non -related parties.

(a) The degree of objectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.

Answer 4 (b)

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5. Which among the following is incorrect with reference to last para of the case study regarding the auditor to obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting :

(a) It involves assessing the efficiency of controls on a timely basis and taking necessary remedial actions.

(b) Management accomplishes it through ongoing activities, separate evaluations etc.

(c) Management's monitoring activities may include using information from communications from external parties.

(d) In small entities, management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations.

Answer 5 (a)

Case Scenario (MTP April 22) (RTP May '21)

Suresh Rana & Associates have been appointed as the statutory auditors of HAIL Ltd. by the Comptroller & Auditor General for the FY 2021-22. HAIL Ltd. is a Government company engaged in the manufacture of metro train coaches. During the course of audit, CA Suresh extended his scope of audit to cover efficiency, effectiveness and economy audit. CA Suresh Rana also asked his audit team to conduct expenditure audit as part of the audit engagement of HAIL Ltd.

During the course of audit, CA Suresh also found that the company has constructed its new stockyard for parking its metro coaches and maintenance of its metro coaches. However, the stockyard was not being used by the company for the designated purpose and the company continued using the rented stockyard. Suresh considered such expenditure as infructuous and avoidable expenditure.

The engagement partner also discussed with his team regarding the areas to be covered while conducting the audit of receipts. The reporting responsibilities of the engagement team were also discussed by the engagement partner with his team. (2 Marks For each question)

Based on the above facts, answer the following:-

Statement 1: Government audit provides public accounting of operational, management programme and policy aspects of public administration as well as accountability of officials administering them.

Statement 2: Government audit is equipped and intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end.

(a) Only statement 1 is correct

(b) Only statement 2 is correct

(c) Both 1 & 2 are correct

(d) Both 1 & 2 are incorrect

Answer 1 (a)

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2. is conducted to ensure that the various programmes, schemes, and projects where large financial expenditure have been incurred are run economically and are yielding results expected of them:-

(a) Propriety audit

(b) Audit against Rules and orders

(c) Performance Audit

(d) Audit against Provision of funds

Answer 2 (c)

3. While conducting audit against provision of funds, the statutory auditors, M/s Suresh Rana & Associates must check:-

(a) That each item of expenditure is covered by a sanction either general or special of a competent authority.

(b) That the expenditure incurred has been on the purpose for which the grant and appropriation has been provided and the amount of expenditure does not exceed the appropriation made.

(c) That the expenditure conforms to the relevant provision of the constitution.

(d) That the expenditure is in accordance with the financial rules, regulations and orders issued by the competent authority.

Answer 3 (b)

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4. Which part of expenditure audit covers the scrutiny of the expenditure incurred on the construction of stockyard by the company which is considered as infructuous and avoidable by CA Suresh Rana?

(a) Propriety Audit

(b) Audit against provision of funds

(c) Audit of sanctions

(d) Performance Audit

Answer 4 (a)

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5. While conducting the audit of receipts of HAIL Ltd., which of the following area is to be covered as part of Audit of Receipts?

1. Whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities of HAIL Ltd.
2. Whether adequate checks are imposed to ensure the prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or willful omission or negligence to levy or collect taxes or to issue refunds.
3. Whether the expenditure incurred has been on the purpose for which the grant and appropriation had been provided and that the amount of such expenditure does not exceed the appropriation made.
4. Whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them.

(a) Only statement 1 is correct

(b) Statements 1 & 2 are correct

(c) Statements 1,2,3,4 are correct

(d) Statements 1,2,3 are correct

Answer 5 (b)

Case scenario (MTP Sep'22) (10 Marks)

GSR & Company have been appointed as the statutory auditors of Raj Textiles Ltd. for the FY 2021- 22. The engagement partner, CA Rahul Dhawan established the overall audit strategy and made the detailed plan with respect to the audit assignment of Raj Textiles Ltd. after discussing the same with the engagement team.

The strategy adopted by GSR & Company consisted of relying on the internal control system of the company and the audit plan and program were developed accordingly and the audit team started to work in accordance with the developed audit plan and program. During the course of audit, the engagement partner, CA Rahul Dhawan found that some internal controls implemented by the company were not operating effectively. So, he decided not to rely on the internal control system of the company & accordingly changed the overall audit strategy, audit plan & audit program.

While conducting the audit, the engagement partner also discussed with his team regarding the audit procedures to be performed to verify the debtors' balances of the company. CA Rahul Dhawan asked for the addresses of various debtors from the management of Raj Textiles Ltd. for the purpose of sending balance confirmation request to such debtors. The management provided such addresses to the audit team. However, the management of Raj Textiles Ltd. asked the debtors to send the responses of such confirmation requests to General Manager of accounts department of the company, who will in turn provide such responses to the audit team.

Further, the audit team found that a legal case has been filed against the company on account of customer complaint. CA Rahul Dhawan discussed with his team regarding the audit procedures that can be performed by the audit team to verify the implications of such litigation on the financial statements of the company.

One of the audit team members, Mr. Girish had the following understanding with respect to the audit file to be maintained by the audit team with respect to the audit assignment:

Point no. 1: The completion of assembly of final audit file after the date of the auditor's report is an administrative process involving the performance of new audit procedures or drawing of new conclusions.

Point no. 2: 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.

CA Rahul Dhawan briefed his engagement team regarding the documents to be included in the audit file with respect to the audit assignment of Raj Textiles Ltd. and also discussed with his team in detail regarding the various aspects of audit file.

1.1 Is CA Rahul Dhawan right in changing the overall audit strategy and plan after the audit team has started working as per the earlier strategy established & plan so developed?

(a) CA Rahul Dhawan is not right as once the audit team has started the audit work, it is not correct to change the audit strategy and plan.

(b) CA Rahul Dhawan is not right as once the overall audit strategy has been established the same cannot be changed. Audit plan however can be revised.

(c) CA Rahul Dhawan is right in making changes to the overall audit strategy and the audit plan.

(d) CA Rahul Dhawan can change the overall audit strategy and audit plan only after taking due permission from the management of Raj Textiles Ltd.(Sep'22)

Answer 1.1(c) CA Rahul Dhawan is right in making changes to the overall audit strategy and the audit plan.

1.2 Which of the following audit procedures should the audit team perform with respect to verification of debtors' balances?

(a) GSR & Company can compare the debtors' balance reflected in financial statements with invoices, debit notes, credit notes, monthly accounts statement sent to the customers.

(b) GSR & Company can obtain direct balance confirmation from the debtors as this is external evidence which is most reliable and relevant.

(c) GSR & Company can obtain management representations with respect to the debtors' balances from the management of ABC Ltd and need not perform other audit procedure as obtaining written representation from management constitutes sufficient and appropriate audit evidence.

(d) Both a & b.(Sep'22)

Answer 1.2:(a) Both a & b.

1.3 Is management correct in asking the debtors to provide the reply of confirmation request directly to the General Manager of accounts department of the company?

(a) Yes, the management has correctly asked the debtors to respond directly to the GM of accounts department.

(b) No, management is not correct in asking for a direct response to GM of accounts department as external confirmation is the response obtained directly by the auditor.

(c) Yes, the management is correct in advising direct response to the GM of accounts department as this will ensure that only correct confirmation is provided to the auditors.

(d) No, management is not correct as this is the option of the auditor to see if the response to external confirmation is to be obtained by management or auditor himself. (Sep'22)

Answer 1.3(b) No, management is not correct in asking for a direct response to GM of accounts department as external confirmation is the response obtained directly by the auditor.

1.4 For confirming/verifying the litigation going against the company which of the following audit procedures is not correct?

(a) GSR & Company can enquire the management including in house legal counsel.

(b) GSR & Company should review the minutes of meetings of those charged with governance.

(c) GSR & Company can review the legal expense account.

(a) GSR & Company need not perform audit procedures with respect to litigation claims of the company except for obtaining written representation from the management in this regard. (Sep'22)

Answer 1.4:(d) GSR & Company need not perform audit procedures with respect to litigation claims of the company except for obtaining written representation from the management inthis regard.

1.5 Is the understanding of Mr. Girish regarding the assembly of audit fi le with respect to an audit assignment, mentioned as point no. 1 & point no. 2 in the case scenario, correct?

(a) Only understanding as per point no. 1 is correct.

(b) Only understanding as per point no. 2 is correct.

(c) Understanding as per point no. 1 & point no. 2 both are correct.

(a) Understanding as per point no. 1 & point no. 2, both are incorrect. (Sep'22)

Answer 1.5:(b) Only understanding as per point no. 2 is correct.

Case scenario (MTP Oct'22) (10 Marks)

Meeta, Neeta, Rita and Babita are friends and all of them have joined office of an auditing firm for undergoing articled training. It is still early days in the office. However, all of them are curious about different issues of auditing. They have also studied auditing subject. They were going through one audit file of a large manufacturing company as part of their training. In the file are included some audit working papers and other related documents.

(A) Some papers contained in file reflect following: -

(i) Are budgets for capital expenditure approved by the Board?

(ii) Are approved budgets communicated in writing to accounts department and to department originating the request?

(iii) Is the authority to incur capital expenditure restricted to specified officials?

(iv) Are receipts of capital items subject to controls as in case of purchases of raw material, stores?

(v) Is there proper check to see that amounts expended do not exceed the amount authorised?

Further, "Yes", "No" and "Not applicable" along with remarks/notes have been provided by the employees of company against items stated at serial no.[i] to [v].

(B) Also included in audit working papers is a detailed note on process of employee recruitment followed by company along with practices on related matters such as orientation, training, evaluation, compensation and promotion of employees. In particular, it seemed that auditors had shown keen interest in standards followed by the company in recruiting most qualified individuals.

(C) The audit file also includes documentation on how customs duty paid by company on imported raw material was verified. The engagement team had examined the payment of custom duty with reference to bill of entry available in client records. It was verified that customs duty was in accordance with applicable duty rate on goods. In cases where duty was paid by clearing and forwarding agent, bill of entry with reference to bill of forwarder was verified.

(D) The audit file includes a document, signed by CEO of company addressed to auditors, extract of which is as under: -

We have provided you with: -

(i) Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

(ii) Additional information that you have requested from us for the purpose of the audit;

(iii) Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.

(iv) All transactions have been recorded in the accounting records and are reflected in the financial statements.

(E) The audit file included following draft to be included in audit report: -

"Revenue is one of the main profit drivers and is, therefore, susceptible to misstatement. Cut -off is the main relevant assertion insofar as revenue recognition is concerned, since an inappropriate cut -off can result in material misstatement of results for the year.

Our audit procedures with regard to revenue recognition included testing controls, automated and manual- around deliveries, inventory reconciliations and substantive testing for cut -offs and analytical review procedures."

The issues pertaining to above for audit period under consideration were communicated with responsible persons in management.

1.1 Regarding description of expenditure on capital items reflected in Para A, which of the following views is Most appropriate?

(a) Meeta is of view that such a document is in nature of a checklist for evaluating internal control over capital items.

