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AUDITING AND ASSURANCE

SEPT 2025 QUESTION BANK

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**Updated for
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Chapter-1

Nature, Objective and Scope of Audit

Topic 1 Nature and Definition of Audit

MCQ

Question 1

The Auditor of a Sole Proprietor Concern is appointed by

- (a) CAG
- (b) Bank
- (c) Sole Proprietor himself
- (d) District Administration

(MTP April 22)

Ans: (c)

Reason:

A sole proprietorship is owned and controlled by a single individual who is personally responsible for the business. Hence, the sole proprietor appoints the auditor (if any) since there is no separate legal entity or governing body to appoint one.

CAG appoints auditors for government entities.

Banks or District Administration do not appoint auditors for private sole proprietors.

Therefore, the correct answer is (c) Sole Proprietor himself.

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Descriptive Question

Question 2

The relationship between auditing and law is very close one.

(MTP Oct 19, RTP Nov '18)

Answer 2

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 3

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 March '23)

Answer 3

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 4

Both accounting and auditing are closely related with each other. Explain

(RTP Nov'20)

Answer 4

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 5

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.

(Study material)

Answer 5

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.

Topic 2 Objectives and Scope of Audit (SA 200)

MCQ

Question 6

Which of the following is the responsibility of the auditor:

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- (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.

(MTP April 22)

Ans: (c)

Reason:

The primary responsibility of the auditor is to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Preparation and presentation of financial statements is the responsibility of management, not the auditor.

Design, implementation, and maintenance of internal controls are also management's responsibilities.

Obtaining limited assurance relates to a review engagement, not a full audit.

Hence, the auditor's responsibility is to express an opinion on the financial statements.

Correct answer: (c)

Descriptive Question

Question 7

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 v statement with reference to "Timeliness of Financial Reporting and the Balance between Benefit and Cost".

(MTP April 22, RTP May' 18]

Answer 7

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 opinion 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 8

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 Oct 20)

Answer 8

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 9

The person conducting the audit should take care to ensure that financial statements would not mislead anybody. Explain

(MTP 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 presents a true and fair picture of the operational results and of the assets and liabilities.

Question 10

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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 April '21)

Answer 10

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 11

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

(RTP-May 25)

Answer 11

Scope of Audit:

(a) The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. The scope of audit of financial statements includes coverage of all

aspects of entity, reliability and sufficiency of financial information and proper disclosure of financial information.

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

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

(d) 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

Conclusion: It can be concluded that proper disclosure of financial information is well within scope of audit.

Question 12

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

- **The company has several ongoing projects, but only selected project revenues have been reported.**

- Several expense vouchers are either missing or are handwritten and lack proper authorisation.
- The company has changed its depreciation method from the straight-line method to the written-down value method without adequate disclosure in the financial statements.

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

(RTP Sep. 2025)

Answer 12

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

(1) Coverage of all aspects of entity

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

(2) Reliability and sufficiency of financial information

The auditor should be reasonably satisfied that information contained in underlying accounting records and other source data (like bills, vouchers, documents etc.) is reliable and sufficient basis for preparation of financial statements. The auditor makes a judgment of reliability and sufficiency of financial information by making a study and assessment of accounting systems and internal controls and by carrying out appropriate tests, enquiries and procedures.

(3) Proper disclosure of financial information

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

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

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

Topic 3 Inherent Limitations of Audit

MCQ

Question 13

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 March '19)

Ans: (a)

Reason:

As per Standards on Auditing (SAs), if an audit procedure is necessary and no alternative procedure exists, the auditor cannot skip it simply because it is difficult, time-consuming, or

costly. The audit evidence must be sufficient and appropriate, and the quality of the audit cannot be compromised due to practical challenges.

If there is an alternative, the auditor may choose a more practical method.

But if no alternative exists, difficulty or cost does not justify omission.

Hence, the correct answer is (a).

Descriptive Question

Question 14

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

Explain giving examples.

(RTP Nov '21, May'20)

Answer 14

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

2. 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.
3. 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.

4. 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 15

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)

Answer 15

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 16

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 Nov'23)

Answer 16

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.

Topic 4 Responsibilities of Auditor vs Management

MCQ

Question 17

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.

Ans: (c)

Reason:

The primary responsibility of a statutory auditor, like M/s KYC & Co., is to examine the financial statements and issue an independent audit report stating whether the financial statements present a true and fair view of the company's financial position and performance in accordance with the applicable financial reporting framework.

- (a) Preparation of financial statements is the management's responsibility.
- (b) Internal control system is also designed and maintained by management.
- (d) Compliance with laws and regulations is again a management responsibility, though the auditor does check for material non-compliance.

Therefore, the correct responsibility of the auditor is (c) Reporting on true and fair view of financial statements.

Descriptive Question

Question 18

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 July '21)

Answer 18

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.

Topic 5 Reasonable vs Absolute Assurance

Descriptive Question

Question 19

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 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 Oct '21)

Answer 19

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.

Lxord 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 20

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 April 19, RTP May'23, RTP May'18)

OR

The auditor is expected to and can reduce audit risk to zero

(MTP May 20, MTP Oct'21)

Answer 20

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 21

An audit is a reasonable assurance engagement, whereas a review is a limited assurance engagement. Both types of assurance engagements provide assurance to users, but they differ in the degree of assurance offered.

In light of this, explain the difference between reasonable assurance engagements and limited assurance engagements, with examples.

(MTP-March 25)

Answer 21

Difference between Reasonable Assurance Engagement and Limited Assurance Engagement:

Reasonable assurance engagement	Limited assurance engagement
Reasonable assurance engagement provides high level of assurance.	Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.
It performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	It performs fewer procedures as compared to reasonable assurance engagement.
It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It involves obtaining sufficient appropriate evidence to draw limited conclusions.
Example of reasonable assurance engagement is an audit engagement, Audit of financial statements.	Example of limited assurance engagement is review engagement, Review of financial statements.

Topic 6 Audit vs Review Engagements

Descriptive Question

Question 22

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 22

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 23

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?

(Study material)

Answer 23

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

MCQ

Question 24

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

(MTP-April 25)

Ans: (d)

Reason:

In this situation, the Chartered Accountant (CA) is asked to provide assurance on:

Half-yearly financial statements, and

Projected financial statements (i.e., future-oriented financial information).

These tasks do not fall under a statutory audit but still require the CA to provide independent assurance, making the engagement fall under the category of Assurance Engagements.

ICAI's Standards on Assurance Engagements (SAEs), like SAE 3400 (for projections), apply in such cases.

Standards on Review Engagements apply to historical financial data, but not to projections.

Standards on Related Services deal with agreed-upon procedures or compilations, not general assurance.

Option (b) is incorrect, as ICAI does have relevant standards for such engagements.

Hence, the correct answer is (d) Standards on Assurance Engagements.

Topic 7 Qualities and Responsibilities of an Auditor

Descriptive Question

Question 25

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)

Answer 25

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 26

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 July '21)

Answer 26

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.

Topic 8 Benefits / Advantages of Audit

Descriptive Question

Question 27

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?

(Study material)

Answer 27

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.

MCQ

Question 28

ABC Ltd. appointed CA Jai to conduct the statutory audit. During the audit, the auditor identified some errors in the financial records and he got it corrected. The audited statements were then submitted to tax authorities for compliance purposes. The audit procedures also helped the company improve its record-keeping processes. However, the management assumed that since the financial statements were audited, they could be

used to predict future profits with certainty. In view of above, 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.

(MTP-March 25)

Ans: (a)

Reason:

Auditing provides assurance on the truth and fairness of past financial information, not on future outcomes. It is not predictive in nature. While audited financial statements are helpful for decision-making, they cannot guarantee or predict future profits with certainty.

- (b) Errors or frauds may be discovered — this is a valid benefit.
- (c) Government authorities often use audited accounts — also valid.
- (d) Audit can help highlight deficiencies in financial record-keeping — a common benefit.

Therefore, (a) is not a likely benefit of auditing, making it the correct answer.

Topic 9 Practical and Legal Limitations in Evidence

MCQ

Question 29

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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 March '21, Oct'23, RTP May '21, Nov'21, Nov'23)

Ans: (b)

Reason:

"Those charged with governance" is a term used in auditing standards (like SA 260) to refer to persons or bodies responsible for overseeing:

The strategic direction of the entity, and

The accountability obligations (e.g., financial reporting, compliance).

This may include the Board of Directors, Audit Committee, or any other supervisory body — depending on the entity's structure.

- (a) Management handles day-to-day operations, not overall governance.
- (c) Audit Committee is part of those charged with governance, but not the full definition.
- (d) Board of Directors may be those charged with governance, but again, it's a subset.

Hence, the correct and most inclusive answer is (b) Those charged with governance.

DESCRIPTIVE QUESTION

Question 30

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“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 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 30

“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; 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.

Topic 10 Role of Auditor in Detecting Fraud

MCQ

Question 31

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 March '23)

Ans: (a)

Reason:

This statement is incorrect because as per SA 200 (Overall Objectives of the Independent Auditor), an auditor is responsible for obtaining reasonable assurance, not absolute assurance, that the financial statements are free from material misstatement.

Absolute assurance is not possible due to inherent limitations of an audit, such as:

Use of judgment

Sampling

Limitations of internal control

The nature of fraud (especially involving collusion or management override)

Other options (b), (c), and (d) correctly reflect the principles in SA 200.

Hence, the incorrect statement — and the correct answer — is (a).

Descriptive Question

Question 32

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 32

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

Topic 11 Appointment of Auditor

None directly mentioned

Topic 12 Materiality and Professional Judgment

MCQ

Question 33

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 scepticism
- (d) All of the above

(MTP April'19)

Ans: (b)

Reason:

When an auditor determines materiality, they must choose an appropriate benchmark (e.g., profit, revenue, assets) and then apply a percentage to it. This process depends on various factors such as:

- Nature and size of the entity
- User needs
- Industry norms

This requires the application of professional judgement, as there are no fixed rules—the auditor must decide what would influence the decisions of users of the financial statements.

- Independence is essential for objectivity but not directly related to calculating materiality.
- Professional scepticism relates to questioning evidence, not setting thresholds.
- All of the above is too broad; the correct and focused reason is professional judgement.

Correct answer: (b) Professional Judgement.

Topic 13 Governance and Oversight

MCQ

Question 34

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 Nov'21)

Ans: (b)

Reason:

"Those charged with governance" refers to the individuals or groups responsible for overseeing the strategic direction and accountability of the entity. This includes supervising management's activities, ensuring integrity of financial reporting, and fulfilling obligations to stakeholders.

Management (a) handles daily operations but does not oversee overall governance.

Audit committee (c) and board of directors (d) are usually part of those charged with governance but are not the full scope.

Hence, the term "those charged with governance" is broader and more accurate, covering all responsible parties overseeing strategic direction and accountability.

Therefore, (b) those charged with governance is the correct choice.

Topic 14 Audit Procedures and Sampling**Descriptive Question****Question 35**

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?

(Study material)

Answer 35

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

Section A

Topic 1 Audit Strategy

MCQ

Question 1

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 April 22)

Ans: (b)

Reason:

The Overall Audit Strategy sets the scope, timing, and direction of the audit at a high level. It provides a framework for developing the more detailed audit plan and audit procedures.

The Audit Programme (a) is a detailed list of audit procedures to be performed.

The Audit Plan (d) is derived from the overall audit strategy and provides detailed steps to achieve the audit objectives.

The Completion Memorandum (c) summarizes the audit work done at the end.

Thus, the Overall Audit Strategy guides the audit by defining its scope, timing, and direction.

Descriptive Question

Question 2

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 Nov '21 & April '23, RTP Nov'23, PYP Nov '19)

Answer 2

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.

Question 3

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 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 May '19)

Answer 3

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 cut-off 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 4

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 4

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 5

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)

Answer 5

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 6

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.

(Study material)

Answer 6

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.

Topic 2 Audit Plan

Descriptive Question

Question 7

The audit plan includes the nature, timing and extent of audit procedures to be performed by engagement team members. Explain.

(RTP Nov '23)

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 7

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 8

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 April 19, 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 Oct 20)

Answer 8

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.

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- 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 9

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

(MTP March '19)

Answer 9

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 10

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

(RTP May '19)

Answer 10

Periodic Review of the Audit Programme

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

Example- if the audit programme 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 programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

Question 11

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)

Answer 11

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 12

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

(Study material)

Answer 12

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.

Topic 3 Audit Programme

MCQ

Question 13

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)

Reason:

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An audit programme is a detailed list or schedule of audit procedures that the auditor plans to perform to gather sufficient audit evidence. It specifies how the audit will be conducted.

(a) is incorrect because the audit programme is not a plan of audit strategy; it's more detailed and focused on procedures.

(b) is incorrect because the audit programme can and should be reviewed to ensure appropriateness.

(d) is incorrect because although audit programmes are prepared for a specific year, they can serve as useful references for subsequent audits with necessary updates.

Hence, (c) is the most appropriate description.

Question 14

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 Oct 21)

Ans: (c)

Reason:

CA R emphasized that the audit programme's usefulness depends on regularly updating it based on changes in the client's operations and internal controls. This refers to Periodic
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Review, which means the audit programme should be reviewed and revised periodically to remain relevant and effective.

Static Review (a) and Mechanical Review (b) imply no or routine review without considering changes.

Obsolete Review (d) refers to a programme that is outdated and not updated.

Thus, the correct attribute highlighted is Periodic Review.

MCQ

Question 15

CA Radha is appointed as an auditor of a PVC Ltd. for the first time. A detailed set of instructions has been prepared by her office and handed over to assistants in engagement team. During the course of audit, she noticed 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. What should be proper course of action by CA Radha?

- (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.

(MTP-April 25)

Ans: (b)

Reason:

When new information (like the production of substantial scrap) comes to the auditor's attention during the audit, she must update the audit instructions and procedures to cover this area. This ensures that the audit adequately addresses all significant aspects of the client's operations.

Ignoring the information (a) is improper as it may lead to incomplete audit coverage.

Leaving it to the team's discretion (c) can cause inconsistency and missed audit risks.

Blaming management (d) is not a professional response.

Therefore, modifying the earlier set of instructions to include audit procedures related to scrap is the correct and responsible action.

Descriptive question

Question 16

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 May '23)

Answer 16

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.

Question 17

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 Dec '21)

Answer 17

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.

Question 18

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 Nov'19)

Answer 18

Correct: Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Thus under a properly framed programme, the danger is significantly less and the audit can proceed systematically.

Question 19

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 19

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. However, it becomes a necessity to specify in detail in the audit programme 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 programme should be drawn up. Audit programme is a list of examination and verification steps to be applied and set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions 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 20

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 Oct'22)

OR

Arpan Hospitals Ltd having Gross Professional Charges of Rs. 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, May '19)

OR

Discuss the points to be considered by auditor for the purpose of constructing an audit program me.

(PYP Nov, 19)

Answer 20

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.

Question 21

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

(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 Sep'22)

Answer 21

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 22

**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 Oct 20, Nov '21, March 22 & Oct 22)

OR

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

(RTP May '19 & May '18)

Answer 22

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 23

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 March 22)

Answer 23

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 24

"An adequate planning benefits the audit of financial statements." Discuss.

(MTP Sep'22 & March '23, May '23, Nov '19, Nov '21, May '18)

Answer 24

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.

Question 25

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 25

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 26

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 26

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.

MCQ

Question 27

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

(Study material)

Ans: (d)

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Reason:

An audit programme typically includes details such as:

Extent of checking (how much to test),

Date of checking (when to perform the procedures),

Nature or type of procedure (what audit procedures to perform).

However, planning of risk assessment procedures is part of the overall audit planning and strategy, not the detailed audit programme. Risk assessment is done earlier to identify areas of higher risk, which then influences the audit programme, but the detailed planning of risk assessment itself is not included in the audit programme.

Thus, (d) is not normally included in the audit programme.

Topic 4 Planning an Audit

MCQ

Question 28

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 Oct 19)

Ans: (b)

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Reason:

According to SA 300 (Planning an Audit of Financial Statements), audit planning is ongoing and iterative, meaning the auditor continuously updates the audit plan as new information is obtained throughout the audit. It is not a one-time or separate phase, but a process that evolves to respond to changes and findings during the audit.

Option (a) and (c) are incorrect because they state planning is not continual or iterative.

Option (d) is partially correct but incomplete, as planning is continual and iterative, not just "not discrete."

Therefore, (b) correctly reflects the nature of audit planning under SA 300.

Question 29

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 Oct 19)

Ans: (a)

Reason:

According to SA 300, planning an audit involves two key steps:

Establishing the overall audit strategy – setting the scope, timing, and direction of the audit.

Developing the audit plan – detailing the nature, timing, and extent of audit procedures to be performed.

Both these steps are essential parts of the audit planning process. Option (a) correctly states this sequence.

Options (b), (c), and (d) incorrectly mix or omit these steps or reverse their order. Hence, (a) is the correct answer.

Descriptive Question

Question 30

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 30

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 31

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

Explain.

(RTP May '20)

Answer 31

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 32

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 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.

(RTP Nov 18, Nov 19 & May '19, May'23)

Answer 32

"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 33

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 May 22)

Answer 33

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 **CATESTSERIES.ORG**

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 34

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

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

(RTP Nov'19)

Answer 34

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 35

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 35

Periodic Review of the Audit Programme

There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. Unless this is done, any change in the business policy of the client may not be

adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

Example- if the audit programme 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 programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

Question 36

"Planning is not a discrete phase of an audit, but rather a continual and iterative process."

Discuss.

(PYP Nov '18)

Answer 36

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.

MCQ

Question 37

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

(Study material)

Ans: (c)

Reason:

Planning an audit involves understanding the entity, its environment, and factors such as:

Legal and regulatory framework (a),

Determination of materiality (b),

Involvement of experts if needed (d).

However, evaluating audit evidence (c) is not part of the planning phase. It is done later during the execution of audit procedures, when the auditor reviews and assesses the audit evidence gathered.

Therefore, (c) is not considered during planning, making it the correct answer.

Question 38

CA Rishu is appointed as an auditor of a manufacturing company with a complex supply chain, multiple inventory locations, and recently introduced financial reporting requirements. Some article assistants and an expert assigned for inventory verification are forming part of audit team of CA Rishu. To ensure that audit risk is reduced to an acceptably low level, CA Rishu is focused on developing an effective and efficient audit plan. Explain the benefits of adequate audit planning in the audit of financial statements.

(RTP Sep. 2025)

Answer 38

Adequate planning benefits the audit of financial statements in the 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 organise 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 others such as experts

Therefore, planning an audit ensures that audit risk is reduced to an acceptable low level. When audit work is adequately and properly planned, it reduces the risk of inappropriate opinion by the auditor.

Topic 5 Documentation in Audit

MCQ

Question 39

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 April'19)

Ans: (d)

Reason:

According to SA 300 (Planning an Audit of Financial Statements), the auditor is required to document:

The overall audit strategy that sets the scope, timing, and direction of the audit,

The audit plan detailing the nature, timing, and extent of audit procedures,

Any significant changes made to the overall audit strategy or audit plan during the audit and the reasons for those changes.

Documenting all these elements ensures proper audit trail, helps in supervision, and provides evidence of compliance with auditing standards. Therefore, all the above (d) must be documented.

Descriptive Question

Question 40

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 May '23)

Answer 40

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.

Question 41

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 July'21)

Answer 41

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

Question 42

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.

Answer 42

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 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.

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 43

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 March'21)

Once the audit plan has been drafted and communicated, it is obligatory on the auditor to follow the same.

(MTP April '23, PYP Nov '18)

Answer 43

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. 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 44

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 44

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

MCQ

Question 45

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

(Study material)

Ans: (d)

Reason:

An audit programme typically includes specific details of audit work such as:

Extent of checking (how much to test) — (a)

Date of checking (when to perform the test) — (b)

Nature or type of procedure (what audit procedures to perform) — (c)

However, planning of risk assessment procedures (d) is part of the broader audit planning process, not detailed within the audit programme itself. Risk assessment is done at a higher strategic level to design the audit approach, while the audit programme focuses on the detailed execution of audit tests.

Hence, (d) is not normally included in the audit programme.

Topic 6 Understanding Client's Business

Descriptive Question

Question 46

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.

Answer 46

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 47

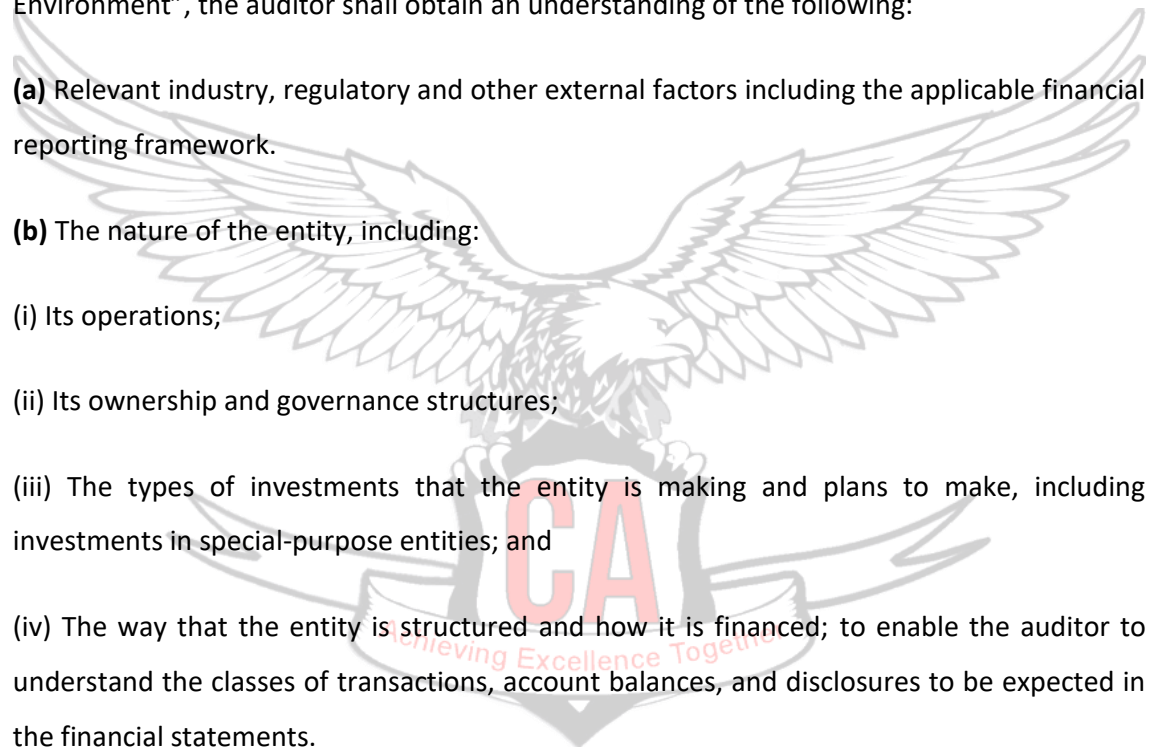
Without adequate knowledge of client's business, a proper audit is not possible. It is one of the important principles in developing an overall audit plan. Explain in context with

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 47

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 48

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 March 22)

Answer 48

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.

MCQ

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Question 49

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.

(Study material)

Ans: (c)

Reason:

An audit programme has several advantages, such as:

- Acting as a guide for audits in coming years by providing a structured approach.
- Fixing responsibility of audit assistants by clearly assigning tasks.
- Serving as evidence or proof of work done by the auditor.

However, an audit programme is not intended to serve as a “shelter” for assistants to avoid accountability or responsibility. The purpose is to guide and monitor work, not to provide protection from responsibility.

Therefore, option (c) is not an advantage of an audit programme.

Topic 7 Preliminary Engagement Activities

MCQ

Question 50

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) (i), (ii), (iv), (v)
- (d) (i),(ii),(iii), (iv)

(MTP (March 22))

Ans: (b)

Reason:

According to auditing standards, the audit engagement letter or written agreement must clearly document all the agreed terms of the audit, which include:

- (i) The objective and scope of the audit,
- (ii) The responsibilities of the auditor,

(iii) The responsibilities of management,

(iv) Identification of the applicable financial reporting framework, and

(v) Reference to the expected form and content of the auditor's report, including a statement that the actual report might differ under certain circumstances.

All these points are essential to avoid misunderstandings and set clear expectations between the auditor and the client. Hence, all five points (i) to (v) must be included, making option (b) correct.

Question 51

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.

(Study material)

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)

Reason:

Preliminary engagement activities include assessing the integrity of the client's management and key personnel, evaluating the competence of the audit team, understanding the nature of the business, and other initial considerations before accepting or continuing an audit engagement. In this case, Simran Kaur is fact-checking the promoters' integrity and competence of her staff, which are typical preliminary engagement procedures.

These activities are performed to decide whether to accept the audit and to plan the audit effectively. Therefore, the correct answer is that she is conducting preliminary engagement activities, not yet designing the audit plan or establishing audit strategy.

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)

Reason:

The overall audit strategy sets the scope, timing, and direction of the audit and considers significant factors such as the number and location of branches, applicable financial reporting framework, and timing requirements. These factors help the auditor determine the resources needed, the nature of audit procedures, and how to coordinate the audit effectively.

In contrast, developing the detailed audit plan or programme happens after the overall strategy is established. Therefore, consideration of these broad factors is primarily related to establishing the overall audit strategy.

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)

Reason:

Planned inquiries and visits are performed to gather information to identify and assess the risks of material misstatement. These procedures are part of risk assessment procedures, which are included in the audit plan. The audit plan details the nature, timing, and extent of audit procedures to be performed based on the overall audit strategy.

While the overall audit strategy sets the broad direction, specific procedures like inquiries and site visits to assess risks are planned as part of the audit plan. Thus, the description fits best under planned risk assessment procedures within the audit plan.

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)

Reason:

A detailed set of instructions given to the audit assistants in the engagement team is known as the Audit Programme. It outlines the specific audit procedures to be performed, the extent of checking, and the timing of those procedures. The audit programme serves as a practical guide for auditors to follow during the audit fieldwork to ensure that all necessary areas are covered systematically and efficiently.

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Audit Plan (option b) refers to the overall strategy and approach of the audit, including risk assessment and resource allocation.

Audit Procedures (option d) are the individual steps or tests performed but are collectively organized in the audit programme.

Audit Guidelines (option a) are general instructions or best practices but do not specify the detailed tasks for a particular audit engagement.

Hence, the detailed instructions for assistants during the audit engagement are contained in the Audit Programme.

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)

Reason:

During the audit, if new information comes to light — such as the significant generation of scrap which was not initially considered — the auditor must update the audit approach accordingly. This means revising the earlier set of instructions (audit programme) to incorporate procedures to address this newly identified area.

Ignoring the information (option a) is not appropriate because the auditor is responsible for gathering sufficient appropriate evidence on all material aspects.

Leaving it to the engagement team's discretion (option c) may lead to inconsistent or insufficient audit coverage.

Shifting responsibility to management for incomplete information (option d) does not relieve the auditor of their responsibility to plan and perform the audit properly.

Therefore, the auditor should modify the earlier set of instructions to ensure that the audit covers all relevant areas, including the scrap generated during manufacturing.

Topic 8 Factors Affecting Supervision

Question 52

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,)

Answer 52

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 53

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 May 20, RTP Nov '20)

Answer 53

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

Question 54

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.

(Study material)

Ans: (c)

Reason:

An audit programme is a detailed plan of audit procedures designed to guide the audit team in performing the audit effectively and efficiently. Its advantages include:

- (a) Guide for future audits: It helps maintain consistency and can be used as a reference for audits in coming years.
- (b) Fixes responsibility: It clearly assigns tasks to assistants, ensuring accountability.
- (d) Proof of work done: It documents the procedures performed, serving as evidence of audit work.

However, option (c) is incorrect because an audit programme is not intended to serve as a “shelter” or excuse for assistants. It does not protect assistants from accountability or scrutiny; rather, it promotes responsibility and proper performance. An audit programme

ensures the work is done systematically, but it does not provide a cover-up or shield for poor work.

Topic 9 Materiality and Risk Assessment

Descriptive Question

Question 55

The audit plan includes the nature, timing and extent of audit procedures to be performed by engagement team members. Explain.

(RTP Nov '23)

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 55

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 56

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

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

(RTP Nov'19)

Answer 56

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 57

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

(Study material)

Answer 57

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.

Topic 10 Role of Engagement Team

Descriptive Question

Question 58

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,)

Answer 58

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 59

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 May 20, RTP Nov '20)

Answer 59

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

MCQ

Question 60

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

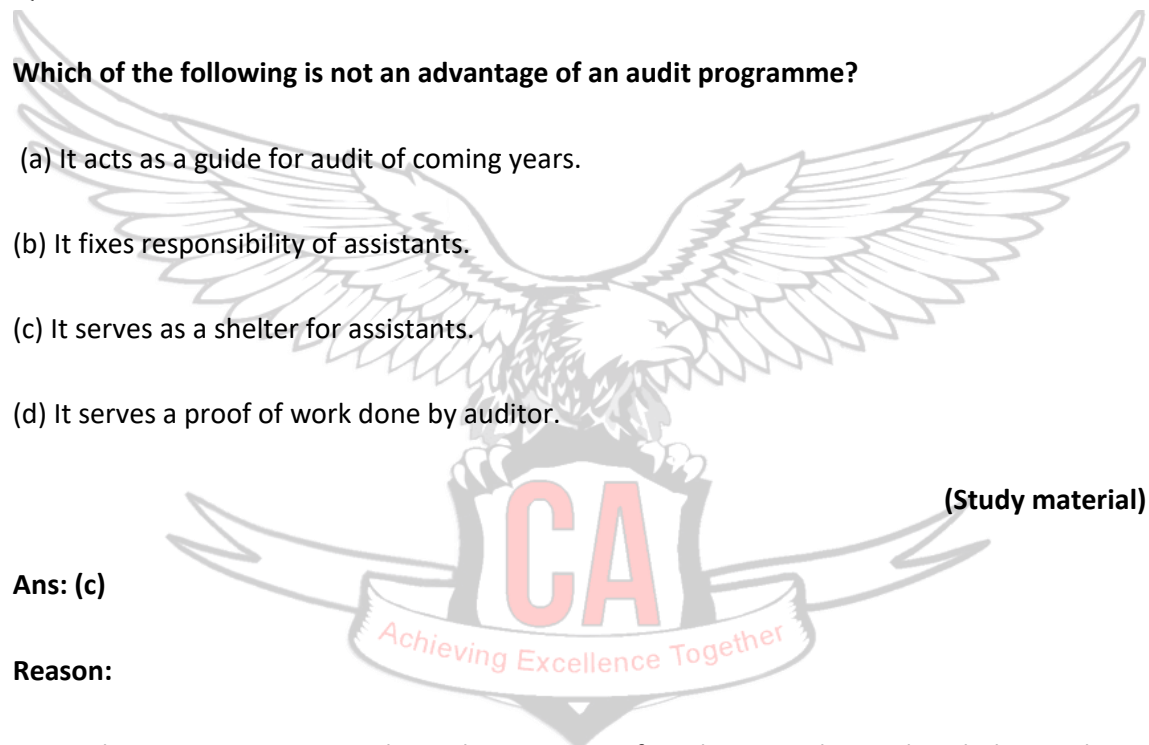
- (a) It acts as a guide for audit of coming years.
- (b) It fixes responsibility of assistants.
- (c) It serves as a shelter for assistants.
- (d) It serves as a proof of work done by auditor.

Ans: (c)

Reason:

An audit programme is a planned sequence of audit procedures that helps auditors systematically perform and document their work. Its advantages include:

- (a) Acts as a guide for future audits: The audit programme can be reused or adapted in subsequent audits, ensuring consistency.
- (b) Fixes responsibility of assistants: It clearly assigns specific tasks to audit team members, ensuring accountability.



(d) Serves as proof of work done: It documents the audit procedures performed, providing evidence of the audit work.

However, (c) is not an advantage because the audit programme is not intended to be a “shelter” or excuse for assistants to avoid responsibility or to justify incomplete or improper work. It is meant to facilitate proper and thorough audit execution, not to shield or protect anyone from accountability.

Topic 11 Modifications During Audit

MCQ

Question 61

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 May 20)

Ans: (b)

Reason:

According to auditing standards (such as SA 300), both the overall audit strategy and the audit plan are dynamic documents that need to be updated and revised as necessary during the course of the audit. This is because new information or circumstances may arise that impact the nature, timing, and extent of audit procedures.

The overall audit strategy sets the scope, timing, and direction of the audit at a high level.

The audit plan contains the detailed procedures to be performed.

Since the audit is an iterative process, these documents are not static and must be adapted to reflect changes or additional risks identified during the audit. However, the audit program (detailed steps for testing) may also be revised, but the standard specifically emphasizes updating both strategy and plan.

Hence, option (b) is correct as it includes both important elements that must be reviewed and updated.

Descriptive Question

Question 62

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 Aug '18)

Answer 62

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 63

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 March'21)

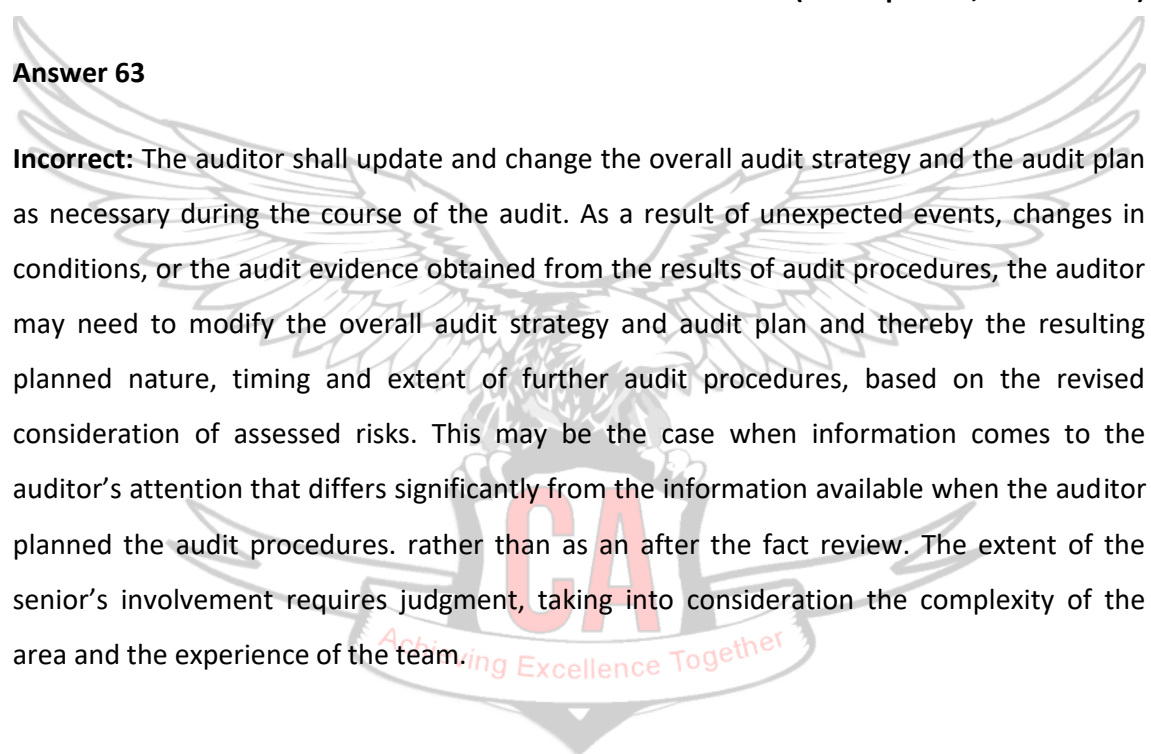
OR

Once the audit plan has been drafted and communicated, it is obligatory on the auditor to follow the same.

(MTP April '23, PYP Nov '18)

Answer 63

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. 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 64

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 May 22)

Answer 64

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 65

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

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

(RTP Nov'19)

Answer 65

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.

Topic 12 Special Industries

Descriptive Question

Question 66

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 March '23)

Answer 66

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 67

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.

(Study material)

Answer 67

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.

Topic 13 Ethical Requirements

MCQ

Question 68

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

(Study material)

Ans: (c)

Reason:

Planning an audit involves setting the overall approach and understanding key factors such as:

The legal and regulatory framework applicable to the entity (to know compliance requirements).

The determination of materiality (to focus audit efforts on significant areas).

Whether there is a need to involve experts (e.g., valuers, IT specialists) for specialized areas.

However, evaluating audit evidence is not part of audit planning. It is a part of the execution phase of the audit, where the auditor assesses the sufficiency and appropriateness of evidence obtained during the audit procedures.

Therefore, evaluating audit evidence comes after planning and is related to performing the audit, not planning it.

Hence, option (c) is the correct answer.

Question 69

Planning is a discrete phase of an audit.

(Study material)

Answer 69

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.

Topic 14 Use of Experts

Question 70

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

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

(RTP Nov'19)

Answer 70

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 71

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.

(Study material)

Answer 71

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.

Topic 15 Legal & Regulatory

Question 72

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

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

(RTP Nov'19)

Answer 72

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 73

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

(Study material)

Answer 73

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.

Chapter 3: RISK ASSESSMENT AND INTERNAL CONTROL

Topic 1 Risk of Material Misstatement

MCQ

Question 1

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

Ans: (d)

Reason:

The risk of material misstatement (RMM) at the assertion level is made up of two components:

Inherent Risk – the susceptibility of an assertion to misstatement without considering controls.

Control Risk – the risk that internal controls will not prevent or detect a misstatement.

Detection risk is not part of RMM; it is part of overall audit risk, which is managed by the auditor.

Therefore, the correct answer is (d).

Question 2

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 April'19)

Ans: (a)

Reason:

Auditors provide reasonable assurance, not absolute assurance.

They cannot reduce audit risk to zero due to inherent limitations of an audit — such as use of sampling, judgment, and the possibility of fraud.

Therefore, (a) is correct: auditors aim for reasonable, not absolute, assurance.

Correct answer: (a)

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Question 3

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 Oct 19)

Ans: (a)

Reason:

Auditors can assess the risk of material misstatement (RMM) using either:

Quantitative terms (e.g., high = 70%), or

Non-quantitative terms (e.g., low, medium, high).

There's no fixed format, and the standard allows professional judgment in expressing risk assessments.

Correct answer: (a)

Question 4

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 April '21, Nov '21, MTP April'19, MTP Oct'19)

Ans: (c)

Reason:

The Risk of Material Misstatement (RMM) refers to the risk that material misstatements already exist in the financial statements before the audit begins.

It includes inherent risk and control risk, both of which exist independently of the auditor.

Correct answer: (c)

Question 5

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 Oct'22)

Ans: (b)

Descriptive Question

Question 6

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,)

Answer 6

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 7

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 Oct'23, RTP May'18)

Answer 7

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 8

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 8

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 9

“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

(Study material)

Answer 9

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 10

“The auditor shall obtain an understanding of the control environment” Explain stating what is included in control environment.

(Study material)

Answer 10

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.

Topic 2 Control Risk

Descriptive Question

Question 11

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 Oct '23)

Answer 11

(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 12

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 12

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
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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 13

ICAI 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.

(Study material)

Answer 13

The review of internal controls will enable the auditors to know whether the controls adequately safeguard the assets.

Topic 3 Detection Risk

Descriptive Question

Question 14

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.

Answer 14

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 responsible 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 15

Discuss what is included in risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls.

Answer 15

Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-

- (a) Inquiring of entity personnel.
- (b) Observing the application of specific controls.
- (c) Inspecting documents and reports.
- (d) Tracing transactions through the information system relevant to financial reporting.

Topic 4 Audit Risk

MCQ

Question 16

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 April'19, MTP Apr'21)

Ans: (a)

Reason:

Audit Risk is the risk that the auditor gives an incorrect opinion when financial statements are materially misstated.

It is a function of:

Risk of Material Misstatement (RMM) = Inherent Risk × Control Risk

Detection Risk = Risk that auditor's procedures fail to detect the misstatement

Audit Risk = RMM × Detection Risk

Correct answer: (a)

Descriptive Question

Question 17

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 17

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 18

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 18

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 19

Internal control cannot eliminate risk of material misstatements in the financial statements.

(PYP Dec '21)

Answer 19

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.

Topic 5 Understanding the Entity & Its Environment

MCQ

Question 20

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 Oct '20, Sep'22, RTP May'21)

Ans: (c)

Reason:

The auditor uses materiality:

During planning to design audit procedures that focus on significant areas.

During performance and conclusion to assess whether identified misstatements are material individually or in aggregate.

Correct answer: (c)

Descriptive Question

Question 21

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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 Nov 22)

Answer 21

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 22

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 22

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 23

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 Nov '21, Mar'22)

Answer 23

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 24

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

(MTP 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 May '23)

OR

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. 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 Sep '23, RTP Nov 21)

Answer 24

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 25

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 April '21)

Answer 25

(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 26

The extent and the nature of the audit programme is substantially influenced by the internal control system in operation. Analyse and explain.

(RTP Nov '19)

OR

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. Analyse and explain.

(RTP Nov 18)

Answer 26

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. 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 programme. 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 programme 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 programme.

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 27

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

(Study material)

Answer 27

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.

Topic 6 IT Risks in Audit

MCQ

Question 28

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)

Reason:

Direct or backend data changes bypass normal controls in IT systems, increasing the risk of unauthorized or undetected modifications, which can lead to material misstatements.