(b) Neeta is of view that such a document is in nature of audit programme for verification of capital items.

(c) Babita considers that such a document is in nature of an internal control questionnaire for evaluating internal control over capital items.

(d) Rita considers it to be specific audit plan in relation to capital items.(Oct'22)

Answer 1.1:

(c)Babita considers that such a document is in nature of an internal control questionnaire for evaluating internal control over capital items.

1.2 On reading description in Para B, what were the auditors trying to do by studying employee recruitment and related HR matters?

(a) Auditors were trying to gain an understanding of how the company is monitoring controls.

(b) Auditors were gaining knowledge to understand how employee pay rolls are prepared and whether there could be any misstatements in pay rolls due to non- inclusion of promotion increments

(c) Auditors were trying to understand control environment of the company.

(d) Auditors were trying to assess the control activities relevant to audit to assess risk of material misstatement. (Oct'22)

Answer 1.2:

(c)Auditors were trying to understand control environment of the company.

1.3 On the basis of description provided in Para C, identify audit procedure(s) performed by auditors.

(a) Test of Controls

(b) Vouching

(c) Analytical Procedures

(d) Verification(Oct'22)

Answer 1.3:

(b) Vouching

1.4 What would the most appropriate nomenclature to extract of document described in Para D?

(a) Engagement letter

(b) Written Representation

(c) External confirmation

(d) Offer letter to auditor(Oct'22)

Answer 1.4:

(b) Written Representation

1.5 Given draft in Para E, which of the following views is Most appropriate in accordance with relevant Standards on Auditing?

(a) Meeta is of the view that draft in Para E needs emphasis in audit report. Therefore, its inclusion under heading "Emphasis of Matter" is proper.

(b) Neeta is of the view that draft in Para E is a residuary matter. Therefore, its inclusion under heading "Other Matters" is proper.

(c) Rita is of the view that draft in Para E provides the basis on which opinion is to be given.

Therefore, its inclusion under heading "Basis for Opinion" is proper.

(d) Babita is of the view that draft in Para E relates to significant matter identified during course of audit and it contains how the same was addressed. Therefore, its inclusion under heading "Key Audit Matters" is proper.(Oct'22)

Answer 1.5:

(d) Babita is of the view that draft in Box E relates to significant matter identified during course of audit and it contains how the same was addressed. Therefore, its inclusion under heading "Key Audit Matters" is proper.

Case Scenario (MTP Oct'22)(10 marks)

Rohan is part of an engagement team conducting statutory audit of branch of a nationalized bank. The financial statements to be audited include Balance sheet and Profit & Loss account of the branch drawn up in accordance with Form A and Form B respectively of the Third Schedule to the Banking Regulation Act, 1949. Besides, various advances and other returns are also to be verified as part of audit.

Rohan was part of all audit work pertaining to verification of deposits, advances, income and expenditure of the branch.

While verifying different items of profit and loss account, it was noticed that income included income on account of interest earned and other income.

The team also verified system of branch prior to sanction of advances like verifying creditworthiness of borrower etc. It was also verified whether there exists system for bringing to the notice of higher authorities, accounts which exceed the sanctioned limits or drawing power. Besides, the team also verified whether there exists a system for review of operations in accounts once a year and more frequently in case of large advances.

During the course of audit, it was noticed that one advance, consisting of a term loan, having outstanding balance of ₹ 20 crore as on balance sheet date has been guaranteed by Uttar Pradesh government. The interest of term loan has remained overdue for more than 90 days. The branch has classified advance as non-performing asset and made applicable provision and reversed unrealized income. Rohan is perplexed as to whether classification, provisioning and reversal of unrealized income made by branch is proper.

The auditee branch is a CBS branch and uses FINACLE software. The core banking system (CBS) is the set of basic software components that manage the services provided by a bank to its customers through its branches. The bank's customers can execute their transactions from any branch, ATM, Service Outlets, Internet, Phone at their disposal. It helps banks to reduce risk that can result from manual data entry and out of date information. It also helps banks to improve service delivery quality and time to its customer. The software is accessed from different branches of bank via communication lines like telephones, satellite , internet, etc.

The engagement team has kept record of audit documentation in accordance with SA 230.

Chapter 12: Audit of Banks

2.1 Which of the following does not constitute "Other income" in the profit and loss account of branch of a bank?

(a) Discount on Bills purchased

(b) Commission on Bills sent for collection

(c) Loan processing fees

(d) Credit card fees(Oct'22)

Answer 2.1:

(a)Discount on Bills purchased

2.2 Identify what the engagement team is trying to do in respect to advances of the branch.

(a) The engagement team is carrying out analytical procedures in respect of advances.

(b) The engagement team is carrying out substantive procedures in respect of advances.

(c) The engagement team is evaluating internal control over advances.

(d) The engagement team is trying to select samples for verification of advances.(Oct'22)

Answer 2.2:

The engagement team is evaluating internal control over advances

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2.3 Considering state government guaranteed advance of ₹20 crore and its NPA classification made by branch, which of the following statements is most appropriate?

(a) The branch has correctly classified account as NPA and has rightly made provisioning and reversal of unrealized income in this regard. Uttar Pradesh government guarantee has no effect on provisioning and income recognition.

(b) The branch has correctly classified account as NPA and has rightly made provisioning. However, unrealized income should not have been reversed due to Uttar Pradesh government guarantee.

(c) The branch should have classified account as Standard asset due to Uttar Pradesh government guarantee without having recourse to provisioning and reversal of unrealized income.

(d) The branch should have classified account as Standard asset due to Uttar Pradesh government guarantee. No provisioning is required. However, for purposes of income recognition, it should be treated as NPA and unrealized income should be reversed.(Oct'22)

Answer 2.3:

(a)The branch has correctly classified account as NPA and has rightly made provisioning and reversal of unrealized income in this regard. Uttar Pradesh government guarantee has no effect on provisioning and income recognition.

2.4 The branch is operating in CBS environment. In view of above, which of the following statements is most appropriate?

(a) Due to CBS environment, substantive procedures alone are effective to reduce audit risk to an acceptably low level.

(b) In CBS environment, in most situations, the auditors' ability to reduce audit risk to an acceptably low level would be affected by the internal control systems established by the management.

(c) The extensive use of IT systems in CBS environment substantially reduces need to assess inherent and control risks.

(d) Low level of branch staff sensitisation to the control expectations of management requires fewer audit procedures.(Oct'22)

Answer 2.4:

(b)In CBS environment, in most situations, the auditors' ability to reduce audit risk to an acceptably low level would be affected by the internal control systems established by the management.

2.5 With regards to audit documentation, consider the following: -

(P) NOC from previous auditor

(Q) Management certified trial balance of branch for year under consideration

(R) KYC verification details

(S) Latest RBI master directions/circulars

Which of the following statements is correct as regards to audit documentation?

(a) Only documents stated at Q and R form part of audit documentation.

(b) Only documents stated at Q, R and S form part of audit documentation.

(c) Only documents stated at Q and S form part of audit documentation.

(d) All documents stated at P, Q, R and S form part of audit documentation.(Oct'22)

Answer 2.5:

(d) All documents stated at P, Q, R and S form part of audit documentation.

Case scenario (MTP March '23) (10 Marks)

M/s SPR & Associates are appointed as auditors of XYZ Ltd. for the Financial Year 2021-22.

- **The team consisted of Mr. S, Mr. P, Mr. R all Chartered Accountants and three article assistants.**

- **Mr. S, the engagement partner, briefed the audit staff about various items of financial statement to be checked in detail in case of XYZ Ltd and about various aspects to be covered in the audit of the company.**
- **Mr. S told the audit staff about audit documentation, audit evidence, audit file, completion memorandum and many other things along with relevant Standards of Auditing applicable.**
- **Mr. S also told the staff about the risk of material misstatement that the financial statements are prone to and how it affects the sufficiency and appropriateness of audit evidence.**
- **The audit staff was also apprised about the various audit procedures to be adopted while conducting the audit of XYZ Ltd.**
- **Further discussions were done about various types of risks related to financial statement and the audit work, the related audit procedures, and the risk assessment procedures.**
- **The engagement team is also very particular about the application of various Standards on Auditing applicable in case of XYZ Ltd.**

Based on the above facts, answer the following:-

1. ____is the summary of significant matters identified during audit and way they are addressed :

(a) Audit File

(b) Audit Programme

(c) Completion memorandum

(d) Checklists

Answer (c)

2. The susceptibility of an assertion to a misstatement that could be material before consideration of any related control is……:

(a) Control Risk

(b) Inherent Risk

(c) Audit Risk

(d) Significant Risk

Answer (b)

3. Statement 1: Audit procedures consist of Risk Assessments Procedures and other procedures.

Statement 2: Substantive procedures consist of test of details and analytical procedures.

(a) Only Statement 1 is correct

(b) Only Statement 2 is correct

(c) Both 1 & 2 are correct

(d) Both 1 & 2 are incorrect

Answer (c)

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4. refers to the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error at the financial statement and assertion levels: -

(a) Analytical Procedures

(b) Risk Assessment Procedures

(c) Audit Procedures

(d) Substantive Analytical Procedures

Answer (b)

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5. Statement 1:- Substantive Procedures alone can provide sufficient and appropriate audit evidence at the assertion level.

Statement 2:-Test of Control is audit procedure designed to evaluate the operating effectiveness of controls in prevention, detection and correcting material misstatement at the assertion level.

(a) Only Statement 1 is correct

(b) Only Statement 2 is correct

(c) Both 1 & 2 are correct

(d) Both 1 & 2 are incorrect

Answer (b)

Case scenario (MTP March '23) (10 Marks)

M/s ABC & Associates have been appointed as auditors of Venus Ltd. for the Financial Year 2020-21.

- **During the course of audit, the auditors notice that certain legal expenses been charged to revenue during the financial year by Venus Ltd.**
- **These legal expenses are related to litigations going against the company regarding its Corporate Social Responsibility expenses incurred near its factory area.**
- **Further, M/s ABC & Associates noticed that there is a major change in the debtors and creditors account of Venus Ltd. during the financial year under audit. The auditors have decided to send balance confirmation requests to the debtors and creditors of Venus Ltd. Also, the auditors decide to take management representation letters wherever required.**
- **The auditors have noticed certain related party transactions reflected in the financial statements of Venus Ltd. during the financial year under audit. The transaction is between Venus Ltd. and a Company owned by wife of one of the directors of Venus Ltd.**
- **The auditors have become aware of certain subsequent events occurring in case of Venus Ltd. These are related to the outcomes of the litigations going against Venus Ltd.**
- **The auditors are also concerned whether the litigations going against Venus Ltd. and their outcomes have any impact on the going concern of the company.**

Based on the above facts, answer the following:-

(1) Statement 1: Although Written Representations provide necessary audit evidence, they do not provide sufficient and appropriate audit evidence on their own about the matters with which they deal.

Statement 2: Written Representations do not include financial statements, the assertions within, or supporting books and records.