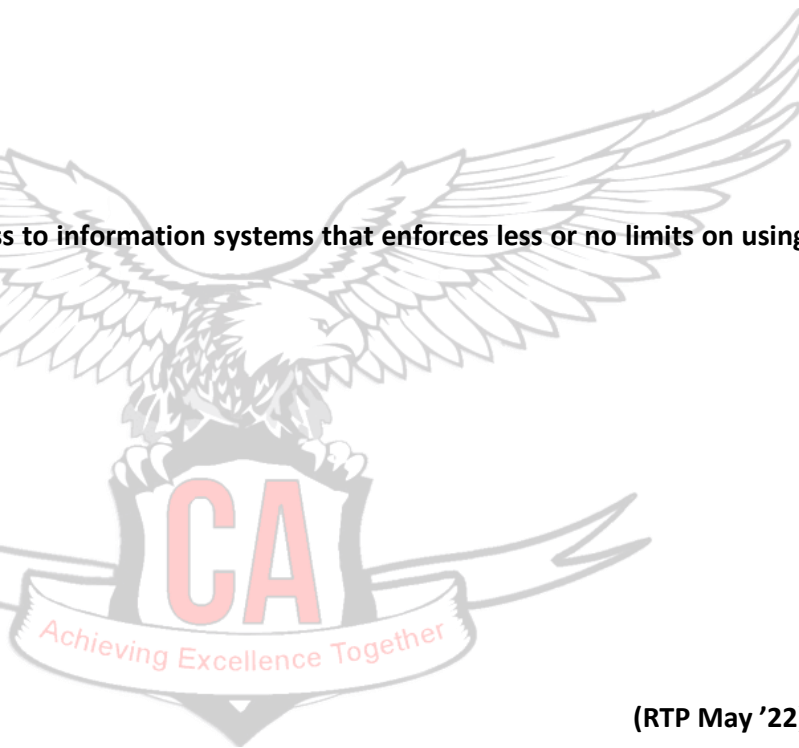
Other options (b), (c), and (d) are controls that help reduce risk.

Correct answer: (a)

Question 29

A type of super user access to information systems that enforces less or no limits on using that system is known as:

- (a) Super access.
- (b) Super user access.
- (c) Unlimited access.
- (d) Privileged access.



(RTP May '22)

Ans: (d)

Reason:

Privileged access refers to high-level or super user access that allows users to perform critical functions with minimal restrictions, such as system configuration or data changes.

It poses higher security and audit risks if not properly controlled.

Question 30

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 March '21)

Ans: (a)

Reason:

The Risk of Material Misstatement (RMM) refers to the risk that the financial statements are materially misstated prior to the audit. It comprises two components:

Inherent Risk: The susceptibility of an assertion to a misstatement due to error or fraud, assuming no related controls.

Control Risk: The risk that a misstatement that could occur in an assertion and that could be material will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Audit risk, on the other hand, is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. It is a function of RMM and detection risk.

Therefore, the correct answer is (a) Risk of material misstatement.

Descriptive Question

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Question 31

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 March '23, RTP May 20)

Answer 31

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 32

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 May 20, RTP May'23, PYP Nov'18,)

OR

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

(i) CAATs

(ii) Data Analytics

(iii) Database

(MTP Oct'22)

Answer 32

(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.

Question 33

Discuss relationship between “General IT controls” and “application controls” in an automated environment.

(Study material)

Answer 33

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.

Topic 7 General IT Controls

Descriptive Question

Question 34

ICAI 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

(Study material)

Answer

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 35

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?

(Study material)

Answer 35

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.”

Topic 8 Application Controls

Question 36

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.

(Study material)

Answer 36

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”.

Topic 9 Internal Control over Financial Reporting (ICFR)

MCQ

Question 37

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.

Ans: (b)

Reason:

Projected misstatement estimates the likely error in the population based on the sample. Anomalous misstatements are unusual errors identified in the sample. If the sum of both exceeds tolerable misstatement, it indicates the sample may not reliably represent the population, so conclusions cannot be reasonably drawn.

Descriptive Question

Question 38

ICAI 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.

(Study material)

Answer

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 39

During the audit of Apex Ltd., the auditor plans to place reliance on the internal controls related to the revenue recognition process, which appear well-designed based on the preliminary assessment. However, due to materiality of revenue and the inherent risk of overstatement, the auditor concludes that more persuasive audit evidence is needed to evaluate the effectiveness of these controls. Discuss the matters the auditor may consider in determining the extent of test of controls.

(RTP Sep. 2025)

Answer 39

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:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

Topic 10 Components of Internal Control

MCQ

Question 40

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_____ 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)

Reason:

Risk assessment procedures are performed to understand the entity and its environment, including internal controls, to identify and assess risks of material misstatement at both the financial statement and assertion levels. These procedures help plan the nature, timing, and extent of further audit work.

Descriptive Question

Question 41

Explain how Internal Financial Control and Internal controls over financial reporting differ?

(PYP Jan'21, RTP Nov'21)

Answer 41

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 42

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 42

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 includes controls over the following:”

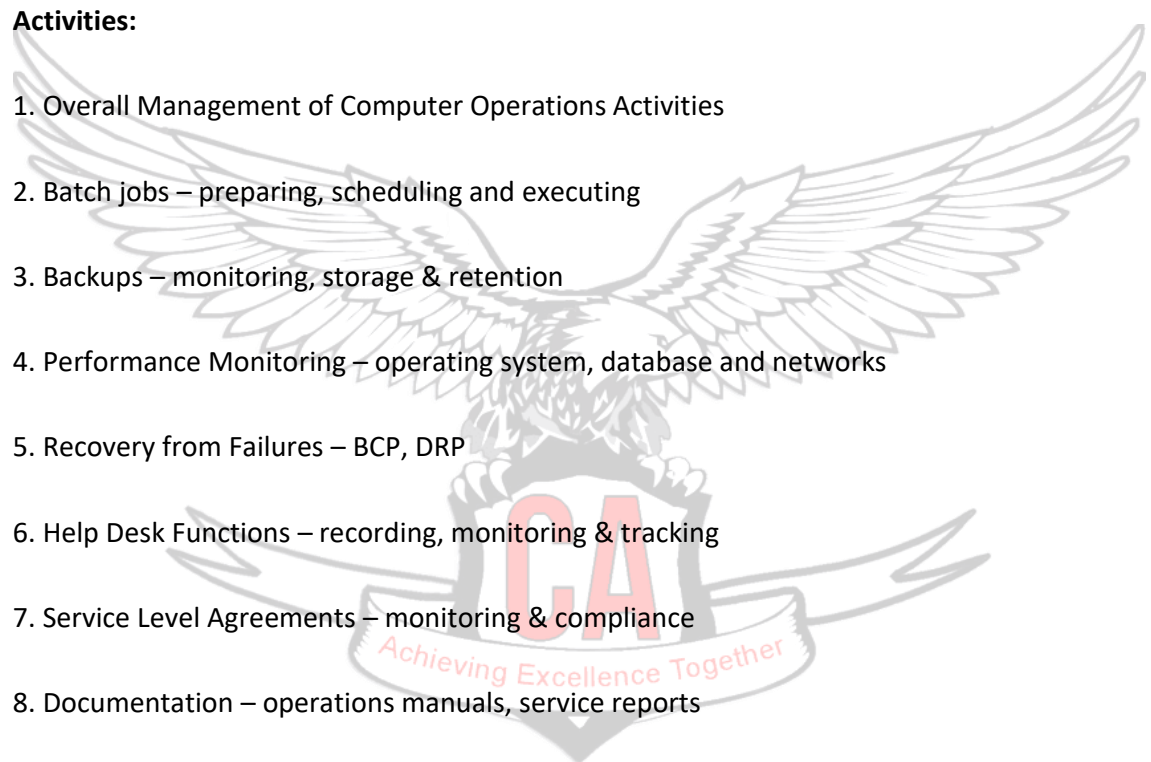
- (i) Data center and network operations
- (ii) Program change
- (iii) Access security
- (iv) Application system acquisition, development, and maintenance (Business Applications)

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 43

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 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 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 Nov'20)

Answer 43

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 44

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 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 Nov'20)

Answer 44

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. 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:

(a) Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.

(b) Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

Question 45

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 Dec '21)

What is understood by “non-routine” transactions? Briefly outline why risks of material misstatement is greater for such transactions. ()

Answer 45

Risk of Material Misstatement – Greater for Significant Non-Routine Transactions: 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. 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.

Topic 11 Types of Controls (Preventive, Detective, Corrective)

MCQ

Question 46

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) Inherent, complete
- (c) Management, unavoidable
- (d) Regulatory, control

(MTP March 22)

Ans: (a)

Reason:

Audit has inherent limitations due to factors like the nature of audit evidence, use of sampling, and judgments involved. These limitations are unavoidable, meaning even a well-planned and properly performed audit cannot guarantee detection of all material misstatements.

Descriptive Question**Question 47**

Explain the meaning of automated environment. Also discuss the key features of an automated environment.

(RTP May '19)

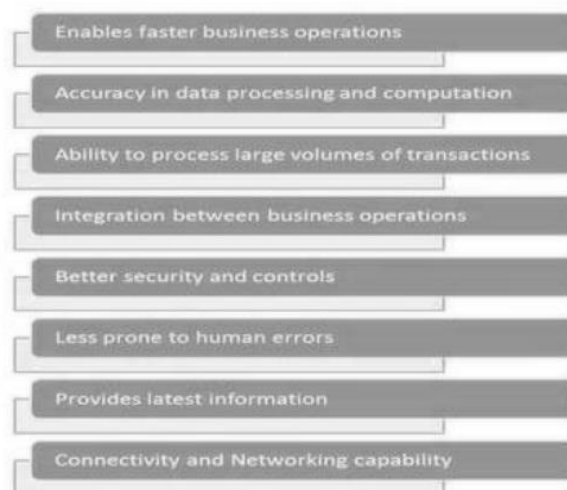
Answer 47

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



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 48

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

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

(MTP Sep'22, Oct'21)

Answer 48

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.

Topic 12 Flowcharts & Documentation of Controls

Descriptive Question

Question 49

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 Oct 18 & March 18)

Answer 49

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 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 50

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 May '23)

Answer 50

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 Rs. 2 Crores in the financial year 2021-2022. The accountant of Gama limited debited Rs. 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.

Topic 13 Material Weakness vs Significant Deficiency

Descriptive Question

Question 51

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 April '23) (PYP July '21 & May '22)

Answer 51

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:

- (a) Are there any weaknesses in IT controls?
 - (b) What is the impact of these weaknesses on overall audit?
 - (c) Report deficiencies to management – Internal Controls Memo or Management Letter.
 - (d) 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.

Question 52

Examine with reasons (in short) whether the following statements are correct or incorrect: Materiality is not a matter of size.

(MTP April '23 PYP May '22)

Answer 52

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 53

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 Nov 22)

Answer 53

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

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

Topic 14 Non-Routine Transactions

Descriptive Question

Question 54

Explain some of the commonly used methods for testing in an automated environment.

(RTP May '20)

Answer 54

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

- (a) 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.
- (b) Observe how a user processes transactions under different scenarios.
- (c) Inspect the configuration defined in an application.

Question 55

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 Oct 19)

Answer 55

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
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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 56

"Professional judgment is essential to the proper conduct of an audit." Discuss.

(MTP Oct 20) (PYP Nov '18)

Answer 56

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.

Topic 15 Role of Management & Auditor in Internal Control

Descriptive Question

Question 57

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 Nov '21, Mar'22)

Answer 57

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 58

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 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 58

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 effectiveness 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.

Topic 16 Communication of Control Deficiencies

Question 59

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 March '23)

Ans: (d)

Reason:

This is incorrect because the auditor must consider the likelihood and potential magnitude of misstatements when identifying and assessing risks. Ignoring these factors would prevent proper evaluation of material misstatement risks

Descriptive Question

Question 60

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 April 22, RTP Nov '20 & Nov '18, PYP 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 Dec '21)

Answer 60

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:

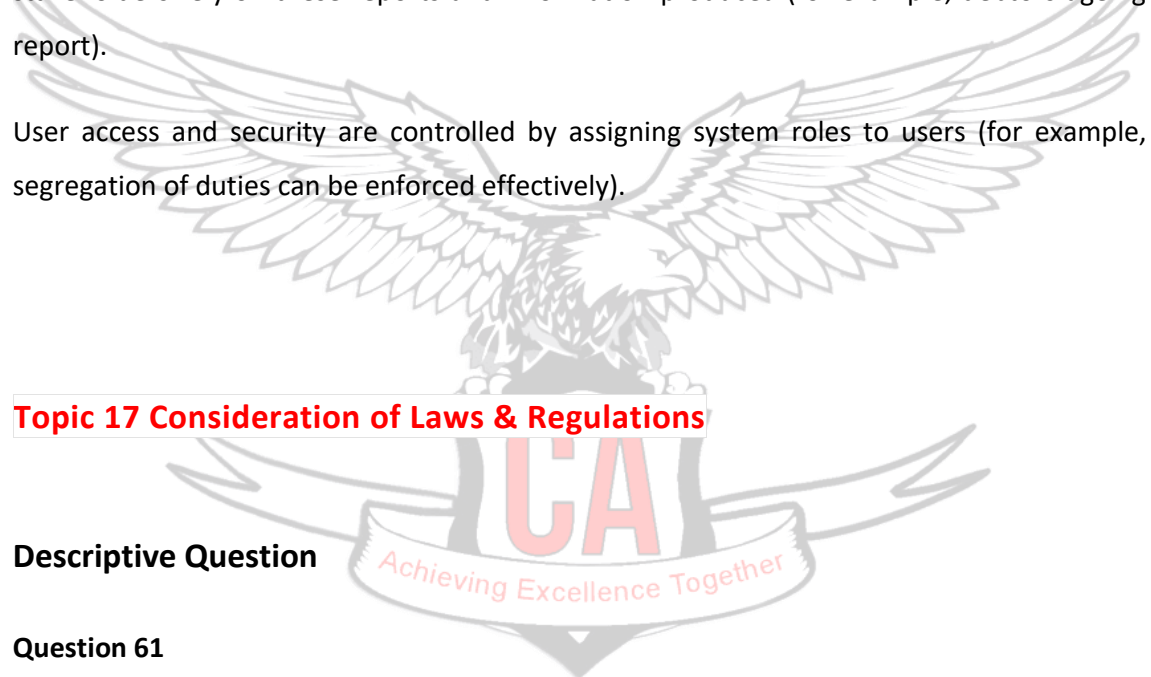
(a) Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).

(b) Accounting entries are posted automatically (for example, sub-ledger to GL postings are automatic).

(c) 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).

(d) 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).



Topic 17 Consideration of Laws & Regulations

Descriptive Question

Question 61

Explain stating clearly what is not included in Audit Risk?

(MTP Aug '18)

Answer 61

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 62

Explain the objective and enlist the activities involved in the General IT Controls over "Program Change".

(MTP Oct'22)

Answer 62

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 63

State with reasons whether the following statements are correct or incorrect inappropriate management can override internal controls of any organization.

(PYP May'22)

Answer 63

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.

Topic 18 Use of Work of Experts in Risk Assessment

Descriptive Question

Question 64

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

(i) General (IT) Controls

(ii) Material Weakness

(iii) Data Processing

(MTP March '23)

Answer 64

(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 65

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 May'22)

Answer 65

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

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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.

Topic 19 Analytical Procedures in Risk Assessment

Descriptive Question

Question 66

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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 April '23, PYP Jan '21)

Answer 66

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 off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.

Question 67

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 Nov 22)

Answer 67

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

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(ii) Security Policies & Procedures

(iii) Application Security

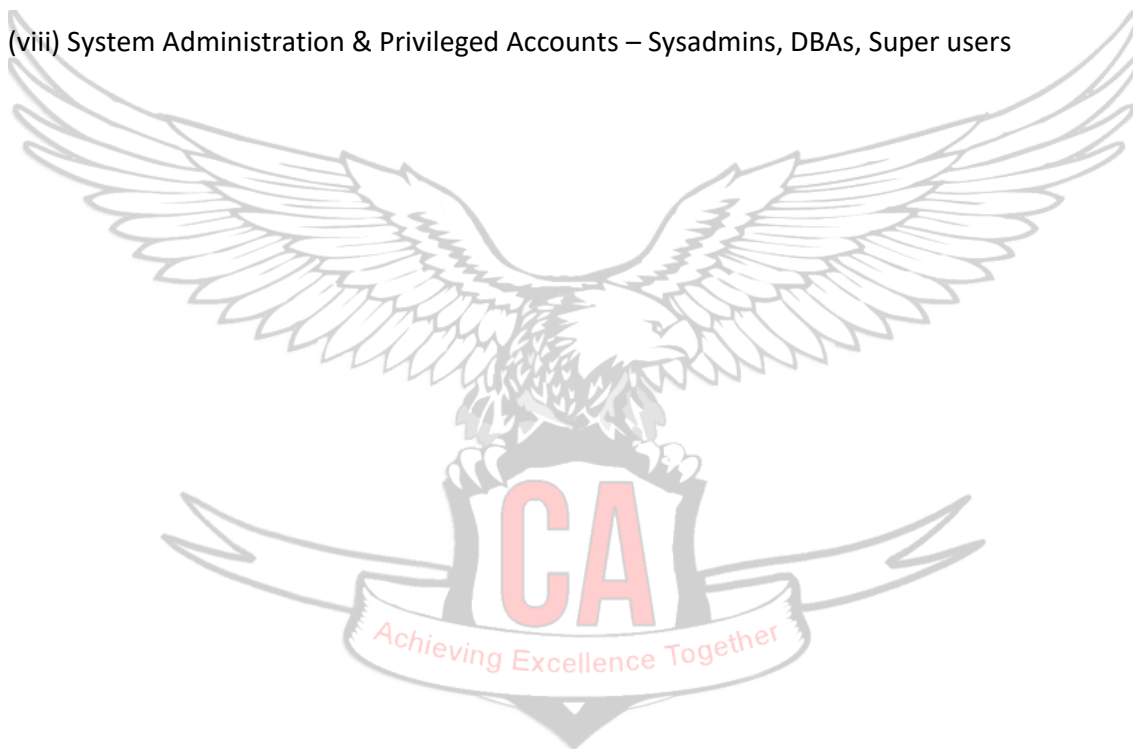
(iv) Data Security

(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



Chapter 4: AUDIT EVIDENCE

Section A

SA 610- Using the Work of Internal Auditors

Topic 1 Audit Evidence – Nature & Purpose

MCQ

Question 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 Oct'22)

Ans: (c)

Reason:

Internal audit is a broad and independent assurance function within an organization. Its scope is not limited to just financial matters but also includes non-financial activities such as operational efficiency, compliance with laws and regulations, risk management, and governance processes.

(a) is true because internal audit provides independent assurance on various aspects of the business.

(b) is true because internal audit helps identify weaknesses and improve internal controls.

(d) is true because internal auditors often review compliance with laws and regulations as part of their role.

However, (c) is not true because internal audit can and does review non-financial activities of the company, such as operational processes, IT systems, compliance, and risk management.

Therefore, option (c) is the correct answer as it incorrectly limits the scope of internal audit.

Question 2

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 Sep'22)

Ans: (a)

Reason:

Inspection as an audit procedure involves the auditor examining records, documents, or tangible assets to obtain audit evidence. In the given scenario, Mr. H and his team are thoroughly checking and evaluating the books of accounts and relevant documents of WT Limited, which directly corresponds to the inspection procedure.

Inspection refers to the examination of records or documents (like books of accounts, invoices, contracts) or physical assets.

Re-performance involves the auditor independently executing procedures or controls originally performed by the client.

Recalculation involves verifying the mathematical accuracy of documents or records.

Observation involves watching a process or procedure being performed by others.

Since the team is examining books of accounts and documents, it is a clear example of inspection, making option (a) the correct answer.

Question 3

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 above said 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 Oct '23)

Ans: (b)

Reason:

The company is engaged in dealing in commodity futures, which is a financial trading activity, not a manufacturing or production business. Therefore, cost of raw material consumed is not relevant to the nature of its operations.

Verification of turnover (a) is important to ensure the revenue from trading activities is correctly recorded.

Examination of accounting policy for revenue recognition (c) is necessary to check if revenue from futures trading is recognized appropriately as per applicable accounting standards.

Verification of contract notes with brokers (d) is crucial since these contract notes provide evidence of transactions in futures trading.

Since the company does not manufacture or consume raw materials, verification of raw material cost is not applicable, making option (b) the correct answer.

Descriptive Question

Question 4

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 May '23)

Answer 4

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.

Question 5

What is meant by sufficiency of Audit Evidence? Explain the factors affecting the auditor's judgement as to the sufficiency of audit evidence.

(MTP April '23, RTP Nov 20 & May 23)

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.

Answer 5

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:

(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 6

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 6

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

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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 all 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.

MCQ

Question 7

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 March '19)

Ans: (c)

Reason:

According to SA 520 (Analytical Procedures), analytical procedures involve the evaluation of financial information by studying relationships between both financial and non-financial data. This includes comparing current financial data with prior periods, budgets, or industry data and also considering relationships with non-financial information such as production volumes, headcount, or sales quantities.

Option (a) is incorrect because it limits the analysis to financial data only.

Option (b) is incorrect because it refers only to non-financial data.

Option (d) is incorrect because analytical procedures are broader than just ratio analysis; they include any plausible relationship analysis.

Thus, the most accurate and comprehensive definition is given in option (c).

Descriptive Question

Question 8

Explain how a statutory auditor of a company can apply analytical procedures at the planning phase of audit.

(MTP Nov '21)

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 8

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.

MCQ

Question 9

_____ 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)

Ans : (a)

Reason:

Haphazard sampling is a method where the auditor selects items for testing without any structured technique or formal randomization process. The selection is made without any conscious bias or pattern, but it is not truly random or statistically controlled. This method is often used when the auditor wants a quick, informal sample to get a general sense of the population.

Monetary Unit Sampling (b) involves selecting samples based on monetary value and is a statistical method.

Block Sampling (c) involves selecting contiguous blocks or groups of items.

Structured Sampling (d) implies a systematic or statistically planned approach to selecting samples.

Therefore, haphazard selection correctly describes a sample chosen without a structured technique.

Descriptive Question

Question 10

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 10

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 11

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 Sep '23, RTP May '23)

Answer 11

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 inspection or other audit procedures appropriate in the circumstances.

Question 12

Substantive analytical procedures are generally less applicable to large volumes of transactions that tend to be predictable over time.

(Study material)

Answer 12

Incorrect. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

Question 13

Write short notes on the following:

- (a) Advantages of Statistical sampling in Auditing.**
- (b) Stratified sampling**

(Study material)

Answer 13

- (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 Rs. 10,00,000;

(b) balances in the range of Rs. 7,75,001 to Rs. 10,00,000;

(c) balances in the range of Rs. 5,50,001 to Rs. 7,75,000;

(d) balances in the range of Rs. 2,25,001 to Rs. 5,50,000; and

(e) balances Rs. 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 Rs. 10,00,000, the auditor may examine all the items; from the second group 25 percent 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.

Topic 2 Sufficiency and Appropriateness of Audit Evidence

Descriptive Question

Question 14

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 14

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 nonfinancial 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.

MCQ

Question 15

_____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 March '21)

Ans: (a)

Reason:

Assertions are the representations made by management, either explicit or implicit, that are reflected in the financial statements. These assertions relate to various aspects such as existence, completeness, rights and obligations, valuation, and presentation. Auditors use these assertions to identify and assess the risk of material misstatements in the financial statements and to design appropriate audit procedures.

Positive Confirmation (b) is a type of audit evidence obtained by requesting confirmation from third parties.

Written representation (c) is a statement from management confirming certain matters but is not the broad concept of assertions.

Audit Evidence (d) refers to the information collected by the auditor to form an opinion on the financial statements.

Hence, Assertions are the management's representations embodied in the financial statements and form the basis for assessing potential misstatements.

Question 16

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 Sep '23)

Ans: (b)

Reason:

Audit evidence is the information collected and used by the auditor to form a basis for the audit opinion. It includes all the data and documents that support the amounts and disclosures in the financial statements, such as accounting records, invoices, confirmations, and other relevant information. The auditor evaluates this evidence to determine whether the financial statements are free from material misstatement.

Audit procedure (a) refers to the specific actions performed by the auditor to obtain audit evidence.

Audit plan (c) is a strategy outlining the nature, timing, and extent of audit procedures.

Audit programme (d) is a detailed list or schedule of audit procedures to be performed.

Thus, audit evidence is the actual information used by the auditor to arrive at conclusions and express an opinion on the financial statements.

Question 17

While auditing Happy Pvt. Ltd., CA M reviews a large number of invoices collected by the audit team. However, noticing that only a few have third-party confirmations, CA M reminds the team that simply having more documents doesn't ensure strong audit evidence and explained that reliability or quality matters too. What CA M is trying to explain in the given situation?

- (a) Sufficiency relates to quality; appropriateness relates to quantity.
- (b) Internal documents are always sufficient and appropriate.
- (c) More documents mean better audit evidence.
- (d) Sufficiency refers to quantity; appropriateness refers to quality.

Answer: (d) Sufficiency refers to quantity; appropriateness refers to quality.

Reason:

In auditing, sufficiency means having enough evidence (quantity), while appropriateness refers to how reliable and relevant that evidence is (quality). CA M is pointing out that simply collecting many documents (like invoices) doesn't ensure strong audit evidence — the evidence must also be reliable, such as through third-party confirmation. This highlights the importance of both quantity (sufficiency) and quality (appropriateness) in audit evidence.

Descriptive Question**Question 18**

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 Dec'21)

Answer 18**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 19

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 Rs. 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 Nov '21)

Answer 19

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 20

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 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 Oct 20)

Answer 20

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 21

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 nonfinancial data.

(PYP Nov 22)

Answer 21

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 22

As per the Standard on Auditing (SA) 520 "Analytical Procedures", what are the examples of analytical procedures having consideration of relationships?

(PYP Nov 22)

Answer 22

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 23

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 Oct 18)

Answer 23

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.

MCQ

Question 24

The relationship between tolerable error and sample size is

- (a) Inverse

- (b) Direct
- (c) Close
- (d) There is no relationship.

(MTP April '23)

Ans: (a)

Reason:

Tolerable error (also called tolerable misstatement) is the maximum error in a population that the auditor is willing to accept without modifying the planned audit approach. The sample size selected by the auditor is inversely related to the tolerable error.

When tolerable error is low (i.e., the auditor can tolerate very little error), the sample size increases because the auditor needs more evidence to be confident that the actual error is below the low threshold.

When tolerable error is high (i.e., the auditor can accept more error), the sample size decreases because less precision is required.

Thus, there is an inverse relationship: as tolerable error decreases, sample size increases, and vice versa.

Descriptive Question

Question 25

Explain the factors that should be considered for deciding upon the extent of checking on a sampling plan.

(RTP Nov'20 & May 19, PYP Nov '18)

Answer 25

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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 26

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 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)

Answer 26

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 27

When statistical sampling is used to select a sample, sample need not be representative because the statistical sampling takes care of the representation.

(Study material)

Answer 27

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 28

Discuss the objective of Auditor with respect to Opening balances in conducting an initial audit engagement.

(Study material)

Answer 28

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 29

ICAI 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.

(Study material)

Answer

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.

Topic 3 Substantive Procedures

MCQ

Question 30

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)

Reason:

A motor car purchased by a company like Saraswati Ltd (a packaged water manufacturer) is a fixed asset and should be classified under Property, Plant, and Equipment (PPE), not under closing inventory.

Inventory refers to goods held for sale in the ordinary course of business or raw materials, work-in-progress, and finished goods.

A motor car is a capital asset used for business operations (e.g., transportation) and not for resale.

Therefore, including the motor car in the closing inventory of goods is incorrect.

The other procedures (a), (b), and (c) are correct and relevant audit checks to verify authenticity, valuation, and ownership of the motor car.

Question 31

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 Sep'22)

Ans: (b)

Reason:

Compliance procedures are the audit firm's internal checks designed to ensure that engagement teams have adhered to the firm's quality control policies and professional standards during completed engagements. These procedures help the firm verify that audits are conducted in accordance with applicable auditing standards and firm policies.

Monitoring refers to the on going process of assessing the quality control system but is broader and continuous.

Inspection usually means examining specific audit work or files to check for compliance.

Subsequent audit procedures relate to audit work performed after the reporting period.

Hence, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies after the audit is completed are called compliance procedures.

Question 32

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 Dec '21)

Answer 32

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 33

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 March '19, Oct'18, RTP Nov '20)

Answer 33

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 34

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 Oct'22)

Answer 34

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 35

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 Nov'19, PYP May'19)

Answer 35

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 36

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 May'22)

Answer 36

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.

MCQ

Question 37

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)

Reason:

In audit confirmations, when an auditor sends a positive confirmation request, the recipient is expected to respond whether they agree or disagree with the information. If the

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confirming party fails to respond or does not respond fully, this situation is called a non-response.

Negative confirmation request means the recipient only responds if they disagree.

Exception refers to a response where the confirming party disagrees or reports a discrepancy.

Positive confirmation request is the initial request itself, not the failure to respond.

Therefore, a failure or incomplete response to a positive confirmation is correctly termed as non-response.

Descriptive Question

Question 38

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 July'21)

OR

What precautions should be taken by the auditor while applying test check techniques?

Answer 38

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:

1. Thorough study of accounting system should be done before adopting sampling
2. Proper study of internal control systems.

3. Areas which are not suitable for sampling should be carefully considered. eg: compliance with statutory provisions, transactions of unusual nature etc.
4. Proper planning for Sampling methods to be used and explaining the staff,
5. Transactions and balances have to be properly classified (stratified)
6. Sample size should be appropriately determined.
7. Sample should be chosen in unbiased way,
8. Errors located in the sample should be analyzed properly.

Question 39

It is imperative for the auditor to project misstatements for the population while performing audit procedures through sampling. Comment.

(MTP Oct'23, May '19 & Nov 23)

Answer 39

(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 projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition 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 deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

Question 40

Non statistical sampling is considered to be more scientific than the statistical sampling.

(Study material)

Answer 40

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 nonstatistical sampling, auditors' judgment and past experience is used to choose samples without any scientific method.

Question 41

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?

(Study material)

Answer 41

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

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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 42

ICAI 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.

(Study material)

Answer

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.

Topic 4 Analytical Procedures

Descriptive Question

Question 43

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 Jan '21)

Answer 43

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.

MCQ

Question 44

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 31st 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)

Reason:

When an auditor sends positive confirmation requests to confirm accounts payable balances, lack of response (non-reply) from some parties does not mean those balances can be accepted without further verification. The auditor cannot simply assume that the balances are correct just because other parties have responded.

In such cases, the auditor must perform alternative audit procedures to obtain sufficient appropriate audit evidence. This may include:

Agreeing the balances to subsequent payments made after the balance sheet date.

Examining supporting documents like invoices, purchase orders, and payment vouchers.

Verifying the transactions recorded in the books with external evidence.

Options (b) and (c) are not appropriate as the auditor cannot accept balances without evidence. The auditor has a responsibility to obtain sufficient audit evidence before concluding.

Hence, option (a) is correct because it emphasizes performing additional audit procedures in absence of confirmation replies.

Question 45

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 Sep'22, RTP May'20)

Ans: (c)

Reason:

Statement 1: Audit procedures include risk assessment procedures and other procedures (which include tests of controls and substantive procedures). Risk assessment procedures are performed to obtain an understanding of the entity and its environment, including its internal controls, to identify and assess the risks of material misstatement.

Statement 2: Substantive procedures are designed to detect material misstatements at the assertion level and consist of two types:

Test of details (of transactions, account balances, and disclosures)

Analytical procedures (evaluations of financial information through analysis of plausible relationships among financial and non-financial data).

Therefore, both statements accurately describe key concepts in auditing standards, making option (c) the correct answer.

Descriptive Question

Question 46

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 46

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 47

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 Nov 22)

Answer 47

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

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- (c) External Confirmation
- (d) Recalculation
- (e) Reperformance
- (f) Analytical Procedures
- (g) Inquiry

Question 48

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 May'18)

Answer 48

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 49

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 49

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 50

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 50

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 51

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

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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 May '23, PYP Nov'20)

Answer 51

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.

Question 52

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 52

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 53

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 April 22, RTP Nov 19)

Answer 53

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.

MCQ

Question 54

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.

(Study material)

Ans: (b)

Reason:

Related party transactions often involve parties that have close relationships with the management or controlling shareholders. Such transactions may not be conducted at arm's length and can be used to manipulate financial results or conceal fraud. Because of this close association, there is a higher risk that management might override established internal controls to hide or misstate such transactions. Therefore, the risk of management overriding controls is generally higher in the case of related party transactions.

Descriptive Question

Question 55

In stratified sampling, the conclusion drawn on each stratum can be directly projected to the whole population.

(Study material)

Answer 55

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.

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Question 56

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.

(Study material)

Answer 56

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 57

ICAI 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 Rs. 1,23,000. That trade receivable

confirmed to the auditor of Healthy and Wealthy Limited, that they were required to pay an amount of Rs. 1,23,000 to Healthy and Wealthy Limited. State and explain the type of Confirmation Request as required by the auditor.

(Study material)

Answer 57

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.

Topic 5 Assertions Used by Auditor

MCQ

Question 58

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 Oct 19)

Ans: (d)

Reason:

Options (a), (b), and (c) relate to specific evaluations that the auditor makes about the financial statements, such as assessing the appropriateness of accounting policies, consistency with the applicable financial reporting framework, and reasonableness of accounting estimates.

However, option (d) — "The sufficient appropriate audit evidence has been obtained" — is not a specific evaluation but rather a general conclusion or requirement that results from the overall audit process. It refers to the auditor's assessment of the adequacy of evidence gathered to support the audit opinion and is not considered a specific evaluation of a particular accounting aspect or disclosure.

Thus, (d) is not a specific evaluation by the auditor, making it the correct answer.

Question 59

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-Oct'19-MTP-APRIL- 2019, April '23)

Ans: (b)

Reason:

Audit evidence is the information the auditor uses to form their opinion on the financial statements. According to auditing standards (such as SA 500), audit evidence includes:

Information contained in the accounting records underlying the financial statements: This includes invoices, contracts, ledgers, journal entries, and other records that support the amounts and disclosures in the financial statements.

Other information: This refers to information outside the accounting records but relevant to the audit, such as minutes of meetings, industry data, third-party confirmations, and external reports.

Hence, audit evidence is not limited to just accounting records; it also includes other relevant information obtained by the auditor to support the audit opinion.

Therefore, option (b) is correct as it covers both types of information comprehensively.

Descriptive Question

Question 60

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 60

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 61

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 Nov'19)

Answer 61

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 62

Identify and explain briefly the audit procedure used by the auditor to obtain audit evidence in following situations:

(i) While auditing the books of accounts of ANT Limited for the financial year 2023-24, the auditor checked the complete documents and records of the company in detail to obtain audit evidence.

(ii) Mr. M, auditor of company, looks at the process of inventory counting by the entity's personnel and of the performance of control activities.

(iii) XYZ Ltd. is engaged in export of goods to Europe. The sales invoices raised in Euros are converted into Indian rupees as per applicable norms. The auditor wants to verify whether conversion of foreign currency into Indian rupees is proper or not.

(iv) CA Isha is appointed as auditor of TUV Ltd., during the initial stage of audit, she reviewed the Gross Profit Ratio of the company. She also compared GP ratio of TUV Ltd. with the other companies operating in similar industry.

(MTP-April 25)

Answer 62

Audit Procedure to obtain Audit Evidence:

(i) The audit procedure used by auditor of ANT 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.

(ii) Mr. M is using Observation as audit procedure as Observation consists of looking at a process or procedure being performed by others.

(iii) The audit procedure used by auditor is Recalculation. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

(iv) CA Isha is using Analytical Procedure to obtain audit evidence. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.

Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

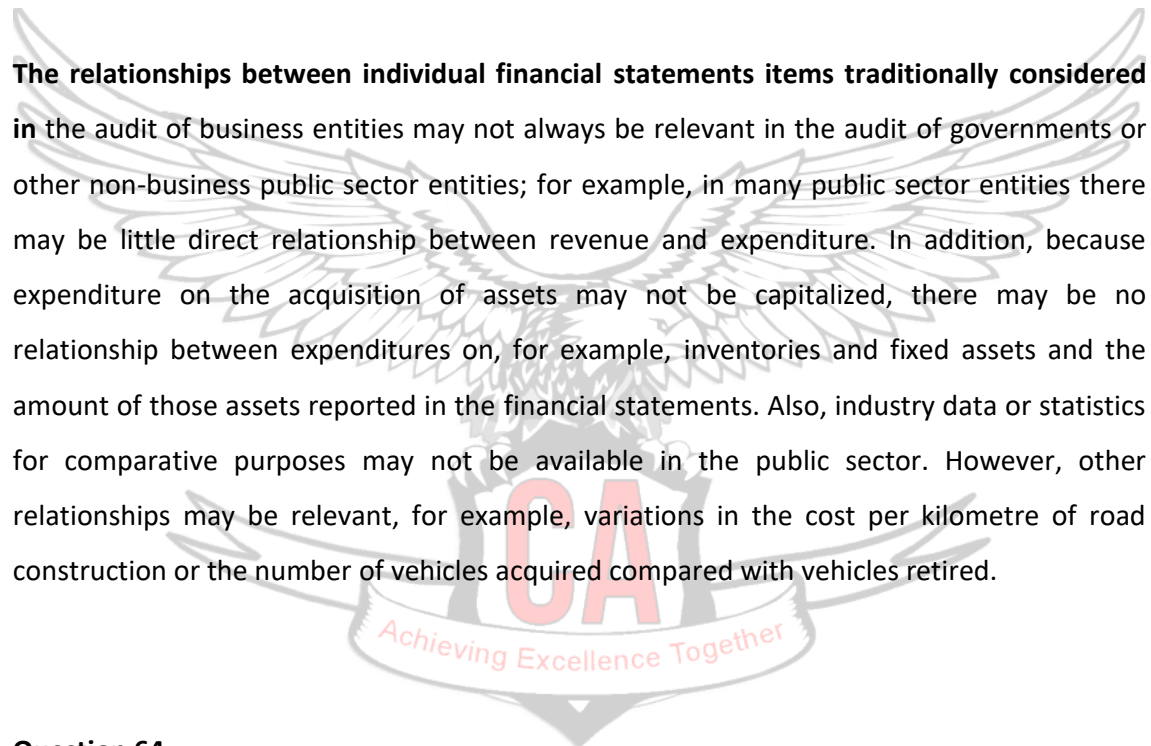
Question 63

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. Analyze and Explain.

(RTP Nov '18)

Answer 63

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 kilometre of road construction or the number of vehicles acquired compared with vehicles retired.



Question 64

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 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”.

Answer 64

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

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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 65

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 65

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 66

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 66

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 67

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 March 22)

Answer 67

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.

MCQ

Question 68

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.

(Study material)

Ans: (d)

Reason:

Statistical sampling offers several advantages in audits, such as:

- (a) Sample size does not increase proportionally with the population size: This means auditors can test a representative sample without having to test a large portion of the entire population, saving time and effort.
- (b) Sample selection is more objective: Statistical methods rely on random selection techniques, reducing auditor bias in choosing samples.
- (c) Provides calculated risk and precision: Statistical sampling allows the auditor to quantify sampling risk and set confidence levels, which improves the reliability of conclusions drawn from the sample.

However,

- (d) Suitability for verifying compliance with specific legal requirements is limited: When compliance with legal requirements is in question, auditors often need to perform 100% testing or apply specific procedures rather than rely on sampling. Sampling may miss

instances of non-compliance due to the risk that the sample does not include those transactions.

Therefore, option (d) is not an advantage of statistical sampling, making it the correct answer.

Question 69

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.

(Study material)

Answer 69

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 70

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”?

(Study material)

Answer 70

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 71

ICAI Illustration

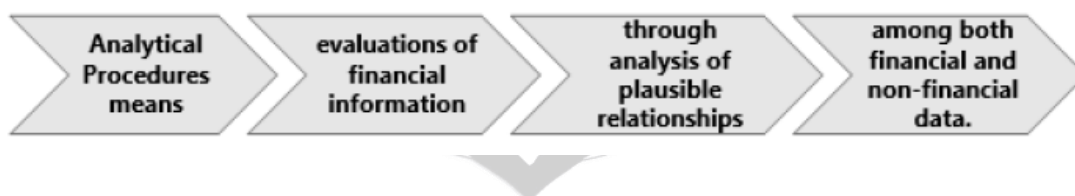
CA Aarav wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2022-23. The rent amounts to Rs.50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of Rs. 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.?

(Study material)

Answer 71

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 Rs. 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.

Topic 6 Use of Internal Audit's Work

MCQ

Question 72

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 Sep '23)

Ans: (d)

Reason:

Inspection involves detailed checking of documents and records to gather audit evidence. Since the auditor examined complete records in detail, this is classified as inspection.

Descriptive Question

Question 73

Appropriateness is the measure of the quantity of audit evidence.

(PYP May '23)

Answer 73

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 74

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 Oct'23, RTP Nov '19)

Answer 74

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:-

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(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 75

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 75

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.

MCQ

Question 76

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)

Reason:

Analytical procedures involve evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. When focusing specifically on comparisons of the entity's financial information, options (a), (b), and (c) clearly refer to comparisons:

- (a) Comparison with prior periods (internal comparison).
- (b) Comparison with anticipated results (budgets, forecasts).
- (c) Comparison with external data like industry averages.

Option (d), however, relates more to internal relationships and trend analysis within the financial data itself, such as checking for consistency in ratios or patterns, rather than a comparison with other periods, expectations, or external benchmarks.