(a) Only Statement 1 is correct

(b) Only Statement 2 is correct

(c) Both Statement 1 & 2 are correct

(d) None of Statement 1 & 2 is correct

Answer (c)

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(2) The auditor can perform the following procedures to identify litigation and claims of Venus Ltd.:-

(i) Inquiry of management including in house legal counsel.

(ii) Reviewing legal expenses account.

(iii) Reviewing of minutes of meetings of those charged to governance and correspondence between entity and external legal counsel.

(a) (i) & (i) are correct

(b) (i), (ii) & (iii) are correct

(c) (ii) & (iii) are correct

(d) only (i) is correct

Answer (b)

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(3) Negative confirmation requests require the third party to respond in the following cases : -

(a) If there is agreement

(b) If there is disagreement

(c) In both cases of agreement as well as disagreement

(d) None of the above.

Answer (b)

---

(4) Statement 1:- A failure of the confirming party to respond, or fully respond to a positive confirmation request or a confirmation request returned undelivered is a case of Non Response.

Statement 2:- A response that indicates difference between information requested to be confirmed and contained in entity's records and information provided by the confirming part is a case of Exception.

(a) Only Statement 1 is correct

(b) Only Statement 2 is correct

(c) Both Statement 1 & 2 are correct

(d) None of Statement 1 & 2 is correct

Answer (c)

---

(5) Which of the following is correct so far as the related party transactions are concerned:-

(i) Many related party transactions are in the normal course of business.

(ii) Related party transactions may not be conducted under normal market term and conditions.

(iii) In some circumstances, related party transactions may give rise to higher risks of material misstatement.

(a) only (i) is correct

(b) (i) & (iii) are correct

(c) (i), (ii) & (iii) are correct

(d) (i) and (ii) are correct

Answer (c)

Case scenario (MTP April '23) (10 Marks)

Aastha Ltd. has published its audited financial statements for the year ended 31 st March, 2023. A shareholder of Aastha Ltd. raised a point to the promoter of the company questioning the authenticity of the financial statements. The Management of the Company conveyed the shareholder that the same have been audited by a Chartered Accountant as per the provisions of Companies Act,2013.

The same shareholder then noticed that in the last year's financial statements, there was a disclosure regarding a legal dispute with its competitor. But in the current year's financial statements, there is neither such disclosure nor there is any update on the resolution of the dispute. However, the management did not give any convincing answer regarding lack of disclosure in current year's financial statements.

The Management also revealed in the meeting that there were few fictitious vendors to whom payments worth ₹ 50 lakhs were made by an employee who has been suspended from the office with immediate effect and a case to that effect has been filed in the court of law. The same has also been appropriately disclosed in the financial statements. The Company transferred ₹ 75 lakhs from current year's profit to asset replacement reserve for making another building for the operations of the company.

Based on the above facts, answer the following:

1. The financial statements audit is a report by the auditor:

a. attesting to the truth and fairness of presentation of the financial statements and related disclosures.

b. attesting to the truth and fairness of presentation of the financial statements.

c. attesting to the truth, transparency and fairness of presentation of the financial statements and related disclosures.

d. attesting to the truth, completeness and fairness of presentation of the financial statements and related disclosures.

Answer (a)

2. Non-disclosure of the legal dispute with the competitor of Aastha Ltd.is:

a. Misappropriation of assets

b. Recording fictitious Journal Entries

c. Manipulation of accounts

d. Misrepresentation in or intentional omission from financial statements.

Answer (d)

---

3. Payment to fictitious vendors by the employee of Aastha Ltd. Is:

a. Misappropriation of assets

b. Intentional misapplication of accounting principles

c. Manipulation of accounts

d. Misrepresentation in or intentional omission

Answer (a)

---

4. The appropriation of ₹ 75 lakhs from the revenue profit to asset replacement reserve is:

a. Revenue Reserve

b. Capital Reserve

c. Capital Redemption Reserve

d. Capital Revenue Reserve

Answer (b)

Case scenario (MTP April '23) (10 Marks)

As per SA 210 "Agreeing the Terms of Audit Engagements", preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

Mridul & Co, a firm of Chartered Accountants agreed on the Terms of Audit Engagements of a Private Limited Company, Jayshree Private Limited. Jayshree Private Limited has conveyed to Mridul & Co that they want the firm to undertake the statutory audit as well as to examine the life of its plant and machinery at Indore which is in existence for 10 years. While finalizing

the scope of the audit, the auditors agreed to cover all the units of the company based at Delhi and Indore. Mridul & Co has asked Jayshree Private Ltd to make all the relevant disclosures in the financial statements. The auditors were vigilant to inquire about any audit evidence that contradicts the other audit evidence.

The auditors decided to cover following aspects under audit:

(i) An examination of the system of accounting and internal control

(ii) Reviewing the system and procedures.

(iii) Checking of the arithmetical accuracy of the books of account.

(iv) Verification of the authenticity and validity of transactions.

(v) Classification between capital and revenue expenditure.

(vi) Comparison of the balance sheet and profit and loss account or other statements with the underlying record.

(vii) Verification of the title, existence and value of the assets.

(viii) Verification of the liabilities stated in the balance sheet.

(ix) Checking the results shown by the profit and loss and to see whether the results shown are true and fair.

(x) Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

(xi) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.

While testing the accounts receivables of Jayshree Private Limited, the auditor decided to divide the accounts receivables by age of receivables in the following manner:

- Below 15 days
- 15 days -30 days
- 31-60 days
- 61-90 days
- 91 days and beyond

Based on the above facts, answer the following:

1. According to you, what is the scope of the audit which Mridul & Co should cover in the audit of financial statements of Jayshree Private Limited?

I. to examine the life of its plant and machinery at Indore which is in existence for 10 years.

II. to cover all the units of the company based at Delhi and Indore.

III to check whether the relevant disclosures are properly made in the financial statements.

a. I,II,III

b. I,II

c. II,III

d. I,III

Answer (c)

2. What is the name of the method used by the auditor for segregation of accounts receivable?

a. Value weighted selection

b. Stratification

c. Systematic method of Sampling

d. Tests of Control

Answer (b)

3. The aspects covered by auditor should be:

a. i,ii,iii,x,vi,vii

b. i,ii,iv,v,vi,vii.

c. i,ii,iii,iv,v,vi,vii,viii,ix,x,xi.

d. ii,iii,viii,x,xi

Answer (c)

4. The auditor's vigilance to question the audit evidence that contradicts the other audit evidence is called as:

a. Professional Skepticism

b. Vigilant Skepticism

c. Professional Judgement

d. Judgement and Skepticism

Answer (a)

5. With respect to the preconditions for an audit, which one of the following is correct:

I. The use by Management of an acceptable financial reporting framework in the preparation of financial statements.

II. Management's responsibility for the internal control

III. Giving auditor access to all information and access to the Entity's premises.

a. I, II

b. I, II, III

c. II, III

d. I, III

Answer (b)

Case Scenario (MTP Sep '23)

Following is the extract of information taken from financial statements of AAF Private Limited for the financial year 2022-23: -

		(All Figs in tables are in ₹ 000s)
Particulars	**31/03/23**	**31/03/22**
Paid up share capital	75000	75000
Long term borrowings	24500	30000
Short term borrowings	55000	50000
Other current liabilities	350	550
Property, Plant and Equipment	48500	56000
Depreciation	7500	9500
Profit/(Loss) after tax	(5000)	(6000)

Assume that there are no taxation adjustments.

The schedule of short-term borrowings reflects as under: -

Particulars	**31/03/23**	**31/03/22**
Loans repayable on demand from MMT Bank (secured) (Cash credit limit against hypothecation of stocks guaranteed by all directors)	55000	50000

It has been further noticed during the course of audit that quarterly statements filed by company with its bank for availing cash credit facilities of ₹5.50 crores during the year vis-à-vis books of accounts reflect following details: -

Period Ending	Value of stocks as per quarterly statements	Value of stocks per Books of accounts
30.6.22	80000	70000
30.9.22	70000	65000
31.12.22	85000	70000
31.3.23	80000	80000

It has also been noticed that long term borrowings consist of a term loan from MMT Bank. Term loan outstanding has reduced in comparison to last year. However, during the year 2022-23, company has not paid one instalment of ₹ 5 lakhs on time which is overdue for 65 days as on balance sheet date.

The credit facilities have been classified as Standard assets by the Bank in accordance with prudential guidelines of RBI.

Other current liabilities as on 31/3/23 include TDS payable of ₹ 1.00 lac (out of which ₹ 0.60 lac for month of Feb 23 was due for deposit on 7.3.23). The balance Rs 0.40 lac pertains to month of March 2023.

You are part of engagement team conducting audit of AAF Private Limited. As part of assigned work, you are also responsible for providing information/input to your senior for reporting under CARO, 2020 for financial year 2022-23.

Based on above, answer the following questions:

1. Considering description about short-term borrowings in the case study, which of following statements is in accordance with CARO, 2020?

(a) The statutory auditor is required to provide details of differences in quarterly statements filed with bankers with its books of accounts.

(b) The statutory auditor is required to provide details of differences only in respect of those quarterly statements where there is discrepancy of more than 10% as compared to its books of accounts.

(c) The statutory auditor is not required to provide details of differences as reporting requirement is triggered only when working capital limits have been sanctioned in excess of ₹ 10 crore during any point of time of the year.

(d) The statutory auditor is not required to provide details of differences, as at end of year, books of accounts are in agreement with quarterly statement filed.

Answer (a)

2. The company has not paid one instalment of ₹ 5 lakhs on time which is overdue for more than 65 days as on balance sheet date. Identify likely correct statement in this regard in relation to reporting under CARO, 2020: -

(a) The account has not become NPA as on 31.3.23. Hence, there is no reporting requirement.

(b) The reporting requirement is necessary only when company is declared a willful defaulter by Bank. In the given situation, there is no reporting requirement.

(c) Amount of default along with period of default is required to be reported.

(d) The reporting requirement is necessary only when company has diverted amount of term loan for some other purpose. In the given situation, there is no reporting requirement.

Answer (c)

---

3. As regards TDS payable of ₹ 1.00 lakh included in other current liabilities, what input would be provided by you to your senior for reporting under CARO, 2020?

(a) TDS payable of ₹ 1.00 lac in financial statements shall not be reported as it does not meet necessary reporting requirements.

(b) It is in nature of undisputed statutory dues. Hence, outstanding amount of ₹ 1.00 lac not deposited is to be reported.

(c) It is in nature of undisputed statutory dues. However, only outstanding amount of ₹ 0.60 lac not deposited is to be reported.

Answer (a)

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4. TDS payable of ₹ 1.00 lac does not fall under meaning of "undisputed statutory dues". Hence there is no question of reporting. Which of following is not a reporting duty of statutory auditor regarding Property, Plant and Equipment reflected in company's financial statements under CARO, 2020?

(a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Property, Plant and Equipment

(b) whether Property, Plant and Equipment have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account

(c) whether Property, Plant and Equipment have been physically verified by the auditor during the year; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account

(d) whether tittle deeds of all immovable properties (other than properties where company is lessee and lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company

Answer (c)

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5. The company has reflected losses in its financial statements for year 2022-23 and 2021-22. Which of following statements is likely to be correct in this regard while reporting under CARO, 2020 for year 2022-23?

(a) Losses reflected in statement of profit and loss for year 2022-23 and 2021-22 are required to be reported under CARO, 2020.

(b) Loss reflected in statement of profit and loss for year 2022-23 is alone required to be reported under CARO, 2020.

(c) There is no requirement to report losses reflected in statement of profit and loss under CARO, 2020.

(d) The company's losses reflected in statement of profit and loss in financial year 2022-23 and 2021-22 are less than prescribed percentage threshold limit of paid- up capital. Hence, these are not required to be reported. **(5 x 2 = 10 Marks)**

Answer (c)

Case Scenario (MTP Sep '23)

Sookrit, a CA student, has decided to participate in "Mega Conference of CA Students" being organized by Student Skills Enrichment Board, (Board of Studies-Operations), ICAI to be held in a city in South India. He has decided to try his luck for presenting a paper in one of the technical sessions of the conference on the topic of "Nature, Objective and Scope of Audit". He has to first submit for approval a soft copy of the paper to the competent authority.

While preparing a draft for the presentation, he has included some paragraphs on the topic. Para A requires filling of certain gaps to explain nature of auditing to prospective audience at the conference.

Para B and C have certain misleading and false statements which need corrections. Para D needs certain elaborations.

Para A

An audit of financial statements provides _____ assurance to the users of financial statements.

It is a_____ level of assurance but it is not_____ assurance. The auditor has to see effect of misstatement(s) _____. Misstatements in financial statements can arise due to frauds or or both.

Para B

Audit of financial statements should be organized adequately to cover all aspects of the entity relevant to the financial statements being audited. The auditor makes a judgment of reliability and sufficiency of financial information by making a study and assessment of accounting systems and internal controls. He also carries out appropriate tests and procedures. Due to professional training and knowledge acquired by auditor, he can authenticate genuineness of documents. However, he is not expected to perform duties which fall outside his domain of competence. Auditor is not an official investigator.

Para C

The process of audit suffers from certain inbuilt limitations. Inherent limitations of audit may arise due to nature of financial reporting, nature of audit procedures and need to strike a balance between reliability of information and cost of obtaining it. The information being relied upon by the auditor cannot lose its reliability due to historical nature of financial information presented in financial statements. However, future events may affect an entity adversely.

Para D

The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Its basic nature lies in providing assurance i.e., confidence to users of financial statements. Apart from this obvious utility, there are other advantages of an audit. Some or all of those are of considerable value even to those enterprises and organizations where audit is not compulsory.

Try to help him by answering the following questions: -

1. Identify appropriate words to be used in blanks to make the sentences meaningful and relevant in context of theme of the topic.

(a) absolute, high, complete, individually, uncertainties

(b) reasonable, high, complete, in totality, errors

(c) reasonable, moderate, low, in totality, errors

(d) moderate, low, complete, individually, judgments

Answer (b)

---

2. After reading Para B, which of following statements is false as regards scope of an audit of financial statements is concerned?

(a) Audit of financial statements should be organized adequately to cover all aspects of the entity relevant to the financial statements being audited.

(b) The auditor makes a judgment of reliability and sufficiency of financial information by making a study and assessment of accounting systems and internal controls.

(c) Due to professional training and knowledge acquired by auditor, he can authenticate genuineness of documents.

(d) Auditor is not an official investigator.

Answer (c)

3. After reading Para C, which statement needs to be corrected in draft regarding inherent limitations of audit?

(a) Inherent limitations of audit may arise due to nature of financial reporting, nature of audit procedures and need to strike a balance between reliability of information and cost of obtaining it.

(b) The information being relied upon by the auditor cannot lose its reliability due to historical nature of financial information presented in financial statements.

(c) Future events may affect an entity adversely.

(d) The process of audit suffers from certain inbuilt limitations.

Answer (b)

4. Para D states that an audit provides advantages of considerable value to enterprises. Which of following is not one of advantages of an audit of financial statements of a listed company?

(a) It acts as a moral check on employees.

(b) It acts as an appraisal function.

(c) Its chief advantage lies in safeguarding financial interest of management.

(d) It is useful for settling trade disputes for higher wages or bonus.

Answer (c)

5. Para D states that audit can be of considerable value even to those enterprises where it is not compulsory. In context of companies in India, which of following statements is correct in relation to Companies Act, 2013?

(a) OPC and small companies are exempted from audit.

(b) OPC, small companies and section 8 companies are exempted from audit.

(c) For all companies in India, except Section 8 companies, audit is legally obligatory.

(d) For all companies in India, audit is legally obligatory. **(5 x 2 = 10 Marks)**

Answer (d)

Case Scenario (MTP Oct '23)

CA Sanjoy is conducting audit of PETA Education Solutions Private Limited for the first time. The company is engaged in providing solutions to students appearing for competitive exams under engineering and medical streams. Company's business is operated from physical centres spread in many states of the country. However, of late, number of aspirants availing company's services are shrinking due to emergence of new competitors and inability of company to switch to new technologies available in market to render its services.

The company had taken bank loans in past years for expansion of its physical centres. However, due to reduction in strength of aspirants opting for services provided by the company, management is always looking for means to meet its financial commitments on time. During the course of audit, CA Sanjoy wants to be sure about revenue and profit assertions reflected in financial statements of the company. Therefore, he is planning to test company's system for booking revenue in its books of accounts.

He notices that during the year under consideration, many experienced teaching faculties have left due to late payment of their contractual payments by the company. These have been replaced by inexperienced faculties having lower contractual costs but leading to poor satisfaction outcomes among aspirants. Besides, employee turnover of regular administrative staff also remains high. The company has not organized any training programmes either for its faculties or administrative staff for considerable period of time.

He has, in his wisdom, decided to increase the area of substantive checking in the company. He does not want to suffer from probable adverse publicity or loss of his professional goodwill.

Based on above case scenario, answer the following MCQs: -

1. After studying description of the company and its nature of operations, which of following statements is most appropriate?

(a) Inherent risk for revenue and profit assertions is likely to be lower.

(b) Inherent risk for revenue and profit assertions is likely to be higher.

(c) Inherent risk for revenue and profit assertions cannot be assessed from given situation.

(d) There does not exist inherent risk for revenue and profit assertions in described situation.

Answer (b)

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2. The case scenario describes a situation of leaving of experienced faculties, high employee turnover and absence of training programmes for staff of the company. Such indicators are an example of _____?

(a) Unsatisfactory risk assessment process used by the company

(b) Unsatisfactory control environment of the company

(c) Unsatisfactory performance reviews carried out by the company

(d) Unsatisfactory system of segregation of duties in the company

Answer (b)

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3. The auditor is planning to test company's system for booking revenue in its books of accounts. Identify the correct statement in this regard: -

(a) He is likely to place greater reliance on controls relating to booking of revenue.

(b) He is likely to place lower reliance on controls relating to booking of revenue.

(c) Reliance placed by him on controls relating to booking of revenue would be unaffected due to reduction in contractual costs by company.

(d) Reliance placed by him on controls relating to booking of revenue would be unaffected due to shrinking number of aspirants.

Answer (b)

---

4. The auditor has increased area of "substantive checking" in the company. It is due to the reason that_____

(a) he wants to lower detection risk

(b) he wants to lower control risk

(c) he wants to raise sample risk

(d) he wants to lower inherent risk

Answer (a)

---

5. 1.5 The auditor does not want to suffer from probable adverse publicity or loss of professional goodwill. Such a situation is indicative of ?

(a) audit risk

(b) auditor's business risk

(c) auditor's detection risk

(d) non-sampling risk (5 x 2 = 10 Marks)

Answer (b)

Case Scenario (MTP Oct '23)(RTP May '22)

You are a partner in ABC & Company, a firm of Chartered Accountants based in New Delhi. ABC & Company have been appointed as the statutory auditors of Onetime Limited, a public company which manufactures and sells wall and table clocks and has many branches all over India. Onetime Limited has been exporting the clocks since past two years. However, the domestic sales have contributed towards major source of rev enue for the Company.

One of the team members, CA B noticed that one of the suppliers of Onetime Limited, Mr AM had sent some raw material to the Company for storage in their warehouse in March 2023. Due to renovation going on at his warehouse, his stock could be damaged and so he had requested Onetime Limited to keep the same in their warehouse. Onetime Limited contended that since the raw material was anyway billed to the Company the next month, so the same had been included in the valuation of stock, since physically the stock was present in the warehouse of Onetime Limited as on 31.03.2023.

While verifying the debtors, team member C noticed that there were a few trade receivables pertaining to export sales mainly to England. Mr. C verified the same with respect to the invoices issued and other supporting documents. The amount booked as on 31.03.2023 was based on the exchange rate as on the date of the invoice.

Mr. T, another team member verified the PPE of the Company. Onetime Limited had purchased

few cars for its directors during the year of audit. The same were appearing in the PPE schedule of the Company. Mr T verified the same with respect to the invoices as well as physically verified the assets in the Company's premises. Since the cars were for the official use of the Directors, they were purchased in the name of the Directors of the Company. Mr. T verified the amount with the Invoice and checked the registration and insurance documents. Besides, all items appearing in the PPE schedule were verified and he was satisfied that all PPE items that should have been recorded have, in fact, been recorded.

One of the articled clerks was assigned the work of verification of "Provisions" appearing in the Balance sheet. He wanted to understand from you the circumstances in which a provision is recognised in the books of accounts. You explained him the situations in which an entity recognises Provisions in its books.

Onetime Limited has invested in the shares of other companies. One of the Companies has declared dividend on its shares. Onetime Limited has not recognised the same in the profit & loss account.

Team Member R has asked you to look into the matter since she is unable to understand the reasons for the same.

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1. Is the raw material lying in the warehouse of Onetime Limited accounted for correctly in its books of account?

(a) No, since the same belongs to Mr. AM and should appear in his books.

(b) Yes, since the same is in possession of Onetime Limited and was billed to it the following month.

(c) It should be shown in the books of both Onetime Limited and Mr. AM.

(d) It should not appear in the books of Onetime Limited or Mr. AM and the raw material should be disclosed as a note in the final accounts of both the entities.

Answer (a)

---

2. Which exchange rate is considered for accounting of foreign debtors at the year end?

(a) Exchange Rate on the date of the invoice.

(b) Exchange Rate on the last day of the financial year.

(c) Exchange Rate on the date of shipment of the products to the customer.

(d) Exchange Rate on the date of delivery of the products to the customer.

Answer (b)

3. Which of the following management assertions is not satisfied with respect to Cars included in the PPE items by the company:

(a) Existence

(b) Valuation

(c) Completeness

(d) Rights and Obligations

Answer (d)

---

4. Which of the following condition is not required to be met for recognizing a provision?

(a) When a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

(b) When an entity has a present obligation (legal or constructive) as a result of a past event.