Thus, (d) is not a comparison in the context of other sources of financial information — making it the correct answer as the one that is not an example of the specified type of analytical procedure.

Descriptive Question

Question 77

Analysis by computation of ratios includes the study of relationships between financial statement amounts. State Commonly used ratios

(RTP Nov '21)

Answer 77

Analysis by computation of ratios includes the study of relationships between financial statement amounts. Commonly used ratios include:

(a) Elements of income or loss as a percentage of sales

(b) Gross profit turnover

(c) Accounts receivable turnover

(d) Inventory turnover

(e) Profitability, leverage, and liquidity

Question 78

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 78

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 79

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)

Answer 79

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 80

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 80

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 81

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 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 81

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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.

Correct/Incorrect

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

Question 82

Purchase invoice is an example of internal evidence.

(Study material)

Answer 82

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 83

Only purpose of analytical procedures is to obtain relevant and reliable audit evidence when using substantive analytical procedures.

(Study material)

Answer 83

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 84

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".

(Study material)

Answer 84

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 85

ICAI Illustration

Particulars	Client		Industry	
	2021- 22	2022- 23	2021- 22	2022- 23
Year				
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.

Topic 7 External Confirmations

MCQ

Question 86

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 Oct'22)

Ans: (c)

Reason:

CA X is independently redoing the ageing of trade payables to verify management's work. This is called re-performance, as he is repeating the client's process to obtain audit evidence.

Question 87

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 March '19)

Ans: (a)

Reason:

This statement is incorrect because inquiry involves seeking information from _known persons_, such as management, employees, and external parties like legal advisors or customers. The term “unknown persons” is incorrect in the context of audit procedures.

Inquiries are typically directed at those with relevant knowledge, and they form an important part of audit evidence-gathering—used alongside other procedures.

Hence, option (a) is the incorrect statement.

Descriptive Question

Question 88

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 May '2018)

Answer 88

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 89

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 Oct'22)

Answer 89

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 90

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 90

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.

MCQ

Question 91

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:

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- (a) Analytical Procedure
- (b) Test of Controls
- (c) Walk Through Test
- (d) Audit Sampling

(MTP April 22 & April '23)

Ans: (a)

Reason:

The comparison of the Gross Profit Ratio with that of the previous year to identify significant changes or trends is a classic example of an Analytical Procedure.

As per SA 520 – Analytical Procedures, such procedures involve the evaluation of financial information through analysis of plausible relationships among both financial and non-financial data. A drop in gross profit ratio may indicate potential issues such as increased cost of sales, pricing problems, or errors/misstatements.

Therefore, identifying and investigating this change helps the auditor assess risks and obtain audit evidence, making option (a) the correct answer.

Descriptive Question

Question 92

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 92

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 93

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 93

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 94

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, July'21)

Answer 94

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 95

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 April '23 & Oct '23, PYP Dec '21)

Answer 95

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 96

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 Oct 18, MTP March'19, MTP 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 March '18)

Answer 96

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.

(i) 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.

(ii) 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.

(iii) 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.

(iv) 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.

(V) 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 97

Inquiry alone is sufficient to test the operating effectiveness of controls.

(Study material)

Answer 97

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 98

Reasonableness test rely only on the events of the prior period like other analytical procedures.

(Study material)

Answer 98

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 99

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?

(Study material)

Answer 99

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 100

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.

(Study material)

Answer 100

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.

Topic 8 Inventory Observation and Physical Verification

MCQ

Question 101

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)

Reason:

When the auditor and team watch a process being performed by others, such as counting inventory, it is called Observation. This procedure helps the auditor gather evidence about the performance of a process or control in real-time.

External Confirmation involves getting direct written confirmation from a third party.

Inquiry is seeking information by asking questions.

Inspection involves examining records or physical assets directly.

Since Mr. H and his team are watching the employees counting doors, this is an observation procedure.

Descriptive Question

Question 102

Examine with reasons (in short) whether the following statements are correct or incorrect:
Inquiry alone ordinarily does not provide sufficient audit evidence.

(MTP Nov '21 & March 22)

Answer 102

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 103

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)

Answer 103

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

MCQ

Question 104

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 Oct 19)

Ans: (a)

Reason:

Analytical procedures involve evaluations of financial information through analysis of plausible relationships among both financial and non-financial data, such as comparisons, ratios, and trend analysis.

Option (b) and (c) involve comparing financial data (wages to number of employees, actual costs to standard costs), which are classic examples of analytical procedures.

Option (a), tracing purchases to invoices, is a test of detail or substantive procedure, involving verification of transaction accuracy, not an analytical procedure.

Therefore, (a) is not an analytical procedure.

Descriptive Question

Question 105

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 March 22, RTP May'23)

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 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 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 Jan '21, PYP May '18)

Answer 105

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 depending upon the availability of data and requirements of the case.

Question 106

Give examples of Analytical Procedures having consideration of comparisons of the entity's financial information

(RTP Nov '19)

Answer 106

Examples of Analytical Procedures having consideration of comparisons of the entity's financial information with are:

- ❖ 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 entities of comparable size in the same industry.

Question 107

Define the following:

- (i) Positive confirmation request**
- (ii) Negative confirmation request**
- (iii) Non-response**
- (iv) Exception**

(RTP May '20)

Answer 107

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 108

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 Oct'22)

Answer 108

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 109

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 May'22)

Answer 109

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.

Question 110

Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur.

(Study material)

Answer 110

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 111

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.

(Study material)

Answer 111

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 112

What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 “Audit Sampling”.

(Study material)

Answer 112

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

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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 113

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?

(Study material)

Answer 113

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 114

Bold Ltd. supplies navy uniforms across the country. The company has 5 warehouses at different locations throughout the India and 4 warehouses at the borders. The major stocks are generally supplied from the borders. Bold Ltd. appointed M/s KPM & Co. to

conduct its audit for the financial year 2024-25. Mr. P, partner of M/s KPM & Co., attended all the physical inventory counting conducted throughout the India but could not attend the same at borders due to some unavoidable reason.

You are required to advise M/s KPM & Co.,

(a) How sufficient appropriate audit evidence regarding the existence and condition of inventory may be obtained?

(b) How is an auditor supposed to deal when attendance at physical inventory counting is impracticable?

(RTP Sep. 2025)

Answer 114

(a) As per SA 501 “Audit Evidence- Specific Considerations for Selected Items”, when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(1) 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.

(2) Performing audit procedures over the entity’s final inventory records to determine whether they accurately reflect actual inventory count results.

(b) Attendance at Physical Inventory Counting Not Practicable: In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the

nature and location of the inventory. For example - where inventory is held in a location that may pose threats to the safety of the auditor.

The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200, 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.

In some cases where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

Topic 9 Audit Sampling

MCQ

Question 115

CA Paras is auditing a firm's financial statements and performs detailed procedures to verify assertions. 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. He checks classification of expenses, ensures trade payables are genuine, compares current and past wages, examines title deeds for land, and check the accuracy of calculation of the conversion of foreign currency into Indian rupees for export invoices. Which audit

procedure he performed to verify whether conversion of foreign currency into Indian rupees is proper or not?

- (a) Inspection.
- (b) Recalculation.
- (c) Observation.
- (d) Reperformance.

(RTP-May 25)

Ans: (b)

Reason:

Recalculation is an audit procedure where the auditor independently checks the mathematical accuracy of documents or records. In this case, CA Paras is verifying the correctness of the conversion of foreign currency (Euros) into Indian rupees by checking the calculation as per applicable norms. This involves redoing the currency conversion calculations to ensure accuracy, which is a classic example of recalculation.

Question 116

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.

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(d) All of the above

(MTP April'19)

Ans: (d)

Reason:

To identify litigation and claims that might cause a material misstatement, the auditor needs to gather comprehensive information from multiple sources. This includes:

Inquiry of management and others (like in-house legal counsel) to get firsthand information about ongoing or potential claims.

Reviewing minutes of meetings and correspondence with external legal counsel to find any discussions or notifications about legal matters.

Reviewing legal expense accounts to identify unusual or significant legal costs that could indicate litigation.

All these procedures collectively help the auditor assess risks related to litigation and claims effectively, so all are necessary and included.

Descriptive Question

Question 117

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.

Answer 117

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 118

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 118

Evidence is the very basis for formulation of opinion and an audit programme 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 programme. 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) acknowledgements 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 n respect of Sales.

Question 119

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 119

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.

MCQ

Question 120

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)

Reason:

Substantive analytical procedures are more effective when applied to large volumes of transactions because such transactions usually follow predictable patterns or trends over time. This predictability allows auditors to develop expectations and identify unusual fluctuations or inconsistencies that may indicate misstatements. In contrast, small volumes or highly variable transactions make it difficult to form reliable expectations, reducing the usefulness of substantive analytical procedures.

Descriptive Question

Question 121

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 121

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 122

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 122

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 risks of material misstatement due to fraud.

Question 123

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 April 22)

Answer 123

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 124

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 124

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 125

While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

(MTP April 19, RTP Nov 18)

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 May '23)

OR

"Sampling risk can lead to erroneous conclusions". Justify.

(MTP April '21, 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 Jan'21)

Answer 125

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 126

Sufficiency is the measure of the quality of audit evidence.

(Study material)

Answer 126

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 127

Ratio analysis is useful in analyzing revenue and expense account only.

(Study material)

Answer 127

Incorrect: Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts

Question 128

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

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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.

(Study material)

Answer 128

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.

Topic 10 Inspection, Observation, Inquiry and Confirmation

MCQ

Question 129

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 instalments. The property in the goods shall be passed to M/s Jerry & Co. on the payment of last of such instalments. While checking such hire-purchase transaction, what would the auditor examine?

- (a) That the periodical instalments 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)

Reason:

In a hire-purchase transaction, it is essential for the auditor to verify that the hire-purchase agreement clearly specifies the total hire-purchase price, as this determines the amount payable and the financial treatment of the asset. This helps ensure proper recognition of asset, liabilities, and expense in the books.

Option (a) is incorrect because the periodical instalments are usually treated as a combination of finance cost and repayment of principal, not entirely charged as expenditure.

Option (c) is incorrect because depreciation is charged by the hirer (M/s Jerry & Co.) only after ownership is transferred, not necessarily by the owner (M/s Tom & Co.) throughout the life.

Therefore, (b) is the key aspect the auditor must check to confirm the terms and valuation in the agreement.

Descriptive Question

Question 130

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 130

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 131

Sufficiency is the measure of the quantity of audit evidence.

(PYP Jan'21)

Answer 131

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 132

Examine with reasons (in short) whether the following statements are correct or incorrect:
While auditing 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 conducting physical examination of assets. In the present case, audit procedure used by the auditor is known as "Observation".

(MTP Sep '23 & Oct '23)

Answer 132

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.

MCQ

Question 133

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)

Reason:

Statement I is incorrect because as per SA 520, analytical procedures involve evaluations of financial information through analysis of plausible relationships among both financial and non-financial data, not just financial data alone.

Statement II is correct because analytical procedures include investigating fluctuations or relationships that are inconsistent with other relevant information or differ significantly from expected values.

Hence, only Statement II correctly reflects the definition and purpose of analytical procedures as per SA 520.

Descriptive Question

Question 134

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 134

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 135

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
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tests of details, if any, for these assertions. Explain the other relevant points in this context.

(RTP May '20)

Answer 135

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 136

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, May'19)

Answer 136

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 137

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 Oct'22)

Answer 137

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 138

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 March '18, Mar'19)

Answer 138

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 basis on which to draw conclusions about the entire population.

Question 139

When auditor inquires the management as part of the audit procedures it should be formal written form only and not informal oral inquiries.

(Study material)

Answer 139

Incorrect: When auditor inquires the management as part of audit procedures such inquiries may range from formal written inquiries to informal oral inquiries.

Question 140

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.

(Study material)

Answer 140

Incorrect: Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Question 141

With reference to Standard on Auditing 530, state the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

(Study material)

Answer 141

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 142

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.

(Study material)

Answer 142

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 143

CA Rimi is appointed as an auditor of ASI Pvt. Ltd. During the audit, she decided to use various audit procedures to gather sufficient and appropriate audit evidence such as:

- i. While verifying the fixed asset, she examined factory equipment and verified the presence of each item.
- ii. To verify the company's accounts receivable, she directly sends balance confirmations to some of the customers.
- iii. CA Rimi examined purchase invoices, contracts, and authorisation records to assess the validity of payments and the approval process.
- iv. She independently performs the bank reconciliation that was originally carried out by the accounts department.
- v. She also checked the accuracy of depreciation calculations made by the client.

Identify and explain the type of abovementioned audit procedure performed by CA Rimi in accordance with relevant SA.

(RTP Sep. 2025)

Answer 143

As per SA 500, "Audit Evidence", auditor perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

(i) Inspection: 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.

(ii) External Confirmation: An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

(iii) Inspection: 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.

(iv) Reperformance: Reperformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

(v) Recalculation: Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Topic 11 Documentation in Audit

MCQ

Question 144

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 Oct 19, Apr'22, RTP Nov'19)

Ans: (a)

Reason:

Audit evidence is cumulative because it is gathered progressively throughout the audit from various audit procedures. The auditor collects evidence from different sources and over time, building up a body of evidence to support the audit opinion. It is not based on a single piece of information but rather the accumulation of multiple pieces of evidence.

Descriptive Question

Question 145

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 May'22)

Answer 145

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 146

CA T, the statutory auditor of a company, is in the process of designing external confirmation requests to be sent to trade receivables outstanding as of March 31, 2024. As properly designed confirmation requests are essential to ensure the reliability and effectiveness of the audit evidence obtained. Further, well-structured requests help in reducing the risk of misstatements, non-responses, or misunderstandings by the recipients.

In this context, explain why designing a proper confirmation request is necessary and discuss the key factors an auditor should consider when designing confirmation requests.

(MTP-March 25)

Answer 146

Factors to be considered in designing of External Confirmations:

The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses. Therefore, designing a proper confirmation request by auditor is necessary.

Factors to be considered when designing confirmation requests include:

- (i) The assertions being addressed.
- (ii) Specific identified risks of material misstatement, including fraud risks.
- (iii) The layout and presentation of the confirmation request.
- (iv) Prior experience on the audit or similar engagements.
- (v) The method of communication (for example, in paper form, or by electronic or other medium).
- (vi) Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
- (vii) The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

Question 147

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 147

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

(a) 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.

(b) 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.

(c) 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 148

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 Nov'20)

Answer 148

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.

MCQ

Question 149

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 May 20 & April'19)

Ans: (d)

Reason:

A negative confirmation request asks the confirming party to respond only if they disagree with the information provided. If the confirming party does not reply, the auditor assumes the information is correct. This contrasts with a positive confirmation, where a response is required whether the party agrees or disagrees.

Descriptive Question

Question 150

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 Nov'19)

Answer 150

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 nonstatistical

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 151

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 Oct 18)

Answer 151

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 152

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)

Answer 152

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

1. 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.
2. Information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties.
3. 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 153

The method which involves dividing the population into groups of items is known as block sampling.

(Study material)

Answer 153

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 154

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?

(Study material)

Answer 154

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 155

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?

(Study material)

Answer 155

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.

Topic 12 Use of Experts in Audit Evidence

MCQ

Descriptive Question

Question 156

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 Rs. 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 156

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 157

_____ 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 March 22)

Ans: (a)

Reason:

Trend analysis involves examining financial data over a period of time to identify patterns or trends. It typically compares current year figures with prior years or multiple years to analyze fluctuations and changes in accounts. This helps auditors and management understand the direction and consistency of financial performance.

Ratio analysis compares relationships between different financial statement items at a point in time but does not necessarily analyze trends over multiple periods.

Structural modelling is a more complex statistical technique, not commonly used for simple year-to-year comparison.

Account fluctuations analysis is a general term but not a specific recognized analytical procedure like trend analysis.

Hence, trend analysis is the correct term for analyzing account fluctuations over time.

Question 157

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 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 157

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 158

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 Oct'23, RTP May '23, May'22, May'19)

Answer 158

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 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.

Question 159

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 April 22, RTP Nov'22)

Answer 159

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 160

The level of sampling risk that the auditor is willing to accept will not affect the sample size.

(MTP April 22, RTP Nov '22)

Answer 160

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 161

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 161

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 162

Universe refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

(Study material)

Answer 162

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 163

Discuss some of circumstances when work of the internal auditor cannot be used by external auditor.

(Study material)

Answer 163

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 164

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?

(Study material)

Answer 164

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.

Topic 13 Legal and Regulatory Considerations in Evidence Collection

Descriptive Question

Question 165

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 165

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 166

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 March 22, RTP May 18)

Answer 166

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 167

Analytical procedures are used in all stages of audit by experienced auditors.

(PYP May '23)

Answer 167

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.

Question 168

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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 Aug '18)

Answer 168

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 169

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 April '21)

Answer 169

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 170

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 Nov '18)

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 May'22, MTP April '23)

Answer 170

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 171

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.

Answer 171

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 172

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 July'21)

Answer 172

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 173

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.

(Study material)

Answer 173

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 174

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Discuss what is understood by “appropriateness” of audit evidence.

(Study material)

Answer 174

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 175

Explain the factors to be considered while determining the extent of checking on a sampling plan.

(Study material)

Answer 175

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 176

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?

(Study material)

Answer 176

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.



Chapter 5: AUDIT OF ITEMS OF FINANCIAL STATEMENTS

Topic 1 Revenue Recognition – Audit Procedures

MCQ

Question 1

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 Rs.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)

Reason:

The company is facing a legal claim of Rs.5 lakhs, but based on legal advice, it is not probable that the company will be held liable. As per AS 29, when an obligation is possible but not probable, it is treated as a contingent liability and disclosed in the notes, not recognized as a provision.

Question 2

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

(RTP May '21)

Ans: (c)

Reason:

As per AS 29, a contingent liability is a possible obligation from past events, which will be confirmed only by the outcome of uncertain future events that are not under the entity's control. Since the obligation is not certain, it is disclosed, not recognized.

Hence, the correct answer is (c) Contingent Liabilities.

Descriptive Question

Question 3

"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 Nov'19)

Answer 3

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 4

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 Sep '23)

Answer 4

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 5

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 March '21, PYP 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 Oct '20 & April '23)

Answer 5

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 intangible 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 6

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 March '21 & Sep '22, RTP May'22)

Answer 6

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 7

Discuss the audit procedures generally required to be undertaken by the auditor while auditing Goods sent out on Sale or Return Basis.

(MTP Sep '23, PYP Nov '20)

Answer 7

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 8

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 8

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:

- (a) Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non-depreciable like freehold land;
- (b) 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.
- (c) 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 9

SRT Pvt. Ltd., based in Mumbai, is engaged in export of brassware goods. The company has huge export receivables as on 31st March 2024. It is also analysed from Export Sales account of the company that large number of small shipments were almost despatched daily during the month of March 2024. The auditor is ensuring that all goods despatched prior to the year-end have been invoiced. Which assertion concerning trade receivables is being verified by auditor? List out few audit procedures you would adopt as an auditor to verify this assertion.

(MTP-March 25)

Answer 9

Audit of Trade Receivables:

In the given situation, the auditor is verifying Completeness assertion by ensuring that all goods dispatched prior to the year-end have been invoiced.

Audit procedures to be adopted by the auditor to verify the Completeness assertion are as under:

(a) 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.

(b) Test invoices listed in receivable report. Select few invoices from the accounts receivable ageing report and compare them to supporting documentation to see if they were billed with the correct amounts, to the correct customers, and on the correct dates.

(c) Match invoices to shipping/ dispatch log. Match invoice dates to the shipment dates for those items in the shipping/ dispatch log, to see if sales are being recorded in the correct accounting period. This can include an examination of invoices issued subsequent to the period being audited, to see if they should have been included in the period under audit.

(d) Assess bill and hold sales. If there is a situation where the Company is billing customers for sales despite still retaining the goods on-site (known as “bill and hold”), examine supporting documentation to determine whether a sale has actually taken place or not.

(e) Review the receiving log to see if the Company has recorded an inordinately large amount of customer returns after the audit period, which would suggest that the Company may have shipped more goods near the end of the audit period than what the customers had authorized to inflate the profits of the company.

(f) Review the process of giving discounts/ incentives and check whether the same were given as per the Company’s policy/ general industry trends.

Question 10

If Company X's balance sheet shows building with carrying amount of Rs. 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.

(Study material)

Answer 10

Incorrect: If Company X's balance sheet shows building with carrying amount of Rs. 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 Rs. 100 lakh (Completeness assertion).

Question 11

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.

(Study material)

Answer 11

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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.

Topic 2 Audit of Sales and Debtors

MCQ

Question 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)

Reason:

As per Accounting Standard 26 (AS 26), internally generated goodwill is not recognized because it cannot be measured reliably. However, purchased goodwill, such as that arising from a business combination (e.g., amalgamation), is recognizable as it is measurable and arises from a transaction. Hence, the auditor rightly gave an example of goodwill acquired through a business combination. Correct option: (a)

Question 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)

Reason:

AS 16 deals with Borrowing Costs, not Intangible Assets.