(c) A reliable estimate can be made of the amount of the obligation.

(d) When it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Answer (a)

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5. Which of the following conditions is not necessary for recognizing dividends in the statement of profit and loss of Onetime Ltd.:

(a) the entity's right to receive payment of the dividend is established.

(b) it is probable that the economic benefits associated with the dividend will flow to the entity.

(c) the amount of the dividend can be measured reliably.

(d) payment of income tax on dividends received (5 x 2 = 10 Marks)

Answer (d)

Case Scenario (RTP May '20)

M/s NSG & Associates have been appointed as auditors of Viaan Ltd. for the financial year 2019-20. The processes, operations, accounting and decisions are carried out by using computers in Viaan Ltd. The auditors understand that there are several aspects that they should consider to determine the level of automation and complexity in the business environment of Viaan Ltd.

CASE SCENARIOS

While planning the audit work, the engagement partners discussed with the audit staff about the various types of controls in the automated environment.

The different types of audit tests that can be used in audit of an automated business environment were also discussed within the engagement team. The responsibility regarding the Internal Financial Controls was also discussed in detail. Further the tools and techniques that can be used to deal with the enormous data and information of Viaan Ltd. were briefed to the audit staff by the engagement partners.

Question 1

Based on the above facts, answer the following: -

_____ are the manual controls that make use of some form of data or information or report produced from the IT systems and applications.

(a) Application Controls

(b) IT dependent Controls

(c) Automated Controls

(d) General IT Controls

Answer 1: (b)

Question 2

Statement 1: Application controls include both manual and automated controls that operate at a business process level.

Statement 2: General IT Controls apply to mainframe, mainframe as well as end user environment.

(a) Only Statement 1 is correct

(b) Only Statement 2 is correct

(c) Both Statements 1 & 2 are correct

(d) Both Statements 1 & 2 are incorrect

Answer 2: (c)

Question 3

……are also known as pervasive or indirect controls: -

(a) General IT Controls

(b) Application Controls

(c) IT dependent Controls

(d) None of the above

Answer 3: (a)

Question 4

Which of the following are not the types of audit tests that can be used in the audit in an automated environment?

(a) Observation

(b) Inspection

(c) Re performance

(d) None of the above

Answer 4:(d)

Question 5

……is the combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information: -

(a) Computer Assisted Audit Techniques

(b) Automated Controls

(c) Data Analytics

(d) None of the above

Answer 5: (c)

Case Scenario (RTP May 20)

M/s JK & Associates have been appointed as auditors of Venus Ltd. for the financial year 2019-20. The team consist of Mr. J & Mr. K both Chartered Accountants as also the engagement partners and the audit staff consisting of 2 article assistants. While starting the audit work of Venus Ltd, the engagement partners briefed the audit staff about the audit work, areas to be covered and the various auditing concepts and their application in the audit of Venus Ltd along with applicable Standard on Auditing.

Various topics like audit planning, overall audit strategy, audit programmer were discussed in detail. The team was told about the purpose and implication of various statements and guidance notes issued by the Institute of Chartered Accountants of India (ICAI) from time to time. Mr. K also briefed the team about the concept of materiality to be applied while planning and performing audit. The team was also explained in detail about the area where benchmark materiality can be applied in case of Venus Ltd.

Question 6

Based on the above facts, answer the following: -

..... sets the scope, timing & direction of the audit and guides the development of the more detailed plan.

(a) Audit Programmed

(b) Overall Audit Strategy

(c) Completion Memorandum

(d) Audit Plan

Answer 6: (b)

Question 7

Statement 1: The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential process but are closely inter -related.

Statement 2: The auditor shall establish an overall audit strategy that guides the development of audit plan.

(a) Only Statement 1 is correct

(b) Only Statement 2 is correct

(c) Both Statements 1 & 2 are correct

(d) Both Statements 1 & 2 are incorrect

Answer 7: (c)

Question 8

……. means the amount set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatement exceeds materiality for the financial statements as a whole: -

(a) Benchmark Materiality

(b) Materiality in Planning

(c) Performance Materiality

(d) Materiality.

Answer8: (c)

Question 9

Which of the following is not an example of benchmark that can be used in determining the materiality in the case of financial statements: -

(a) Total Revenue

(b) Profit before tax

(c) Net Asset Value

(d) None of the above

Answer 9: (d)

Question 10

(I) Guidance notes issued by ICAI provide guidance to members on matters which may arise in the course of their professional work.

(ii) Statements are issued by ICAI with a view to secure compliance by members on some matters.

(iii) Guidance notes are recommendatory in nature.

(iv) Statements are mandatory in nature.

(a) All the above statements are correct.

(b) Statements 1 & 2 are correct

(c) Statements 1, 2 & 3 are correct

(d) Statements 1,2 & 4 are core

Answer 10:(a)

Case Scenario (RTP Nov'20)

(Chapter 3.3 SA 501- Audit Evidence-Specific Considerations for Selected Items.)

M/s JJ & associates having office in Chennai are statutory auditors under Companies Act, 2013 of a company viz. Sweet Aroma Private Limited engaged in business of obtaining and manufacturing rice from paddy catering to both domestic as well as international market mainly in Gulf nations. The company has a huge plant capacity for rice extraction in one of the states in Northern India.

Needless to state that inventories are in huge quantity in such type of business consisting of raw material, work in progress and finished goods. The auditors want to obtain sufficient appropriate audit evidence regarding inventories.

In above context, answer the following questions: -

Question 1

Which of the following is most likely correct in relation to obtaining of sufficient appropriate audit evidence regarding existence and condition of inventory?

(a) It is mandatory for the auditor to attend physical inventory counting on the date of financial statements in all circumstances.

(b) Physical inventory counting may be attended by auditor on the date of financial statement or at a date other than date of financial statements in his discretion mandatorily in all circumstances

(c) The attendance of auditors at physical inventory counting is impracticable due to time and costs involved because of auditor's office location vis-à-vis company's plant location. Hence, attendance at physical inventory counting may be skipped and alternative audit procedures may be performed to obtain sufficient appropriate evidence. .

(d) The auditor shall attend at physical inventory counting unless impracticable. However, issue of time and costs involved because of auditor's office location vis-à- vis company's plant location is not a valid basis for skipping physical inventory counting. (Nov'20)

Answer 1: (d)

Question 2

Below are given certain cluster of matters which are relevant in planning attendance of auditor at physical inventory counting. Which of the following clusters consists of a likely inappropriate combination?

(a) Nature of inventory, timing of physical inventory counting and stages of completion of work in progress

(b) Nature of inventory, timing of physical inventory counting and valuation method of inventory

(c) Nature of inventory, timing of physical inventory counting, considerations regarding maintenance of a perpetual inventory system

(d) Risks of material misstatements related to inventory, nature of internal control pertaining to inventory, considerations regarding maintenance of a perpetual inventory system. (Nov'20)

Answer (b)

Question 3

Which of the following is the most likely logical sequence of steps in relation to attendance at physical inventory counting by auditor?

(a) Observance of performance of management's count procedures, inspection of inventory, performing test counts and evaluation of management's procedures for recording and controlling results of physical inventory counting

(b) Observance of performance of management's count procedures, performing test counts, inspection of inventory and evaluation of management's procedures for recording and controlling results of physical inventory counting

(c) Performing test counts, inspection of inventory, Observance of performance of management's count procedures and evaluation of management's procedures for recording and controlling results of physical inventory counting

(d) Evaluation of management's procedures for recording and controlling results of physical inventory counting, Observance of performance of management's count procedures, inspection of inventory and performing test counts. (Nov'20)

Answer 3:(d)

Question 4

During attendance at physical inventory counting, the auditor inspects inventory. Following outcomes stated as I, II & III are given below of this inspection procedure: -

Outcome I Existence of inventory

Outcome II Ownership of inventory

Outcome III Condition of inventory

Which of following statements is most likely true?

(a) Outcomes I, II and III are all necessarily established after inspection.

(b) Only Outcomes I and III are established after inspection and Outcome II is never established.

(c) Outcomes I and III are established after inspection. However, outcome II may not be necessarily established.

(d) Outcome II and III are established after inspection. However, outcome I may not be necessarily established. (Nov'20)

Answer4: (c)

Question 5

It was observed by auditors that, out of total rice physically counted on 31 set March, 2020 about 67 quintals of rice belonged to M/s PQR, a proprietary concern which had sent paddy to this company's plant for extraction of rice. What would be treatment of this item in financial statements of company?

(a) The value of 67 quintals rice would be reflected in company's financial statements as per method of valuation adopted by the company.

(b) The value of 67 quintals rice would be reflected in company's financial statements as per method of valuation adopted by the proprietary concern.

(c) The value of 67 quintals rice would not be reflected in company's financial statements.

(d) The value of 67 quintals rice would be reflected in proprietary concern's financial statements as per method of valuation adopted by the company. (Nov'20)

Answer 5: (c)

Case Scenario (RTP Nov'20)

1. **Mr. T of UV Private Limited have been shown as Rent Expenses of business of UV Private Limited.**
2. **Repair and Maintenance Expenses for the months of February 2019 and March 2019 were still outstanding and were not shown in Balance Sheet of UV Private Limited.**
3. **Repair and Maintenance Expenses for the financial year 1 April, 2018 to 31 March, 2019 were very high as compared to financial year 1 April, 2017 to 31 March, 2018. The auditor Mr. H asked the appropriate authority about the reasons for such huge differences in amounts of two financial years.**
4. **While verifying the insurance expenses, the insurance policies were not shown to auditor Mr. H.**

The above mentioned five points were some of the issues which Mr. H was unable to understand.

Answer the following questions:

Question 6

As per the point number (1) mentioned in the above case, the Power and Fuel Expenses paid for the months of April 2019 and May 2019 must be shown under asset side of balance sheet of UV Private Limited as on 31 March, 2019 as:

(a) Outstanding Power and Fuel Expenses

(b) Prepaid Power and Fuel Expenses

(c) Power and Fuel Expenses

(d) Power and Fuel Expenses Payable (Nov'20)

Answer 6:(b)

Question 7

As per point number (2) mentioned above in the case, the Personal Rent Expenses of the son of one of the director Mr. T were added to Rent Expenses of business of UV Private Limited. The amount of personal rent expenses of the son of the director Mr. T must be:

(a) Subtracted from Rent Expenses of business of UV Private Limited

(b) Remain Added to Rent Expenses of business of UV Private Limited

(c) Again Added to Rent Expenses of business of UV Private Limited

(d) Subtracted twice from Rent Expenses of business of UV Private Limited (Nov'20)

Answer 7 (a)

Question 8

As per point number (3) mentioned above in the case, the Repair and Maintenance Expenses outstanding for the months of February 2019 and March 2019 must be shown under liability side of balance sheet of UV Private Limited as on 31 March, 2019 as:

(a) Prepaid Repair and Maintenance Expenses

(b) Repair and Maintenance Expenses

(c) Repair and Maintenance Expenses paid in advance

(d) Repair and Maintenance Expenses Payable(Nov'20)

Answer 8 (d)

Question 9

As per point number (4) mentioned in the case above, the auditor Mr. H asked the appropriate authority for reasons of huge differences in the amount of two financial years of repair and maintenance expenses. By appropriate authority Mr. H was referring to:

(a) All employees of UV Private Limited

(b) Management of UV Private Limited

(c) Members of UV Private Limited

(d) Any one director of UV Private Limited. (Nov'20)

Answer 9: (b)

Question 10

As per point number (5) mentioned in the case above, in verifying insurance expenses the insurance policies would provide auditor Mr. H as:

(a) Invalid Supporting

(b) No Supporting

(c) Lack of proper Supporting

(d) Valid Supporting. (Nov'20)

Answer 10: (d)

Case Scenario (RTP May '21)

RS & Associates have been appointed as the statutory auditors of MNO Ltd. for the Financial Year 2019-20. CA Ramesh is the engagement partner for the assignment. The management of MNO Ltd. has duly given a written representation letter to CA Ramesh regarding acknowledgement of its responsibility for the implementation and operation of accounting system and the internal control system of the company. The management has assured the audit firm that such accounting and internal control systems are designed and implemented to prevent and detect any misstatement on account of fraud or error.

During the course of audit, the auditor found that the wages cost has increased substantially as compared to the last year. On detailed checking CA Ramesh found that many new workers have been added to the workers list which appear to be dummy workers to CA Ramesh.

Further the auditor found that there was a fraud amounting to Rs. 2 crores committed during the year under audit by an officer of the company. Such fraud has already been reported by

the Cost Accountant of the company, Mr. Sudesh, to the Central Government. The statutory auditors are considering their reporting responsibilities in this regard.

The audit team also realized that there is inadequate Internal Control System with respect to the following:

- **The system of authorization and approval of transactions specially in the process of making purchases.**
- **The system of record keeping with respect to the assets. Based on the above facts, answer the following:**

Question 6

1. As the management of MNO Ltd. has given a written representation regarding its responsibility for prevention and detection of misstatement on account of fraud and error, M/s RS & Associates:-

(a) Should rely on such management representation and conduct its audit procedures without wasting much time and resources towards detection of fraud and error.

(b) Should not consider such management representation as a substitute for obtaining sufficient and appropriate audit evidence and design its audit procedures accordingly.

(c) Should not rely on such management representation and should obtain written representation from those charged with governance.

(d) Should concentrate on audit of accounting system and accounting policies so used by the company as the prevention and detection of fraud and error is the responsibility of the management (May '21)

Answer 6: (b)

Question 7

The inclusion of dummy workmen in the workmen list by the management of MNO Ltd. as noticed by CA Ramesh amounts to:-

(a) Suppressing cash receipts

(b) Casting wrong total in cash book

(c) Inflating cash payment

(d) Misappropriation of good (May '21)

Answer 7: (c)

Question 8

With respect to the fraud which has already been reported by The Cost accountant of the company, Mr. Sudesh, what is the responsibility of M/s RS & Associates in this regard?

(a) Since the reporting has been done to the Central Government by the cost accountant of the company, the statutory auditor has no responsibility for such fraud and its reporting.

(b) The cost accountant has detected and reported the fraud to the Central Government. The statutory auditor should not interfere in the work of the Cost Accountant.

(c) CA Ramesh should review the steps taken by the management with respect to the reported fraud and if he is not satisfied with such steps, he should request the management to perform additional procedures to enable him to satisfy himself that the matter has been appropriately addressed.

(d) CA Ramesh should obtain written representation from the management that once the matter is appropriately addressed, he will be duly informed by the management. (May '21)

Answer 8: (c)

Question 9

…….refers to events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud:-

(a) Fraud Risk Factors

(b) Misappropriation of assets

(c) Incentives/ Pressures

(d) Fraud(May '21)

Answer 9: (a)

Question 10

Statement 1: The risk of auditor not detecting a material misstatement resulting from employee fraud is greater than for management fraud.

Statement 2: The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error.

(a) Only statement 1 is correct

(b) Only statement 2 is correct

(c) Both 1 & 2 are correct

(d) Both 1 & 2 are incorrect(May '21)

Answer 10: (b)

Case Scenario (RTP Nov '21)

Ms. Rhea was among the promoters who set up a public company by the name "Aksham Ltd". The company appointed CA Rajendra as the auditor of Aksham Ltd. CA Rajendra is the brother of one of the directors of Aksham Ltd. After setting up of company, the company had a dispute with one customer of the company in year 2019-20 who took the company to court. There are probable chances that company will have to shelve out `50 lakhs as compensation but the case will likely to be finalised in year 2021-22.

CA Rajender considers the fact that Askham Ltd has a present obligation and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and that a reliable estimate i.e. ` 50 Lakhs can be made of the amount of the obligation.

Aksham Ltd. declared dividend of ` 10 per equity share on 10th April,2021. The financial statements were approved on 30th June,2021. Askham Ltd took loan of ` 65 lakhs from Saksham Bank for a period of 10 years; the loan amount was guaranteed by Mr. Pramod, one of the directors of Aksham Ltd. The loan was completely secured against the fixed assets of the company. Aksham Ltd drew designs of one of the products of the company and this product constituted 90 % sales of the company. The designs of the product were such that the sale of the company will increase every year for the next 5 years. Aksham Ltd booked the designs of the company at a value of ` 1 crore in the books of account of the company as intangibles at its cost.

Based on the above information, answer the following questions:

Question 1

State whether appointment of CA Rajendra is correct in law.

(a) Yes, it is correct in law as per Companies Act, 2013

(b) It is incorrect in law as per Companies Act, 2013 as the relative of director is not allowed to be appointed as an auditor of the company.

(c) It is correct in law as per Companies Act, 2013 because brother is not covered under the definition of relative.

(d) It is correct as appointment of auditor is not governed by any law in India. (Nov '21)

Answer 1: (b)

Question 2

Advise the company regarding the course of action Aksham Ltd will have to follow for the court case for financial statements prepared for year ending 31st March, 2021

(a) create provision

(b) create revenue reserve

(c) create capital reserve

(d) to be disclosed as contingent liability.(Nov '21)

Answer 2: (a)

Question 3

What is the action which Aksham Ltd is supposed to take with regard to treatment of dividend declared while preparing and finalizing financial statements for year ending 31st March,2021?

(a) recognise dividends as a liability

(b) disclose the amount of dividend

(c) both a and b

(d) none of the above.(Nov '21)

Answer 3 : (b)

Question 4

State the disclosures Aksham Ltd is required to make with respect to the long-term borrowings taken from Saksham Bank.

I. Secured loan from Saksham Bank.

II. The fixed assets are secured against the loan

III. The loan of ` 65 lakhs is guaranteed by director.

IV. Repayment terms of the loan

(a) I, II, III and IV

(b) I, II

(c) I, II, III

(d) II, III (Nov '21)

Answer 4: (a)

Question 5

State which of the following statement is true with respect to recording an intangible in the books of the company.

(a) Intangible is correctly booked by the company.

(b) Intangible is wrongly booked by the company as an intangible cannot be booked as per the accounting standard of India.

(c) Intangible is wrongly booked by the company as an intangible cannot be booked as per the auditing standards of India.

(d) Intangible is wrongly booked by the company as an intangible cannot be booked as per the Companies Act, 2013. (Nov '21)

Answer 5: (a)

Case Scenario (RTP Nov '21)

Best Tea House is a Co-operative society formed as per the provisions of the Co-operative Societies Act, 1912. It runs a chain of restaurants serving mainly tea and snacks in Delhi. RAS & Associates, a Chartered Accountant firm, has been appointed to conduct the statutory audit of the society. None of the partners of the firm, CA R, CA A and CA S have ever conducted a Cooperative Society audit before and so familiarise themselves with the provisions of the particular Act governing the society before starting the audit.

During the audit, Best Tea House informs the auditors that they have been in operation for the last five years, and no audit was required earlier since their turnover had not exceeded the prescribed limit.

While examining the books of account of Best Tea House, RAS & Associates notice that as stated under section 43(h) of the Central Act, certain rules were framed prescribing the books and accounts to be kept by Best Tea House.

The auditors also understand that 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 a certain percentage of the total number of shares or of the value of shareholding to a specified amount. RAS & Associates were concerned with this provision so as to watch any breach relating to holding of shares.

While examining the loans of Best Tea House, the auditors notice that the society has given a loan to a relative named Mr. P, of a member of the society, Mr. T, of an amount not exceeding ` 1000.

RAS & Associates examined the overdue debts and checked its classification which they are required to report.

During the audit, RAS & Associates notice few transactions for personal profiteering by members of the management committee, which are ultimately detrimental to the interest of the society.

RAS & Associates report this matter to the required authority to take necessary action.

After the conclusion of the audit, in addition to the audit certificate in the prescribed form and various schedules, RAS & Associates also answered two sets of questionnaires called audit memos.

The auditors also submitted the audit report in a narrative form addressed to the Chairman of the society which was divided into two parts styled as part I and part II.

Based on the above information, answer the following questions:

Question 6

According to section 5 of the Central Act, what is maximum percentage of the total number of shares and what is the maximum value of shareholding that RAS & Associates were concerned with, so as to watch any breach relating to holding of shares?

(a) Twenty-five percent of the total number of shares or of the value of shareholding upto ` 5,000

(b) Twenty percent of the total number of shares or of the value of shareholding upto ` 5,000

(c) Twenty-five percent of the total number of shares or of the value of shareholding upto ` 1,000

(d) Twenty percent of the total number of shares or of the value of shareholding upto 1,000.

(Nov '21)

Answer 6: (d)

Question 7

As per Section 29 of the Central Act, Best Tea House cannot give a loan to any person other than:

(a) A member and with the special sanction of the Registrar, relatives of the member not exceeding an amount of ` 1000.

(b) A member and with the special sanction of the Registrar, another registered society.

(c) A member and with the special sanction of the Registrar, relatives of the member.

(d) A member and with the special sanction of the Registrar, another registered society not exceeding an amount of ` 1000.(Nov '21)

Answer 7: (b)

Question 8

Overdue debts for a period from _____to_____ and more than were classified and reported by RAS & Associates.

(a) 3 months to 6 months and more than 6 months.

(b) 6 months to 3 years and more than 3 years.

(c) 6 months to 5 years and more than 5 years.

(d) 3 months to 5 years and more than 5 years.(Nov '21)

Answer 8 (c)

Question 9

To whom does RAS & Associates report the few transactions noticed during audit?

(a) Registrar of Co-operative Societies

(b) Secretary of Best Tea House.

(c) State Government

(d) Management Committee of Best Tea House(Nov '21)

Answer 9: (a)

Question 10

Mistakes having an impact on the profitability of society were pointed out by RAS & Associates as it had a consequential effect on the financial position of society. In which of the following submissions was this information included?