The correct standard for Intangible Assets is AS 26.

Hence, option (d) is not correct.

Question 14

As statutory auditor of the company, list out audit procedures required to be undertaken for the following:

(i) Interest income from fixed deposits

(PYP May'18)

(ii) Dividend income.

(PYP May'18)

(iii) Gain/(loss) on sale of investment in Mutual funds.

(PYP May'18)

Also indicate disclosure requirements of above as per Companies Act, 2013.

(PYP May'18)

Answer 14

(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)

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

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

(Rs.)

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 Sep '23, MTP April 19, March'21)

Answer 15

- (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 Rs. 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 Rs. 1,66,000 to date on which Rs. 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 16

As per AS 26, internally generated goodwill is not recognised as an asset.

(MTP March '21)

Answer 16

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.

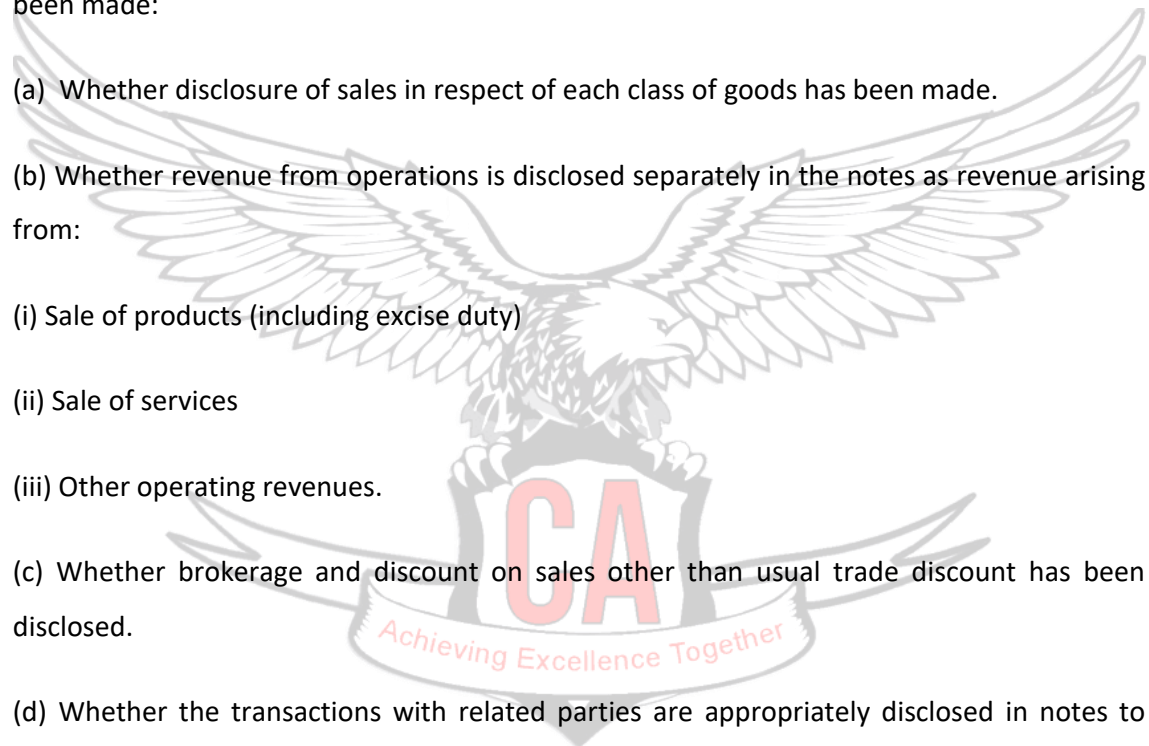
Question 17

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 March '21)

Answer 17

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:

- 
- (a) Whether disclosure of sales in respect of each class of goods has been made.
 - (b) Whether revenue from operations is disclosed separately in the notes as revenue arising from:
 - (i) Sale of products (including excise duty)
 - (ii) Sale of services
 - (iii) Other operating revenues.
 - (c) Whether brokerage and discount on sales other than usual trade discount has been disclosed.
 - (d) Whether the transactions with related parties are appropriately disclosed in notes to accounts.

Question 18

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 Oct '23)

Answer 18

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 19

While reviewing Employee benefits expenses of a company, how you as an auditor you will evaluate its hiring, appraisal and retirement process?

(PYP May'19)

Answer 19

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. If 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 20

CA Tripti is in midst of conducting audit of a company engaged in manufacturing of range of bicycles in an industrial township located in a North Indian state. As part of its activities, the company procures bicycle components from various small and medium sized enterprises. Besides, company imports few bicycle components from China on credit terms. The auditor notices that company has huge trade payables reflected in its financial statements. He wants to be sure that all trade payables reflected in financial statements have been valued appropriately. Suggest few audit procedures to be performed in this respect.

(RTP-May 25)

Answer 20

Audit of Trade Payables:

Audit procedures to be performed to verify that all trade payables reflected in financial statements have been valued appropriately are:

- Review the process followed by the Company to identify if any old creditor balance needs to be written back. 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 of payable balances, and the list of vendors with whom the Company has disputes and any claims from customers, under litigation and compare with previous year.
- Check that write backs in the trade payable balances assessed as no longer payable have been approved by an appropriate and authorised member of senior management, for example, CEO/MD.

- Check that the restatement of foreign currency trade payables has been done properly in accordance with AS 11.
- Understand management's process to identify the principal amount and the interest due thereon (if any) remaining unpaid to any Micro, Small and Medium Sized Enterprises suppliers at the end of accounting year. Test check the management process to assess if the auditor could rely on the management process.

Question 21

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.

(Study material)

Answer 21

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.

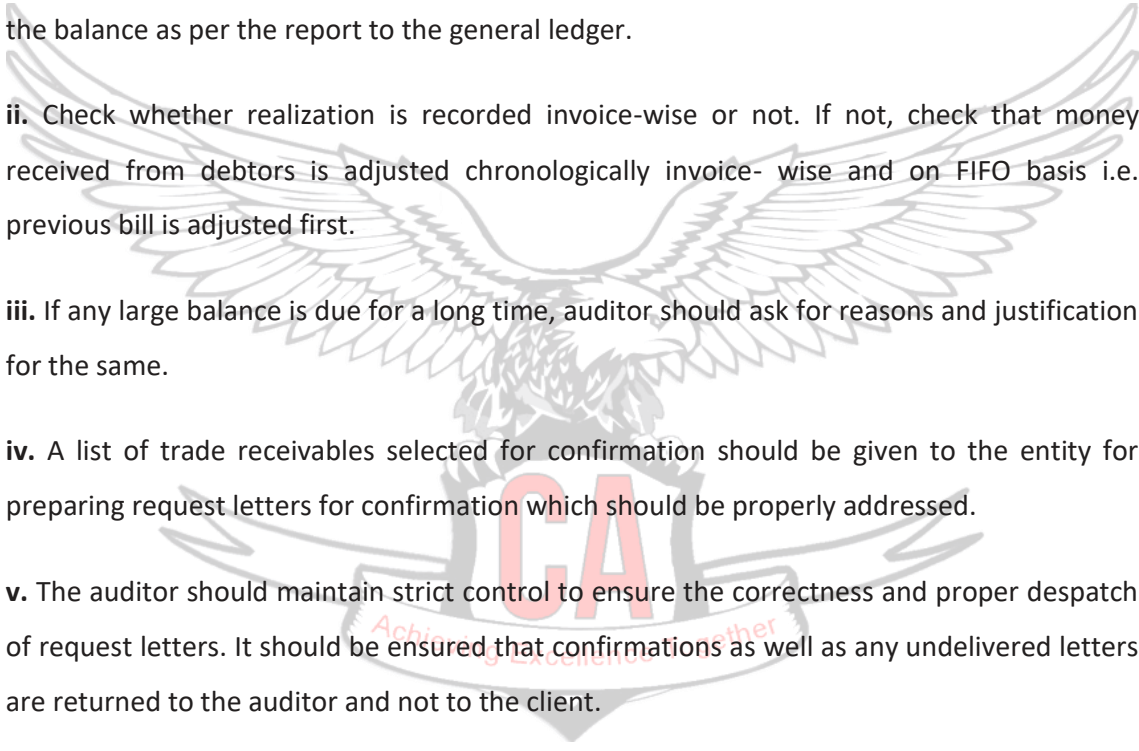
Question 22

Write the audit Procedure for verification of existence of Trade Receivables.

(Study material)

Answer 22

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.

Topic 3 Audit of Purchases and Creditors

MCQ

Question 23

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 Sep '23)

Ans: (c)

Reason:

In this case, ABC Ltd is converting yarn owned by mills into fabric, and does not own the yarn or the resulting fabric — it only earns labour charges.

The auditor wants to ensure that stock belonging to others (the mills) is not wrongly included in ABC Ltd's inventory.

This relates to the assertion of "Rights and Obligations", which verifies that the entity has legal ownership and rights over the assets it reports.

so, the auditor is checking that ABC Ltd has rights over the inventory it reports — hence, the correct assertion is (c) Rights and Obligations.

Question 24

AMN Ltd. has capitalised a software as an intangible asset in its financial statements. To verify whether the software is actively in use, the auditor reviews the sale of goods and services that rely on this software during the audit period. Which assertion regarding intangible assets is the auditor verifying?

- (a) Completeness.
- (b) Valuation.
- (c) Disclosure.
- (d) Existence.

(MTP-March 25)

Ans: (d)

Reason:

The auditor is checking whether the software actually exists and is being used in the business operations. By reviewing sales of goods and services that depend on the software, the auditor verifies that the intangible asset (software) is not fictitious and is actively in use.

This directly relates to the "Existence" assertion, which confirms that the asset recorded in the books is real and present as of the reporting date.

Hence, the correct answer is (d) Existence.

Descriptive Question**Question 25**

(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 25

(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 is 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 representation in the financial statements.

Question 26

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 April '23, PYP Dec '21)

Answer 26

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 27

Write the audit procedures to be performed as an auditor for valuation (assertion) of following:

(i) Loans and Advances and other current assets.

(PYP Nov '18)

(ii) Finished goods and goods for resale.

(MTP May '20, PYP Nov '18)

Answer 27

(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 labour, direct material and overhead have been included.
- Verify the correct application of lower-of-cost-or-net realizable value principles.

Question 28

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 April '21)(PYP May '18)

Answer 28

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 29

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 Oct'23)

Answer 29

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 30

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 Nov'20)

Answer 30

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 pre computing 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 31

CAR Ltd., an automotive parts manufacturer, appointed Amit & Associates as auditors for F.Y. 2024-25. During the audit, CA Amit noticed a significant rise in raw material consumption (steel and aluminium) despite a decrease in production. This discrepancy led to detailed reviews of vendors supplying these raw materials. While verifying the existence of vendors and the actual receipt of goods or raw materials by the company, which assertion is being verified by CA Amit. Explain the procedure for the same.

(MTP-April 25)

Answer 31

Audit of Purchases:

CA Amit is verifying Occurrence Assertion while verifying the existence of vendors and the actual receipt of goods or raw materials by the company.

The audit procedures generally required to be undertaken while verifying Occurrence Assertion: Ensure purchases are not understated/ overstated by performing following audit procedures:

- Whether any fictitious vendors have been booked or purchases have been recorded by reviewing the vendor selection process followed by the entity and also performing procedures to ensure existence of the vendors.
- Whether the goods were received at the factory gate and whether there exists an entry in the security gate inward register.
- Whether quality inspection of goods was done.
- Whether a goods receipt note was prepared and signed by an appropriate client personnel.
- Whether the purchase invoice was approved as per delegation of authority and whether a 3 or 2- way match was done.
- Whether stock record has been updated by the stores personnel.

Special considerations during audit of purchases:

- The purchase invoice received should be the “Original” copy (and not photocopy/ carbon copy) against which the entity has recorded the purchase in its books of account.
- Purchase invoice should have been booked only once risk and reward incidental to ownership has been transferred to the entity. Specific consideration for cases where the terms of delivery as agreed with vendor are F.O.B., C.I.F. etc.
- Purchase invoice should be in the name of entity. However, in case of different branches, it should be addressed to the appropriate branch.
- Input tax component should have been booked in the input tax ledger. The auditor should obtain tax returns filed with the authorities and tally the input tax as reflected in the books to the amount disclosed in the returns.
- In case of purchases made from related parties or allied and associated concerns, the auditor needs to verify if requisite approval from Board of Directors (appropriate authority)

has been obtained and should verify the selected samples and perform analytical procedures in relation to price of goods to confirm that the price charged is at arm's length.

- The auditor should review whether purchases should be capitalized or expensed off in Statement of Profit and loss according to his professional judgement.
- Review journal entries for unusual transactions

Question 32

Material and wages are considered to be revenue expenditure when incurred for construction of building.

(Study material)

Answer 32

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 33

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 Rs. 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

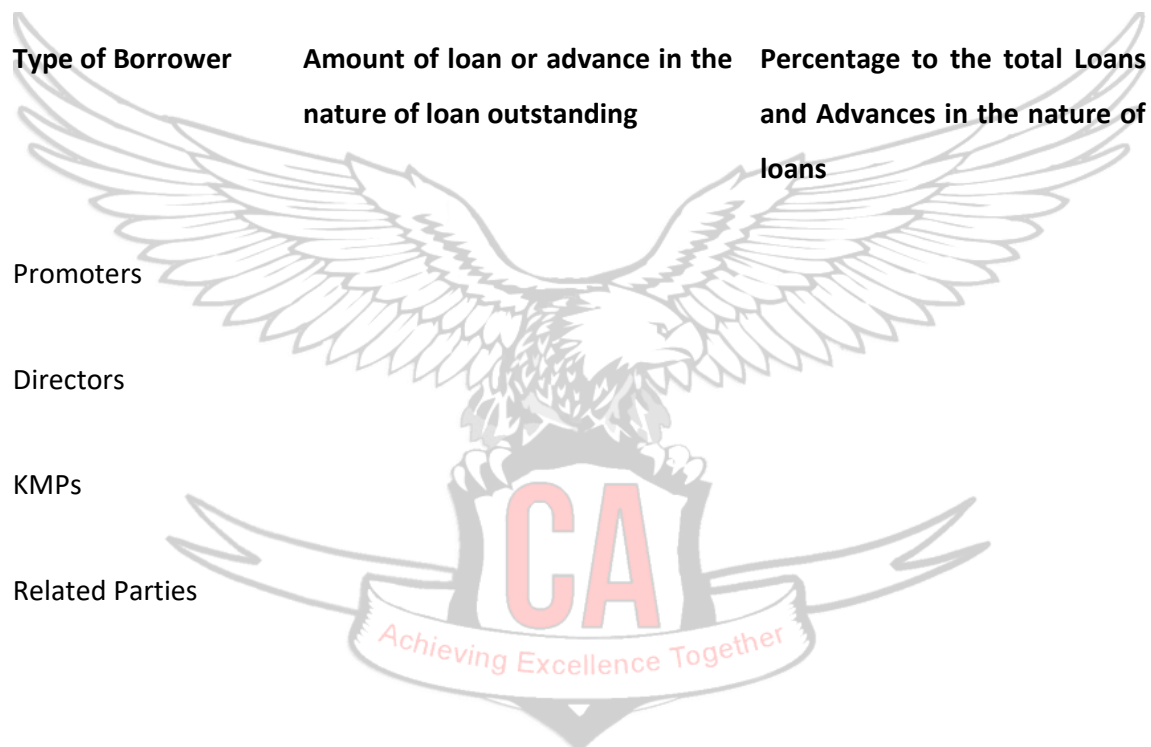
Schedule III to the Companies Act, 2013. What should Mr. Manik advise Mr. Viaan?

Answer 33

(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		



Topic 4 Audit of Inventory

MCQ

Question 34

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 Sep '23)

Ans: (d)

Reason:

As per Section 52(2) of the Companies Act, 2013, the Securities Premium Account can be used only for specific purposes, such as:

- Issuing fully paid bonus shares
- Writing off preliminary expenses
- Writing off expenses, commission, or discount on issue of shares or debentures
- Providing for the premium payable on redemption of preference shares or debentures
- Buying back its own shares under Section 68

Since writing off preliminary expenses is one of the legally permitted uses, and the other options are not allowed uses of the securities premium,

The correct answer is (d) Writing off the preliminary expenses.

Question 35

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?

Answer 35

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.

Question 36

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.

OR

An unexplained decrease in GP Ratio may result due to fictitious sales.

(RTP Nov '23 & Nov '22)

Answer 36

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 37

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 Rs. 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 March '23)

Answer 37

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
Rs.)

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

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 38

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 38

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 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 Rs. 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 Rs. 50 lakh (Completeness assertion).

Question 39

ABC Limited has a closing balance of work in progress of inventories aggregating Rs. 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 Jan'21)

Answer 39

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 40

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

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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 Rs. 5 Cr during the FY 2022-23. The shares with the nominal value of Rs. 10 per share were issued at a premium of Rs. 5 per share.

The company has the Reserves and Surplus totalling to Rs. 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 Rs. 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:

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- (i) Current maturities to long term borrowings
- (ii) Long term maturities of finance lease obligations
- (iii) Interest accrued but not due on borrowings
- (iv) Interest accrued and due on borrowings

(Study material)

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)

Reason:

This statement is not correct, which makes it the right answer to the question.

As per Section 52(2) of the Companies Act, 2013, the Securities Premium Account can be used for:

- Issuing fully paid bonus shares
- Writing off preliminary expenses
- Writing off expenses, commission, or discount allowed on any issue of shares or debentures (including equity shares)
- Paying premium on redemption of preference shares or debentures
- Buying back its own shares under Section 68

Therefore, saying that the securities premium cannot be applied to write off such expenses is incorrect.

Correct answer: (c) because it contradicts the allowed uses under the law.

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)

Reason:

A Capital Reserve is created out of capital profits, not from normal business operations. Examples include:

Revaluation reserve (option a)

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Securities premium (option b)

Capital redemption reserve (option c)

These are all capital reserves because they arise from non-operating or capital transactions.

In contrast, a General Reserve is created from revenue profits (i.e., profits from regular operations), and is therefore classified as a revenue reserve, not a capital reserve.

Hence, the correct answer is (d) General reserve — it is not a capital reserve.

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)

Reason:

Statement 1: Confirmations and undelivered letters should be sent directly to the auditor, not the client, to ensure the authenticity and reliability of the confirmation process.

Statement 2: If no reply is received from the confirmation requests, the auditor must perform alternative audit procedures to verify the balances.

Both statements align with standard auditing practices regarding external confirmations.

Therefore, both statements are correct.

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)

Reason:

Stock Composition Analysis involves examining the types and quantities of raw materials held in inventory to check if they align with the company's production requirements. This helps in assessing the overall reasonableness of purchase quantity and price by ensuring that the stock matches what should have been used or purchased.

Consumption Analysis focuses on usage, not directly on purchase quantity and price.

Reasonableness test is a broad term and less specific here.

Ratio analysis involves financial ratios but may not directly relate to purchase quantity and price of raw material.

Hence, the correct analytical procedure used for this purpose is Stock Composition Analysis.

Correct answer: (b)

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)

Reason:

As per Schedule III of the Companies Act, 2013, current maturities of long-term borrowings (i.e., the portion of long-term borrowings due within one year) must be disclosed under "Current Liabilities" and not under long-term borrowings.

Options (b), (c), and (d) correctly describe the disclosures:

Long-term maturities of finance lease obligations are under long-term borrowings.

Interest accrued but not due, and interest accrued and due, are shown under Other Current Liabilities.

Hence, (a) is incorrect because current maturities should not be shown as long-term borrowings.

Correct answer: (a)

Question 41

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PPE are depreciated when the asset is actually put to active use.

(Study material)

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

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?

(Study material)

Answer 42

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:

- (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.

Topic 5 Audit of Fixed Assets

MCQ

Question 43

_____ 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 April '23)

Ans: (b)

Reason:

A provision is a charge against profits made to cover a known liability where the exact amount is uncertain but can be estimated reliably. It ensures that expenses or losses are recognized in the period they relate to, even if the exact figure is not yet known.

Contingent liabilities are possible obligations that depend on future events and are not recognized but disclosed.

Securities Premium Reserve is a capital reserve, not related to liabilities.

Liabilities are definite obligations, not provisions.

Therefore, the correct answer is (b) Provision.

Descriptive Question

Question 44

Amortization represents systematic allocation of the depreciable amount of an item of Property, Plant and Equipment (PPE) over its useful life.

(PYP May '23)

Answer 44

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 45

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 45

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 46

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 Oct 20)

Answer 46

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
- (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 47

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 April 19, RTP Nov 18)

Answer 47

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 48

What audit points are to be borne in mind in case of issue of “Sweat Equity Shares” by a limited company?