(a) Part I of the audit report

(b) Part II of the audit report

(c) Schedules to the audit report

(d) Audit memos(Nov '21)

Answer 10 : (b)

Case Scenario (RTP May '22)

Save Lives Limited is a listed Company which deals in the manufacture of Sanitizers, floor cleaners, dish and fabric cleaners etc. In spite of spread of covid 19 in the country, the company's sales have been very high in the last financial year due to essential products it deals in. The Company is highly automated and is driven by IT systems and applications that are used in the preparation of the financial statements of the Company. The Company uses an integrated enterprise resource planning system since last five years.

KRAN & Associates has been appointed to conduct the statutory audit of the Company. The firm consists of eight partners, and CA N has been appointed as engagement partner for the audit of SaveLives Limited.

CA N briefed the team about the audit and also how IT would be relevant to the audit of Save Lives Limited. The team obtained an understanding of the entity and its automated environment which involved an understanding of how the IT department was organised, IT activities, IT dependence and the relevant risks and controls.

One of the team members wanted to understand the importance of different types of controls in an automated environment viz., General IT Controls, Application Controls and IT - Dependent Controls. Same was discussed in detail along with the relationship between different controls.

The Companies Act, 2013 has placed a greater emphasis on the effective implementation and reporting on the internal controls for a company. So, CA N decided to himself evaluate and validate the design and operating effectiveness of Internal Financial Controls over Financial Reporting (IFC-FR) of the company as at the Balance Sheet date. Internal Financial Controls (IFC) refers to the policies and procedures put in place by SaveLives Limited for ensuring adequacy and also the operating effectiveness of such controls.

The audit team decided to use the tools and techniques that auditors use in applying the principles of data analytics which are known as CAATs. Data analytics could also 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 various functions.

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1. Under which situation is IT not relevant to an audit?

(a) Increased complexity of transactions

(b) Hi-tech nature of business

(c) Volume of transactions is low

(d) Company Policy (Compliance).

Answer 1.1 (c)

2. Which of the following is a risk that arises from the use of IT systems?

(a) Direct data changes (backend changes).

(b) Limited/Monitored access.

(c) Adequate segregation of duties.

(d) Authorized access to data.

Answer 1.2 (a)

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3. The relationship between two controls is such that are needed to support the functioning of _____, and both are needed to ensure complete and accurate information processing through IT systems.

(a) IT Dependent Controls, General Controls

(b) Application Controls, General Controls.

(c) General Controls, IT Dependent Controls.

(d) General IT Controls, Application Controls.

Answer 1.3 (d)

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4. The term Internal Financial Controls (IFC) refers to the policies and procedures put in place by companies for ensuring which of the following:

(a) reliability of financial transactions.

(b) effectiveness and efficiency of operations.

(c) safeguarding of human resources.

(d) prevention and detection of errors.

Answer 1.4 (b)

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

(a) Evaluating impact of control deficiencies.

(b) Compliance with applicable laws and regulations.

(c) Authorized changes to system or programs.

(d) Providing latest information.

Answer 1.5 (a)

Case Scenario (RTP Nov'22)

Bharat Bank, a nationalised bank, has branches all over India and has been the most popular public sector bank in India for the past few years. The bank is governed by the Banking Regulations Act, 1949 and the Central Statutory Auditors of the bank, ABC & Associates, were appointed according to the provisions of the relevant enactments. The engagement partner CA C commenced the audit with his team of seven members so that the audit is completed on time and all the documents are submitted before the due date. The audit at all the branches also started simultaneously and ABC & Associates was in constant touch with all the branch auditors to ensure timely completion of the audit.

As per the audit strategy and plan, CA Q along with Ms. R and Mr. P were assigned the audit of the advances of Bharat Bank. Advances constituted the largest item on the assets side of the balance sheet of the bank. Since audit of advances is one of the most important areas covered by auditors in a bank audit, it was assigned to CA Q since he was aware of the various functional areas of the bank/branches, its processes, procedures, systems and prevailing internal controls with regard to advances.

CA Q started with verifying whether the advances were classified as per RBI Prudential Norms.

There were five categories of advances which were available to CA Q for verification. They were:

Standard Regular, Sub Standard, Doubtful, Loss and Special Mention Accounts. An ageing analysis was available for doubtful advances and Special Mention Accounts which was examined in detail by CA Q.

Ms. R, on being instructed by CA Q, verified the securities offered by the borrowers for the bank finance. For a particular customer named Aquabrass Pvt Ltd., the security was in the form of delivery of goods by Aquabrass to Bharat Bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remained with Aquabrass. In case of another customer named Prism Works, there was a transfer of a life insurance policy in favour of the bank as security. The bank had absolute right over the policy.Ms. R examined all the relevant documents for the above two cases in detail. She continued with her examination of other securities based on the sample selected by her.

While checking the classification of NPA, Mr. P came across a customer named Trustworthy whose term loan instalment was overdue for 90 days at the year-end, but it was 100% secured against the office building. The same was classified as a Substandard asset. There was another customer named Super40, who had a cash credit account and a term loan with the bank. Super40 had been paying the instalments on the term loan as well as the interest on the cash credit account regularly and there was no overdue amount. Mr. P verified the drawing power of Super40 and found it to be less than the sanctioned limit throughout the year. The outstanding

balance of Super40 during the whole year exceeded the drawing power but was less than the sanctioned limit. Both the advances to Super40 were classified as Standard Advances since the recoveries were regular and outstanding balance in the cash credit was less than the sanctioned limit. On examination of large advances, CA Q noticed that a customer named Stylish N Smart Private Limited had one funded loan (term loan) and one non funded loan (bank guarantee) sanctioned from the bank. CA Q checked in detail whether commission earned by the bank on the bank guarantee was provided for on accrual basis.

CA Q along with Ms. R and Mr. P verified the advances in detail and also recommended a few changes in the classification/provisions based on the examination of the sample selected by them.

Based on the above information, answer the following questions:

1. What are the sub categories of the special mention accounts?

(a) SMA 0 (accounts showing stress signals), SMA 1 (Overdue between 31-60 days) and SMA 2 (Overdue between 61-90 days)

(b) SMA 0 (accounts showing stress signals), SMA 1 (Overdue between 0-45 days) and SMA 2 (Overdue between 46-90 days)

(c) SMA 0 (accounts not yet due for payment), SMA 1 (Overdue between 31 -60 days) and SMA 2 (Overdue between 61-90 days)

(d) SMA 0 (accounts not yet due for payment), SMA 1 (Overdue between 0-45 days) and SMA 2 (Overdue between 46-90 days)(Nov'22)

Answer (a)

2. Creation of security of Aquabrass Private Ltd. and Prism Works was in the form of:

(a) Mortgage and Hypothecation.

(b) Lien and Set-off.

(c) Hypothecation and Pledge.

(d) Pledge and Assignment.(Nov'22)

Answer (d)

3. In your opinion is Trustworthy a standard asset or a substandard asset?

(a) Though it is due for 90 days, it is 100% secured so it is a standard asset.

(b) Since it is due for 90 days, it is a substandard asset irrespective of the security.

(c) Since it is not due for more than 90 days, it is a standard asset irrespective of the security.

(d) Since it is not due for more than 90 days and it is 100 % secured, it is a standard asset. .(Nov'22)

Answer (c)

4. Is Super40 correctly classified as a standard asset?

(a) Yes, since the recoveries in both term loan and cash credit were regular and outstanding balance in the cash credit was less than the sanctioned limit.

(b) No, since the outstanding balance of the cash credit facility exceeded the drawing power for more than 90 days, so both the advances, that is, the term loan and cash credit facility will be classified as NPA.

(c) No, since the outstanding balance of the cash credit facility exceeded the drawing power for more than 90 days, the cash credit facility will be classified as NPA and term loan as standard.

(d) Yes, since the recoveries in both term loan and cash credit were regular, there is no relevance of sanctioning power/drawing power. .(Nov'22)

Answer (b)

5. Which among the following is a non- funded loan?

(a) Demand Loans

(b) Bills Discounted and Purchased

(c) Letter of Credit

(d) Participation on Risk Sharing basis.(Nov'22)

Answer (c)

Case Scenario (RTP May '23)

Kaur & Associates, a sole proprietor firm of Simran Kaur, is offered appointment as auditor of a company engaged in manufacturing of automobile components for the first time. She is fact checking about the integrity of promoters of the company and key managerial persons. Matters such as competence of staff to perform the engagement are also considered by her. The

appointment is subsequently accepted by her.

She is also taking into account number and location of branches of the company, requirements of Schedule III of Companies Act, 2013 and expected time by which audit has to be completed keeping in view statutory requirements. Initially, she has thought it proper to inquire key employees of the company in procurement and marketing departments and planned for the same. She has also planned to visit three plants of the company. The purpose of planned inquiry and visit is to identify and assess risk of material misstatements.

A detailed set of instructions has been prepared by her office and it has been handed over to assistants in engagement team. These set of instructions include details of extent of checking and nature of audit procedures to be performed regarding purchases, sales, items of income, items of expenditure etc. During the course of execution of above set of instructions, it has been brought to her notice that company is also producing substantial quantities of scrap generated during manufacturing process. However, no instructions have been given to engagement team in this regard.

Based on above, answer the following questions:

1. Auditor is fact checking about promoters and key managerial persons. She is also considering competence of staff to perform engagement. What is she trying to do?

(a) She is establishing audit strategy.

(b) She is conducting preliminary engagement activities.

(c) She is designing audit plan.

(d) She is checking her compliance of ethical requirements.

Answer: (b)

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2. Consideration of number and location of branches, requirements of financial reporting framework and expected time of completion are relevant factors primarily for which of the following -

(a) Developing audit plan

(b) Establishing overall audit strategy

(c) Designing audit programme

(d) Designing risk assessment procedures

Answer: (b)

3. Taking into account description of planned inquiry and visit, which of the following statements is TRUE?

(a) Planned inquiry and visit fall in area of audit strategy.

(b) Planned inquiry and visit are planned risk assessment procedures and fall in field of audit plan.

(c) The said description is not related to audit planning.

(d) Planned inquiry and visit fall in scope of audit programme.

Answer: (b)

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4. What is detailed set of instructions given to assistants in engagement team known as?

(a) Audit guidelines

(b) Audit plan

(c) Audit Programme

(d) Audit Procedures

Answer: (c)

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5. The issue of generation of scrap has been overlooked in detailed set of instructions given to engagement team. What should be proper course of action by CA Simran Kaur?

(a) She should ignore this information as audit has already begun.

(b) She should modify earlier set of instructions.

(c) She should leave the matter to wisdom of engagement team.

(d) She should put the ball in court of management as she was not provided with complete information earlier.