(MTP Oct 19)

Answer 48

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 knowhow 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) 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 49

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 49

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 50

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 July'21)

Answer 50

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.)

MCQ

Question 51

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

(Study material)

Ans: (a)

Reason:

For purchase transactions, the auditor verifies the Occurrence assertion to ensure that the purchases actually took place and are genuine (no fake purchases recorded).

For trade payables, the auditor checks the Existence assertion to confirm that the liabilities recorded actually exist and are not fictitious.

Hence, the auditor is verifying Occurrence for purchases and Existence for trade payables.

Correct answer: (a) Occurrence; Existence

Descriptive Question

Question 52

Increase in authorised capital of the company requires special resolution to be passed at the general meeting.

(Study material)

Answer 52

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 53

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 Rs. 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?

(Study material)

Answer 53

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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#					Total
	Less than 6 months	6 months 1 year	1-2 years	2-3 years	More than 3 years	
(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.

Topic 6 Audit of Cash and Bank Balances

MCQ

Question 54

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

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

Read the following statements on basis of above: -

(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 Oct'22)

Ans: (d)

Reason:

The data shows cost, accumulated depreciation, and written down value (WDV) of machinery, which implies:

(i) Ownership: The machinery is recorded as an asset, so the firm owns it.

(ii) Utilization: Depreciation charged for the year indicates the machinery is being used productively in business.

(iii) Physical existence: Since depreciation is calculated, it means the machinery physically exists.

Hence, all three assertions are supported by the given information.

Correct answer: (d)

Descriptive Question

Question 55

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 Nov 22)

Answer 55

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 56

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 Oct '23)

Answer 56

(ii) Year-end inventory verification: Existence Assertion.

(iii) Depreciation has been properly charged on all assets: Valuation Assertion.

(iv) Title deed of lands disclosed in the Balance Sheet are held in the name of the Company: Rights & Obligations Assertion.

(v) All liabilities are properly recorded in the financial statements: Completeness.

(vi) Related party transactions are shown properly: Presentation & Disclosure.

Question 57

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 Oct'22)

Answer 57

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 58

Explain the difference between reserves and provisions.

(MTP March '19)

Answer 58

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 59

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 March 22, Sep 22)

Answer 59

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 60

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, etc. as at the end of the reporting period under audit. Explain the audit procedure in this context.

(RTP Nov'20)

Answer 60

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 61

When Profit before tax from continuing operations is non-volatile, other benchmarks will be appropriate.

(PYP Dec '21)

Answer 61

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.

MCQ

Question 62

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

(Study material)

Ans: (c)

Reason:

Sweat equity shares are shares issued by a company at a discount or for consideration other than cash to directors or employees as a reward for their services or know-how provided to the company. This helps the company to compensate key personnel without immediate cash outflow.

They are not issued to clients or auditors.

Hence, the correct recipients are directors or employees.

Correct answer: (c) Directors or employees

Descriptive Question

Question 63

Capital redemption reserve can be used for distribution of dividends.

(Study material)

Answer 63

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 64

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?

(Study material)

Answer 64

Capital-Work-in Progress

a) For Capital-work-in progress, following ageing schedule shall be given: CWIP ageing schedule

(Amount in Rs.)

CWIP	Amount in CWIP for a period of				Total
	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:

CWIP	To be completed in				(Amount in Rs.)
	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.

Topic 7 Audit of Expenses

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MCQ

Question 65

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 March 22)

Ans: (a)

Reason:

Obtaining the trade receivables ageing report and identifying doubtful debts helps the auditor assess whether receivables are stated at their net realizable value. This relates to the valuation assertion, which ensures assets are recorded at appropriate amounts after considering possible bad debts or impairments.

Existence verifies if receivables actually exist.

Rights and obligations confirm the company's ownership.

Completeness ensures all receivables are recorded.

Since the focus is on doubtful debts and adjusting value, the relevant assertion is Valuation.

Correct answer: (a) Valuation

Descriptive Question

Question 66

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 Nov 22)

Answer 66

Meaning of Sweat Equity & Disclosure of shares held by Promoters:

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 67

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 67

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 determined 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 68

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 Oct'22)

Answer 68

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:

1. Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non- depreciable like freehold land;

2. 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.

3. 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 69

“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 March '18, MTP Oct'18)

Answer 69

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 70

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 Sep'22)

Answer 70

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 71

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

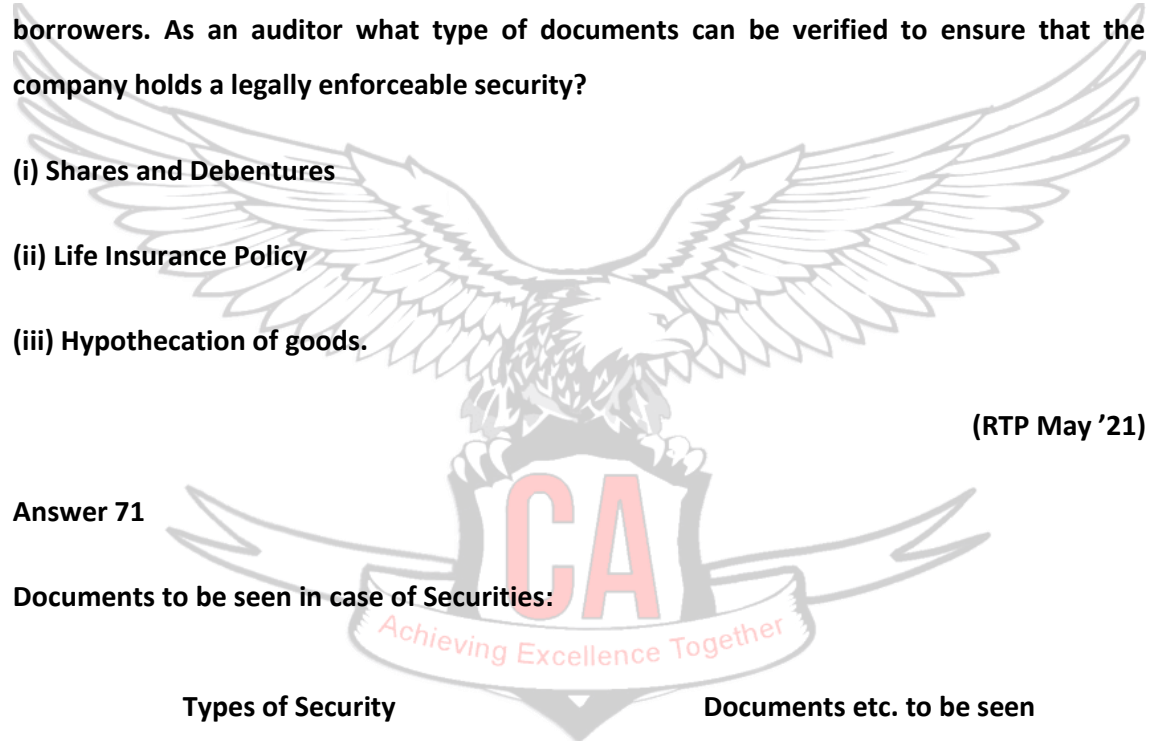
(ii) Life Insurance Policy

(iii) Hypothecation of goods.

(RTP May '21)

Answer 71

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 favor 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 72

Profit 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 Dec '21)

Answer 72

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.

MCQ

Question 73

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

(Study material)

Ans: (c)

Reason:

The cost of an item of machinery under Property, Plant and Equipment (PPE) includes all costs necessary to bring the asset to its intended use, such as:

Installation costs (a)

Freight costs (b)

Employee benefits related to making the asset ready (d)

However, inaugural costs (costs related to the first production or trial run) are not capitalized as part of the machinery cost; they are considered period expenses.

Hence, (c) Inaugural costs is not an element of the cost of machinery.

Descriptive Question

Question 74

Dividends are recommended by the Board, and declared by the Shareholders.

(Study material)

Answer 74

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.

Topic 8 Audit of Capital and Reserves

MCQ

Question 75

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 March '21)

Ans: (b)

Reason:

Revenue expenditure refers to expenses that are incurred for the day-to-day running or maintenance of assets and are charged to the Profit & Loss account immediately.

Regular repairs on Property, Plant & Equipment (PPE) are routine maintenance costs and thus considered revenue expenditure.

Other options like wages on installation (a), legal expenses on purchase (c), and freight inwards on purchase (d) are capital expenditures as they are part of bringing the asset to use.

Therefore, the correct answer is (b) Regular repairs incurred on PPE.

Descriptive Question

Question 76

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 Jan 21)

Answer 76

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 77

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)

Answer 77

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 78

Explain how you would verify Employee Benefit Expense incurred by a Company.

(MTP Sep'22)

Answer 78

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 79

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.”

Advice stating clearly the audit procedures generally required to be undertaken for verification of existence of Borrowings

(MTP March '18, Oct '18)

Answer 79

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 80

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 80

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 81

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 May'22, MTP Apr'22)

Answer 81

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.

MCQ

Question 82

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

(Study material)

Ans: (b)

Reason:

Under Cash and Cash Equivalents, companies classify items that are readily available for use.

This typically includes:

Balance with Banks (general category)

Cash on hand

Cheques on hand

However, "Balance with scheduled banks" is a more specific term and is not a mandatory classification under cash and cash equivalents. The requirement is generally to disclose cash and bank balances without necessarily breaking down between scheduled or non-scheduled banks.

Hence, (b) Balance with scheduled banks is not required as a separate classification.

Descriptive Question**Question 83**

In verifying Trade Receivables balance, Direct Confirmation Procedure is one of the important audit activity

(Study material)

Answer 83

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 he client to prepare the confirmations properly addressed to the debtors. Auditor maintains strict control over this process.

Question 84

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?

(Study material)

Answer 84

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.

Topic 9 Audit of Current and Non-Current Liabilities

MCQ

Question 85

..... 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 April 22, Oct'20, Sep 22)

Ans: (c)

Reason:

A contingent liability is a possible obligation arising from past events, where the actual existence of the liability depends on the outcome of one or more uncertain future events not fully under the entity's control.

Provisions are recognized liabilities where the obligation is probable and the amount can be estimated reliably.

Reserves are appropriations of profit, not liabilities.

Liabilities are present obligations, not uncertain ones.

Therefore, the definition fits contingent liabilities.

Correct answer: (c) Contingent Liabilities

Descriptive Question

Question 86

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 Dec '21)

Answer 86

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 87

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 87

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 88

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 April 22)

Answer 88

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 89

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 Aug '18)

Answer 89

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 to 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

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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 90

Explain how you would verify rent expense incurred by a Company.

(MTP Oct'22, RTP May 19)

Answer 90

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 91

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 91

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 92

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 Nov 22)

Answer 92

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.

Correct/Incorrect

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

Question 93

Employee benefits expenses represent the sum an entity pays to its employees for their labour/ efforts only.

(Study material)

Answer 93

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 94

How will you vouch and/or verify the following:

(a) Goods sent out on Sale or Return Basis.

(b) Borrowing from Banks.

(Study material)

Answer 94

(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 95

A company has availed cash credit facility of Rs. 2 crore (O/s balance Rs. 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.

(Study material)

Answer 95

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

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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.

Topic 10 Verification and Valuation of Assets and Liabilities

MCQ

Question 96

Cut-off testing is performed during audit of sales to address the following assertion:

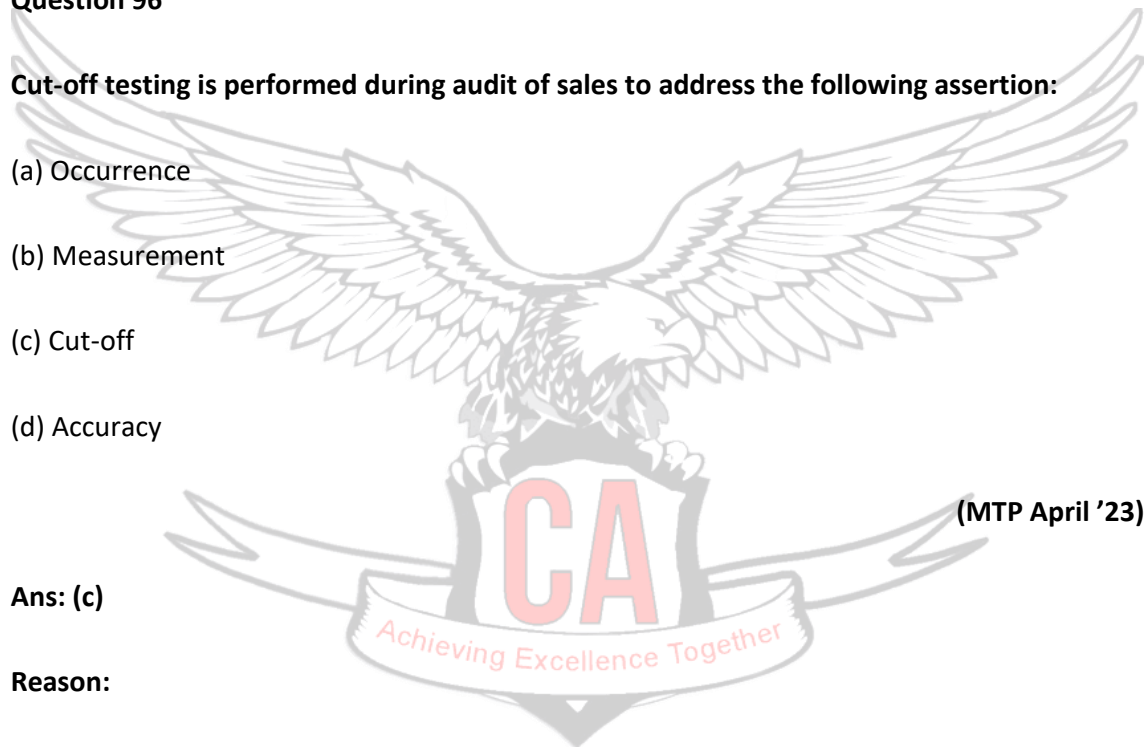
- (a) Occurrence
- (b) Measurement
- (c) Cut-off
- (d) Accuracy

Ans: (c)

Reason:

Cut-off testing ensures that sales transactions are recorded in the correct accounting period — i.e., sales that belong to the current period are recorded in the current period and not before or after. This directly relates to the cut-off assertion, which verifies the timing of transactions.

- Occurrence ensures sales actually happened.
- Measurement/Accuracy relate to amounts recorded.
- But cut-off specifically addresses the period in which the transaction is recorded.



Hence, correct answer is (c) Cut-off.

Descriptive Question

Question 97

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 Dec '21)

Answer 97

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 98

List out the steps to be taken by auditor while vouching/ verifying the 'Refund of General Insurance premium paid'.

(RTP May '21)

Answer 98

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 cheque for the refund. Sometimes, a cheque 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-in-slips can also be verified.

Question 99

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 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 March '19)

OR

Validity and consequence of issue of shares at discount check with respect to the provisions of the Companies Act 2013.

(PYP 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 May '23)

Answer 99

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.

Question 100

Explain with examples the audit procedure to establish the existence of intangible fixed assets as at the period- end.

(MTP April 19, RTP Nov '19 & Nov '18)

Answer 100

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 101

The auditor may choose to analyse the monthly trend for Power & Fuel expense. Explain how this analysis will be performed by the auditor

(MTP Nov '21, RTP May 19)

Answer 101

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 102

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 102

(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 claims

- a. 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 103

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 Nov 22)

Answer 103

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 104

Dividends are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established.

(Study material)

Answer 104

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 105

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.**

(Study material)

Answer 105

(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 106

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).

(Study material)

Answer 106

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.

Topic 11 Cut-off Procedures in Audit

MCQ

Question 107

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 Sep '23)

Ans: (b)

Reason:

The auditor is verifying that the bills recorded in the “Machinery repair” account are correctly entered and properly classified. This involves examining the individual transactions to ensure accuracy and validity.

- Tests of transactions focus on verifying the details of individual transactions during the period.
- Tests of controls evaluate the effectiveness of internal controls.
- Tests of balances verify the year-end balances, not individual transactions.
- Risk assessment procedures are preliminary steps to identify risk areas.

Hence, the auditor is performing tests of transactions.

Correct answer: (b) Tests of transactions.

Descriptive Question

Question 108

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 July'21)

Answer 108

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 109

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 109

(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 110

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?

(Nov '21)

Answer 110

Examples of costs to be excluded in determining cost of Inventory:

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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 111

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 Oct 19)

Answer 111

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(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 112

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 March '23, RTP May 23, PYP Dec'21)

Answer 112

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 113

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 113

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 despatch 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 114

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 Nov 22)

Answer 114

Disclosure of Crypto Currency or Virtual Currency:

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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 115

“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.

(Study material)

Answer 115

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 116

How will you vouch and/or verify payment of taxes?

(Study material)

Answer 116

(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 117

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.

(Study material)

Answer 117

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 118

Identify and explain the assertions that the auditor will check by performing the following audit procedures:

- (i) Employee benefit expenses recognised during the period relates to the current accounting period only.**
- (ii) Employee benefit expenses in respect of all personnel have been fully accounted for.**
- (iii) Any inventory held by the entity on behalf of another entity has not been recognised as part of inventory of the entity.**
- (iv) Recorded sales represent goods which were ordered by valid customers and were despatched and invoiced in the period.**

(RTP Sep. 2025)

Answer 118

- (i) The auditor will check the cut-off assertion to ensure that whether all income and expenses are reported in the-correct accounting period. Cut-off is a separate assertion because the substantive procedures to verify it are typically different from those applied to the other components of completeness.**
- (ii) The auditor will check the completeness assertion for the same to ensure that all transactions that were supposed to be recorded have been recognised in the financial statements. Transactions have not been omitted.**

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(iii) The auditor will check rights & obligations assertion to ensure that the entity has the right to assets i.e. (whether the entity has ownership and legal title to assets) and the liabilities recognised in the financial statements represent all the entity's obligations to repayment as at a given date.

(iv) The auditor will check the occurrence assertion for the same to ensure that transactions recognised in the financial statements have occurred and relate to the entity.

Topic 12 Analytical Procedures for Financial Statement Items

MCQ

Question 119

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 Sep '23)

Ans: (a)

Reason:

The auditor is verifying that the sales recorded actually took place—i.e., goods were genuinely ordered, dispatched, and invoiced to valid customers. This addresses the Occurrence assertion, which ensures that recorded transactions are real and not fictitious.

- Measurement relates to the accuracy of amounts.
- Cut-off deals with timing of recording.
- Accuracy ensures amounts are correct.

Since the focus is on validity of sales, the correct assertion is Occurrence.

Correct answer: (a) Occurrence.

Descriptive Question

Question 120

As a Statutory Auditor of the company list out audit procedure required to be undertaken for the recognition of following other income:

- Interest income from fixed deposit**
- Dividend income**
- Gain/(loss) on sale of investment in mutual funds.**

(PYP Jan'21)

Answer 120

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 121

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 121

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 122

"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 Oct '21, PYP Nov '18)

Answer 122

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

Question 123

"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 May 20, Apr'21)(PYP May '19)

Answer 123

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 124

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 March '23)

Answer 124

- (a) Completeness

(b) Measurement

(c) Cut Off

Question 125

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 125

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 126

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?

(May '23, RTP May '22, RTP Nov'21)

Answer 126

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 127

Capital reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose.

(Study material)

Answer 127

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Incorrect: Revenue reserves represent profits that are available for distribution to shareholders.

Question 128

How would you vouch/verify the following:

(a) Advertisement Expenses.

(b) Sale of Scrap.

(Study material)

Answer 128

(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.

Topic 13 Documentation and Evidence in Item-wise Audit

Question 129

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 Jan'21 & May '18)

Answer 129

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:

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- 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 130

While verifying the legal and professional expenses of the client company, what audit procedures should the auditor perform?

(MTP March '23)

Answer 130

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 131

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 March '21, Apr'21)

Answer 131

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 132

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 Oct 20)

Answer 132

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 133

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 Sep '23, PYP, Nov '20)

Answer 133

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 134

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 134

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 135

Identify and explain the assertions that the auditor will check by performing the following audit procedures:

- (i) Inventory recognised in the balance sheet actually existed as at the period end.**
- (ii) All the items of inventory pertaining to the relevant year shall be included regardless of the location.**

(iii) All goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis.

(iv) Examine client correspondence, sales and receivables records, purchase documents.

(v) Verifying that the entity has charged depreciation on all items of PPE unless any item of PPE is non-depreciable like freehold land.

(MTP-April 25)

Answer 135

Assertions:

(i) The auditor will check the Existence Assertion to ensure Assets, liabilities and equity balances exist as at the period end.

(ii) The auditor will check the Cut-off assertion to ensure that all assets and liabilities are reported in the appropriate period.

(iii) The auditor will check Completeness Assertion to ensure all Trade receivable balances that were supposed to be recorded have been recognized in the financial statements.