Answer: (b)

Case Scenario (RTP May '23)

CA Rajan Pillai is heading the engagement team conducting audit of a company. While audit is in progress, consider following issues regarding audit documentation: -

Audit programmed was prepared assigning responsibilities for different types of works to be performed by team members. The engagement team consists of 4 members Mohit (CA final student), Rohit (CA final student), Shobhit (Paid CA) and CA Rajan Pillai (partner of audit firm).

(A) The team has determined materiality for financial statements as a whole.

(B) The team has assessed risks of material misstatements to be low.

(C) CA Shobhit is responsible for attending inventory count process and putting down its documentation part.

(D) During the course of audit, many related party transactions have come to notice.

On the basis of above, answer the following questions: -

1. Work relating to verification of revenue was assigned to Mohit in audit programme. However, it is being performed by Rohit actually. Verification of trade receivables was planned to be carried out by Rohit in audit programme. However, it being performed by CA Rajan Pillai due to last minute practical issues.

Which of the following statements is most appropriate in this regard relating to audit documentation?

(a) Audit programme contains names of persons and work to be performed. It is immaterial whether work assigned to one person is performed by another person.

(b) Audit programme was already prepared. Only persons assigned specific responsibilities can perform those duties.

(c) It is necessary that audit programme be suitably updated or notes are given in working papers to this effect so that planned duties are in accordance with actual work performance.

(d) Changes in audit programme or notes clarifying the matter are required only when a person not forming part of engagement team is deputed to perform a duty. Otherwise, this issue of inter-shuffling of team members is frivolous.

Answer: (c)

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2. As regards materiality, which of the following statements is most appropriate in context of audit documentation?(Chapter SA 320- Materiality in Planning and Performing an Audit)

(a) Materiality has already been determined. There is no need to put it into working papers.

(b) Materiality depends upon professional judgment of auditor. Whatever amount has been determined can be documented in working papers.

(c) Materiality arrived on basis of professional judgment along with factors considered in the determination has to be documented.

(d) Materiality has been arrived upon professional judgment. It also depends upon professional judgment of auditor whether he wants to document it or not.

Answer: (c)

3. As regards team's assessment that risk of material misstatements is low, which of the following statements is odd one relating to documentation of risk? (Chapter A 315- Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment)

(a) Discussion amongst engagement team members and detail of significant decisions reached has to be documented.

(b) Details of risk assessment procedures have to be documented.

(c) Details about how understanding of each component of internal control was obtained has to be documented.

(d) Precise calculation of risk of material misstatements has to be documented.

Answer: (d)

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4. CA Shobhit is responsible for attending physical inventory count of the company. Which of the following is usually not true in this regard relating to audit documentation? (Chapter SA 501- Audit Evidence-

Specific Considerations for Selected Items)

(a) Dates on which physical inventory count process was attended by him should be documented. It may also include photographs of that date showing his attendance of inventory counting process at a particular location.

(b) Detail of test counting undertaken should form part of audit documentation.

(c) Detail of obsolete goods found should form part of audit documentation.

(d) Reports showing that stocks conform to quality control standards in accordance with law are essential part of audit documentation.

Answer: (d)

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5. As regards related party transactions, which of the following should not be part of audit documentation? (Chapter SA 550- Related Parties)

(a) Management representation letter in this regard

(b) Related party transaction policy of the company

(c) Documentation to show that such transactions are at arm's length basis

(d) Documentation to show that such transactions are at close length basis.

Answer: (d)

Case Scenario (RTP Nov'23)

(Chapter SA 300- Planning an Audit of Financial Statements)

Kartik, a CA student undergoing his articled training, is part of an engagement team conducting statutory audit of MSE Auto Private Limited, a company engaged in manufacturing of automobile spare parts. The company has its manufacturing facilities located in Pimpri-Chinchwad industrial belt near Pune. It is a profit-making company and one of the most sought after by banks in the area due to its good track record. The following is extract of financial information taken from its preaudit financial statements for year 2022-23. Figures have been rounded off in ` 000's.

Particulars	Year 2022-23	Year 2021-22
Share capital	2500.00	2500.00
Long term borrowings	0.00	15000.00
Short term borrowings	55000.00	15000.00
Inventories	35000.00	27000.00
Trade receivables	60000.00	25000.00
Revenue from Operations	300000.00	100000.00
Profit before tax	60000.00	18000.00

While going through schedule of long term borrowings and books of accounts, he finds that reduction of long term borrowings of the company is on account of full payment of a term loan in month of April 2022 taken from a bank in past. However, he finds that charge in respect of above term loan in favour of bank is still subsisting on MCA portal beyond statutory period due to nonregistration of charge satisfaction.

He had read about assertions pertaining to balance sheet and income statement. However, he was not sure about nomenclatures assigned to assertions pertaining to balance sheet and income statement.

The team had also attended physical inventory count of the company as at year end in accordance with SA 501.

Besides, company's trade receivables have increased from ` 25000 in year 2021-22 to ` 60000 in year 2022-23 (both figs in '000s). His understanding is that increase in company's trade receivables as compared to last year signifies longer time taken by company's customers to make their payments.

Considering substantial rise in revenue from operations of the company in the year under audit, team wants to ensure that revenues of company are not overstated.

Based on above, answer the following questions: -

1. Keeping in view description regarding full payment of term loan in April 22 taken from a bank in past and non-registration of satisfaction of charge, which of following statements is correct?

(a) The above fact may be disclosed by the company's management in its financial statements at its discretion along with reasons as such disclosure would bring transparency.

(b) The above fact along with reasons is required to be disclosed by the company in its financial statements in accordance with requirements of Standards on Auditing.

(c) The above fact along with reasons is required to be disclosed by the company in its financial statements in accordance with requirements of Schedule III of Companies Act, 2013.

(d) The above fact is not required to be disclosed as term loan has already been repaid in full and there are no outstanding long term borrowings.

Answer 1.1 (c)

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2. The company's short-term borrowings have increased during the year 2022-23 as compared to last year.

One of following assertions is not relevant to verification of short - term borrowings. Which odd one you would suggest to Kartik in this regard?

(a) Existence

(b) Occurrence

(c) Completeness

(d) Valuation

Answer 1.2 (b)

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3. As regards team's attendance at physical inventory count process of company's inventories in accordance with SA 501 is concerned, which of following is not a relevant audit procedure?

(a) Inspection of inventories

(b) Checking appropriateness of method employed for valuation of inventories

(c) Evaluating management's instructions for recording results of physical inventory count

(d) Performing test counts

Answer 1.3 (b)

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4. The company's trade receivables have increased during year 2022-23 as compared to last year. Which of following statements is most appropriate regrading understanding of Kartik on this issue?

(a) The view of Kartik is correct and it has led to increased audit risk pertaining to valuation of trade receivables. Therefore, team needs to go through trade receivables ageing schedule to confirm it.

(b) The view of Kartik is incorrect.

(c) The view of Kartik is correct and it has led to increased audit risk pertaining to valuation of trade receivables. Therefore, team needs to perform direct confirmation procedures to confirm it.

(d) The view of Kartik is correct and it has led to increased audit risk pertaining to valuation of trade receivables. Therefore, team needs to perform cut-off procedures to confirm it.

Answer 1.4 (b)

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5. The team wants to ensure that revenues of company are not overstated. Which of following is not likely to be a relevant audit procedure in this regard?

(a) Obtaining confirmations from customers

(b) Reviewing GST returns and their reconciliation with revenue stated in statement of profit & loss

(c) Reviewing credit notes issued by company post year end

(d) Reviewing debit notes issued by company post year end

Answer 1.5 (d)

Case Scenario (Nov '23)

CA X has accepted offer of conducting statutory audit of financial statements of DOS Solutions Private Limited. Keeping in mind requirements of Standards on Auditing including those relating to SA 300, he plans audit so that it is conducted in an effective manner. He knows that because of inherent limitations of an audit, there is audit risk in audit of financial statements even though audit is properly planned and performed in accordance with Standards on Auditing.

Considering nature of operations of the company, he has decided to use audit sampling in performing audit procedures. The various areas of his testing include testing controls over revenues, expenditures, assets and liabilities of the company. Besides, he has decided to perform tests of details in respect of all these areas of financial statements.

While verifying tests of controls over purchase orders placed by the company based on selected audit samples, he has erroneously concluded that Standard operating procedures (SOP) for placing purchase orders are not being followed strictly and controls are less effective than they actually are.

Further, while testing controls over wage payments, he has tested 20 sample wage sheets of different sections of company and finds that one wage sheet has not been signed by authorized officer of the company. The rate of deviation was earlier set by him at 3%.

During the course of designing procedures for selecting samples for verification of trade receivables, he has decided to divide trade receivable balances into groups viz. balances in excess of ` 10 lakh, balances in range of ` 7,50,001 to ` 10,00,000, balances in range of ` 5,00,001 to ` 7,50,000, balances in range of ` 2,50,001 to ` 5,00,000 and balances of ` 2,50,000 and below. He has planned to pick up different percentage of items from each of above groups. Random sample is chosen from each group using random number tables.

Some of the trade payables of the company were outstanding since long. He has decided to merely verify arithmetical accuracy of ageing schedule and its reconciliation with books of accounts.

Therefore, nature of audit procedures, nature of financial reporting itself and need for audit to be conducted within a reasonable period of time and at a reasonable period of cost all lead to inherent limitations of audit.

1. The auditor has erroneously concluded that Standard operating procedures (SOP) for placing purchase order are not being followed strictly and controls are less effective than they actually are. Which of the following statements is likely to be true in this regard?

(a) It is a sampling risk and might lead to auditor expressing inappropriate audit opinion.

(b) It is a sampling risk and affects audit effectiveness.

(c) It is a sampling risk and affects audit efficiency.

(d) It is a control risk and affects audit effectiveness.

Answer 1 (c)

2. The auditor has tested 20 sample wage sheets in different sections of the company and finds that one wage sheet has not been signed by authorized officer of the company. It represents ?

(a) Tolerable misstatement

(b) Misstatement

(c) Tolerable rate of deviation

(d) Actual rate of deviation

Answer 2 (d)

3. Which method of selecting samples for verification of trade receivables has been planned by auditor?

(a) Simple random sampling

(b) Systematic sampling

(c) Block sampling

(d) Stratified sampling

Answer 3 (d)

4. The auditor has decided to merely verify arithmetical accuracy and reconciliation of ageing schedule relating to trade payables. The use of above audit procedure can lead to _____?

(a) Sampling risk

(b) Non-sampling risk

(c) Inherent risk

(d) Control risk

Answer 4 (b)

5. Keeping in view inherent limitations of audit of financial statements, which of following statements is likely to be most appropriate?

(a) Due to inherent limitations of audit, auditor obtains conclusive audit evidence.

(b) Due to inherent limitations of audit, auditor can be satisfied with less than persuasive evidence.

(c) Due to inherent limitations of audit, subsequent discovery of material misstatement in financial statements after audit, which was conducted in accordance with SAs, does not indicate a failure of audit.

(d) Due to inherent limitations of audit, auditor can skip a difficult, time-consuming and costly procedure.

Answer 5 (c)

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