(iv) The auditor will check Rights & Obligations assertion to ensure that the entity has valid legal ownership rights over the inventories claimed to be held by the entity and recorded in the financial statements.

(v) The auditor will check Valuation assertion to ensure PPE have been valued appropriately and as per generally accepted accounting policies and practices.

Question 136

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.

(Study material)

Answer 136

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 137

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.

(Study material)

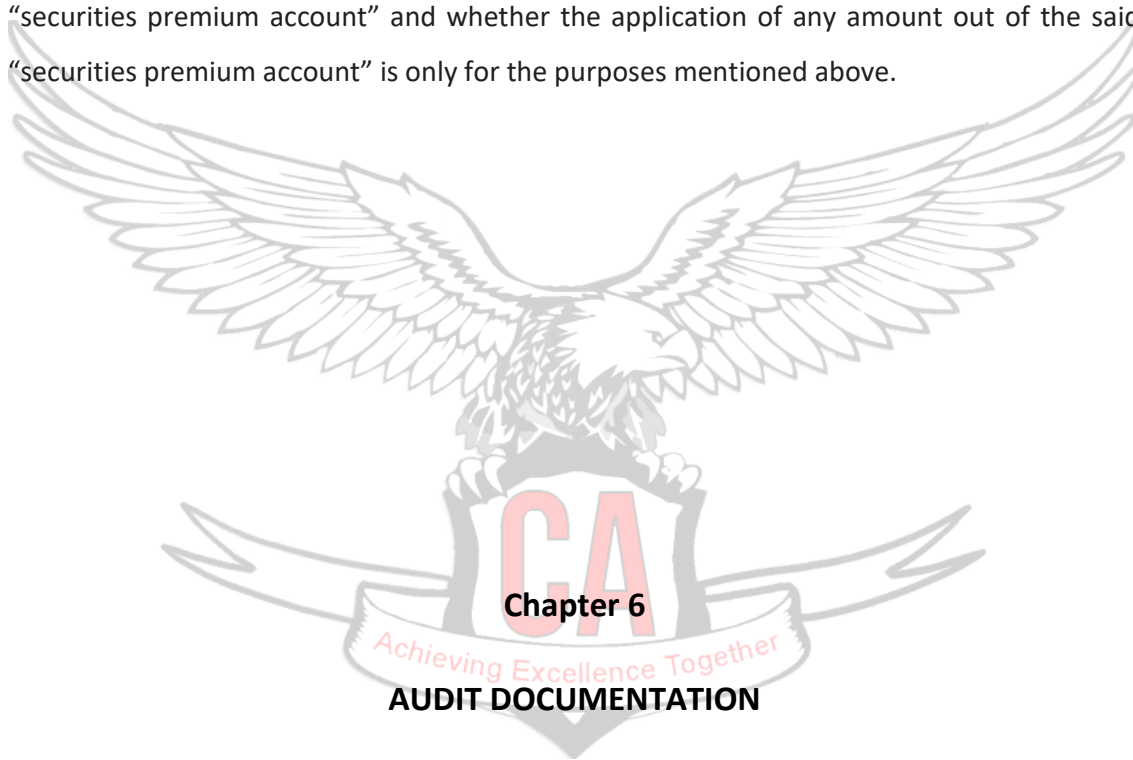
Answer 137

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.



Topic 1 Meaning and Definition of Audit Documentation

Question 1

_____ 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 March '23)

Ans: (c)

Reason: Audit documentation refers to the written record of audit procedures performed, evidence obtained, and conclusions reached by the auditor. This documentation serves as a record to support the audit opinion and provides evidence of compliance with auditing standards. It is a critical component of the audit process, ensuring transparency, reliability, and accountability in the auditor's work.

Option (a) Audit Techniques refers to the methods or approaches used by the auditor to gather audit evidence.

Option (b) Audit Evidence refers to the information collected during the audit to support the auditor's opinion.

Option (d) Audit Procedures record is not a standard term used in auditing practices.

Question 2

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

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(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

(Study material)

Ans: (c)

Reason

Audit documentation primarily focuses on gathering evidence and providing support for the auditor's opinion regarding financial statements, compliance, and going concern assumptions.

Option (a) Previous years audited financial statements: These are relevant to the current audit as they are necessary for comparative analysis and to assess trends, errors, or issues in financial reporting.

Option (b) Projected cash flow statement for the next twelve months: This is important for assessing the going concern assumption of the company. The auditor needs this information to evaluate the company's ability to continue operations in the foreseeable future.

Option (d) Statement showing verification of ageing of trade receivables: This is directly relevant to the audit process. The auditor verifies the ageing of trade receivables to assess the likelihood of collection and evaluate potential bad debts.

However, Option (c), the statement showing dispatch of overseas consignments, is less likely to be included in audit documentation, as it pertains more to the operational side of the business rather than financial reporting. While it may be part of the company's operational records, it is not directly related to the financial statement audit unless specific concerns arise. Therefore, it is less likely to be included in the documentation supporting the financial audit.

Question 3

“Audit documentation summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits”. Explain.

(Study material)

Answer 3

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.

Topic 2 Purposes of Audit Documentation

Question 4

Discuss any two purposes of audit documentation.

(Study material)

Answer 4

The following are the purpose of Audit documentation:

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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 5

ICAI 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.

(Study material)

Answer 5

Audit Documentation of a company is not the property of the company rather Audit Documentation is the property of Auditor of that company.

Question 6

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?

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Answer 6

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.

Topic 3 Contents of Audit Documentation

Question 7

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 inter-shuffling of team members is frivolous.

Ans: (c)

Reason

Audit documentation serves as a record of the actual work performed during the audit. Any deviation from the planned assignment of tasks, such as when one auditor (Rohit) is assigned work that another auditor (Mohit) is performing, or when a third-party professional (CA Rajan Pillai) takes over a task originally planned for Rohit, needs to be documented.

Option (a) is incorrect because while the audit programme may list persons and duties, the actual performance of duties by different individuals should be documented, ensuring accountability and consistency.

Option (b) is incorrect because, although responsibilities are assigned, it is common for circumstances to require a change in who performs certain tasks, especially in the case of unplanned issues. The change needs to be documented.

Option (d) is incorrect because it assumes that only the involvement of an external party (not part of the engagement team) requires documentation. Internal changes to team responsibilities should also be documented for clarity and accountability.

Thus, Option (c) is the most appropriate because it emphasizes the need for updating the audit programme or adding explanatory notes in the working papers to reflect actual performance, ensuring transparency and maintaining proper documentation of the audit process.

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)

Reason

Materiality is a critical concept in auditing, as it helps the auditor determine whether misstatements or omissions in the financial statements could influence the economic decisions of users. The auditor's professional judgment is essential in determining materiality, and the factors considered should be documented to ensure transparency and provide a clear basis for the auditor's decisions.

Option (a) is incorrect because materiality should always be documented in the working papers, as it is essential to support the auditor's judgment and the conclusions drawn during the audit.

Option (b) is partially correct but lacks the detail required. It is important to document not only the amount but also the factors that led to the determination of materiality.

Option (d) is incorrect because materiality is an essential factor in the audit process and should always be documented. The auditor's judgment does not allow them to omit documentation of such key decisions.

Thus, Option (c) is the most appropriate because it ensures that both the determination of materiality and the factors influencing that judgment are documented, providing a clear record for future reference and accountability.

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)

Reason

When assessing the risk of material misstatements, auditors consider various factors and make judgments based on their understanding of the entity and its internal controls. However, there is no "precise calculation" of the risk of material misstatements, as the assessment is based on professional judgment and qualitative factors rather than a formula or exact calculation. The risk is assessed on a spectrum, considering the nature of the entity's activities, internal controls, financial reporting risks, and other elements.

Option (a) is correct because discussions among the engagement team about risks and the decisions made should be documented to ensure that there is a record of how the team reached their conclusions.

Option (b) is correct because documenting the procedures performed to assess risk is essential for transparency and accountability.

Option (c) is correct because documenting how the team gained an understanding of internal controls is necessary to support the risk assessment and audit strategy.

Thus, Option (d) is the odd one because a "precise calculation" of risk is not feasible or required in audit documentation; the risk is determined through professional judgment, not through a calculable figure.

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)

Reason

In the context of audit documentation related to the physical inventory count, the auditor's primary focus is on verifying the existence and accuracy of the inventory, not on ensuring that the inventory conforms to quality control standards. While the auditor may note any issues related to the quality of goods if it affects financial reporting, it is not typically part of the standard audit documentation unless the quality issue affects the valuation of inventory (e.g., obsolete goods).

Option (a) is true because documenting the dates and photographic evidence of the auditor's attendance during the inventory count is an important part of audit documentation, ensuring proper supervision and verification of the process.

Option (b) is true because documenting the test counts undertaken by the auditor helps provide evidence of the accuracy of the physical count and the reliability of the inventory records.

Option (c) is true because documenting details of obsolete goods found is essential, as it may affect the valuation of inventory and, consequently, the financial statements.

Thus, Option (d) is the correct answer because it is not necessary for the auditor to document reports regarding conformity to quality control standards unless those issues affect the financial reporting or the valuation of inventory.

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)

Reason

In the context of related party transactions, auditors need to assess whether such transactions are conducted at arm's length to ensure that they are fair and in line with market conditions. Transactions at close length do not conform to auditing standards, as it is not a recognized or acceptable term for related party transactions. The correct term is "arm's length," which means that transactions are conducted as if the parties were unrelated, ensuring fairness.

Option (a) is correct because a management representation letter related to related party transactions is an essential part of the audit documentation. It serves as a formal statement from the management confirming the accuracy and completeness of related party transactions.

Option (b) is correct because the related party transaction policy of the company is relevant to understand the company's approach and controls around such transactions, ensuring compliance with regulations.

Option (c) is correct because the auditor needs to document that the related party transactions were conducted on an arm's length basis, ensuring that the transactions are fair and reasonable.

Thus, Option (d) is the correct answer because "close length" is not a recognized term in the context of related party transactions, and it should not be part of the audit documentation.

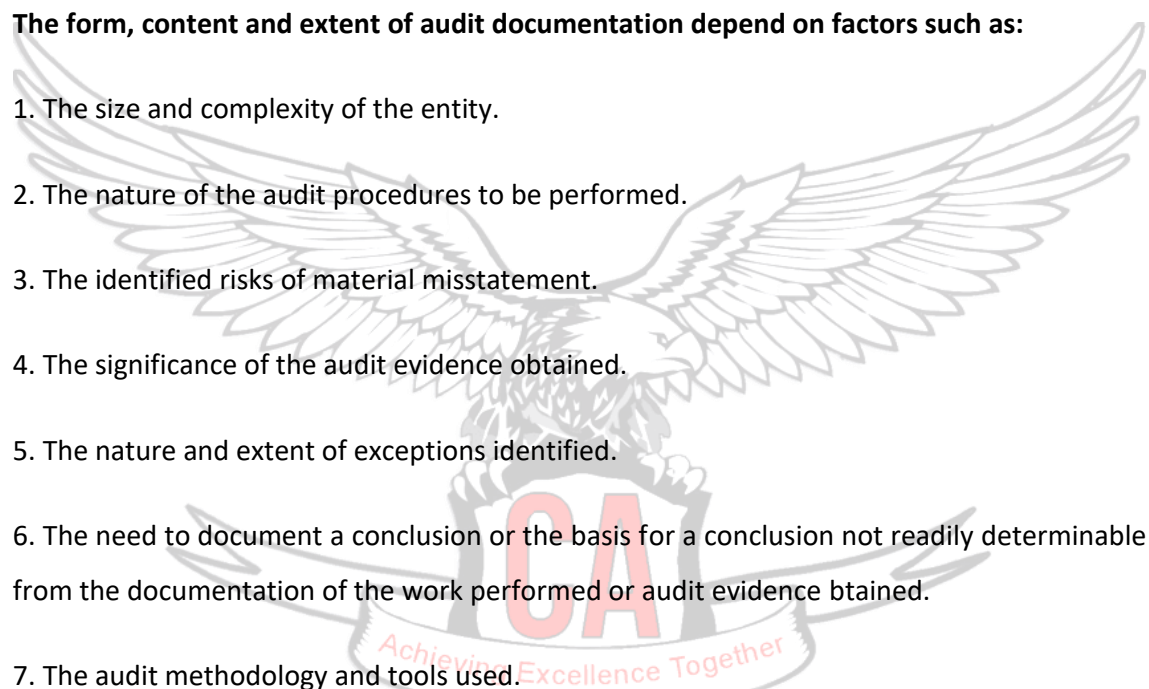
Question 8

The form, content and extent of audit documentation depends upon number of factors.
List out any four such factors.

(Study material)

Answer 8

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 9

ICAI 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.

(Study material)

Answer 9

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 10

ICAI 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.

(Study material)

Answer 10

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.

Topic 4 Form, Content and Extent of Audit Documentation

Question 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

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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)

Reason

Audit documentation should include sufficient and appropriate records to support the auditor's conclusions and findings, but it does not require the inclusion of preliminary or draft thoughts that do not directly contribute to the final audit evidence or conclusions. Notes reflecting preliminary thinking may not be necessary if they do not provide substantive evidence or conclusions relevant to the audit.

Option (a) Audit programmers are an essential part of audit documentation. These document the plan and approach for the audit and are critical for ensuring that the audit is conducted systematically and in accordance with auditing standards.

Option (c) Letters of confirmation are also necessary to be included as part of the audit documentation, particularly when obtaining third-party confirmations to verify balances or transactions.

Option (d) E-mails concerning significant matters are relevant in audit documentation if they contain information about significant matters or decisions made during the audit process. These communications provide evidence of discussions or resolutions regarding key audit issues.

Thus, Option (b), which refers to preliminary thinking, is not required as part of the audit documentation because it does not contribute to the final audit evidence or conclusions, and it may not be relevant for the purposes of supporting the audit opinion.

Question 12

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 12

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.

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- 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 13

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 Oct'22)

Answer 13

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 14

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 Oct 20)

Answer 14

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

Discuss with reference to SA-230, factors affecting form, contents and extent of audit documentation.

(MTP 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)

Answer 15

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:

- (a) The size and complexity of the entity.
- (b) The nature of the audit procedures to be performed.
- (c) The identified risks of material misstatement.
- (d) The significance of the audit evidence obtained.
- (e) The nature and extent of exceptions identified.

(f) 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.

(g) The audit methodology and tools used.

Question 16

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 Aug'18 & Oct '18)

OR

Audit documentation serves a number of purposes. List such purposes.

(MTP 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 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

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 16

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

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(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 17

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 May '18)

Answer 17

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 18

CA Piku has prepared audit documentation of an entity describing nature, timing and extent of audit procedures performed during the course of audit. In documenting nature, time and extent of audit procedures performed, which matters shall be recorded? He is also of the view that such documentation alone as described above meets requirements of Standards on Auditing. Comment upon validity of his views.

(RTP-May 25)

Answer 18

Nature of Audit Documentation:

In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

- (a) The identifying characteristics of the specific items or matters tested.
- (b) Who performed the audit work and the date such work was completed; and
- (c) Who reviewed the audit work performed and the date and extent of such review.

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

- (a) The nature, timing and extent of the audit procedures performed.

- (b) The results of the audit procedures performed, and the audit evidence obtained; and
- (c) Significant matters arising during the audit and the conclusions reached thereon and significant professional judgements made in reaching those conclusions.

Conclusion: All above matters shall be recorded to meet requirements of SA 230. Documenting nature, time and extent of audit procedures performed alone does not meet the requirements of SA 230. Therefore, CA Piku's views are not valid.

Question 19

CA Shilpi, the engagement partner at MN Associates, is assigned the audit of following two companies:

- Zed Ltd., a small family-run business with straightforward operations, minimal internal controls, and low transaction volume.
- Ted Ltd., a large multinational corporation with complex operations, multiple subsidiaries, high transaction volumes.

During the audit planning stage, CA Shilpi highlights that the form, content, and extent of audit documentation must be customised for each client based on specific factors. Discuss those factors on which form, content, and extent of audit documentation depends.

(RTP Sep. 2025)

Answer 19

The form, content and extent of audit documentation depend on factors such as:

- (i) The size and complexity of the entity.
- (ii) The nature of the audit procedures to be performed.
- (iii) The identified risks of material misstatement.
- (iv) The significance of the audit evidence obtained.

- (v) The nature and extent of exceptions identified.
- (vi) 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.
- (vii) The audit methodology and tools used.

Topic 5 Ownership and Retention of Audit Files

Question 20

As per SA 230 on “Audit Documentation”, the working papers are not the property of the auditor.

(Study material)

Answer 20

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.

Topic 6 Assembly and Completion of Final Audit File

Question 21

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.

(Study material)

Ans: (d)

Reason

When an external auditor relies on the work of an internal auditor, the focus of audit documentation is on evaluating the competence and objectivity of the internal auditor and ensuring that the work performed is appropriate to rely upon. However, specific recommendations made by the internal auditor for risk assessment to the external auditor are not typically part of the audit documentation. The external auditor is responsible for conducting their own risk assessment, and any recommendations from the internal auditor may be useful but are not a formal requirement to be documented.

Option (a) is true because evaluating the objectivity and competence of the internal auditor is essential for the external auditor to assess whether the internal auditor's work can be relied upon. This evaluation must be documented.

Option (b) is true because the nature of the work performed by the internal auditor and the reasons for relying on their work must be documented. This provides clarity on the work used and why it is deemed reliable.

Option (c) is true because documentation of quality control exercised in internal audit work is important. This ensures that the internal audit work was performed in accordance with proper standards and quality, making it more reliable for the external auditor to use.

Thus, Option (d) is false because the documentation on specific recommendations for risk assessment made by the internal auditor is not part of the audit documentation. The external auditor conducts their own risk assessment and should not rely solely on the internal auditor's recommendations.

Question 22

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”.

(Study material)

Answer 22

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.

Topic 7 Documentation of Significant Matters and Professional Judgment

Question 23

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 matters of continuing 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 Sep '23)

Ans: (d)

Reason

Audit documentation serves several important purposes, but helping the auditor directly expand their client base is not one of them. The primary purposes of audit documentation include ensuring that the audit is conducted in accordance with professional standards, serving as a record for future audits, and assisting the engagement team in planning and performing the audit.

Option (a) is true because audit documentation provides evidence that the audit was conducted in compliance with the standards and requirements of SQC 1 (Quality Control for Firms that Perform Audits and Reviews of Financial Statements).

Option (b) is true because audit documentation often includes matters of continuing significance that will be useful for future audits, providing consistency and insights for future engagements.

Option (c) is true because audit documentation serves as a valuable tool for the engagement team to plan, organize, and perform the audit efficiently and effectively, ensuring that all necessary steps are followed.

However, Option (d) is incorrect because audit documentation is not used to directly help the auditor in expanding their client base. Audit documentation focuses on supporting the auditor's findings, providing a record of the audit process, and ensuring compliance with auditing standards, rather than business development or marketing purposes.

Question 24

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 March '23)

Ans: (d)

Reason

During the final assembly process of the audit documentation, the focus is on organizing, completing, and ensuring that the working papers are properly cross-referenced and ready for the final review. However, recalculating depreciation is a substantive audit procedure, not an administrative task. Any recalculation of depreciation should have been done earlier in the audit process as part of the substantive testing and evaluation of the financial statements. The final assembly process should only involve organizing and confirming that all audit work is properly documented, not conducting additional audit procedures like recalculating figures.

Option (a) is correct because sorting, collating, and cross-referencing of working papers is an important part of the final assembly process to ensure that all relevant documents are in place and easy to navigate.

Option (b) is correct because signing off completion checklists ensures that all audit procedures have been completed, and the audit file is ready for final review or submission.

Option (c) is correct because deleting or discarding superseded documents is acceptable as part of the final assembly process to ensure that outdated or irrelevant information is removed from the file.

Thus, Option (d) is the correct answer because recalculation of depreciation is a substantive procedure that should be completed earlier in the audit process, not as part of the final assembly phase.

Question 25

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-MTP-April'19)

Ans: (a)

Reason

According to auditing standards, the audit documentation should be assembled in a timely manner after the date of the auditor's report. This is because the auditor needs time to finalize and review the documentation, ensure all audit procedures are properly completed, and make any necessary final adjustments before the audit file is considered complete. The process should be completed in a timely manner, but it is not required to be done before the auditor's report is issued, as some elements of the audit file may still need to be updated or finalized.

Option (b) is incorrect because the auditor must complete the administrative process of assembling the final audit file. Not completing this process would leave the audit file incomplete, which would not comply with auditing standards.

Option (c) is incorrect because the audit documentation is typically finalized after the auditor's report is issued, not before. The final assembly process should occur after the auditor has completed all the necessary audit procedures and issued the report.

Option (d) is incorrect because assembling the audit documentation in an audit file is a fundamental part of the audit process. Proper documentation is required for compliance with auditing standards and for providing evidence to support the audit opinion.

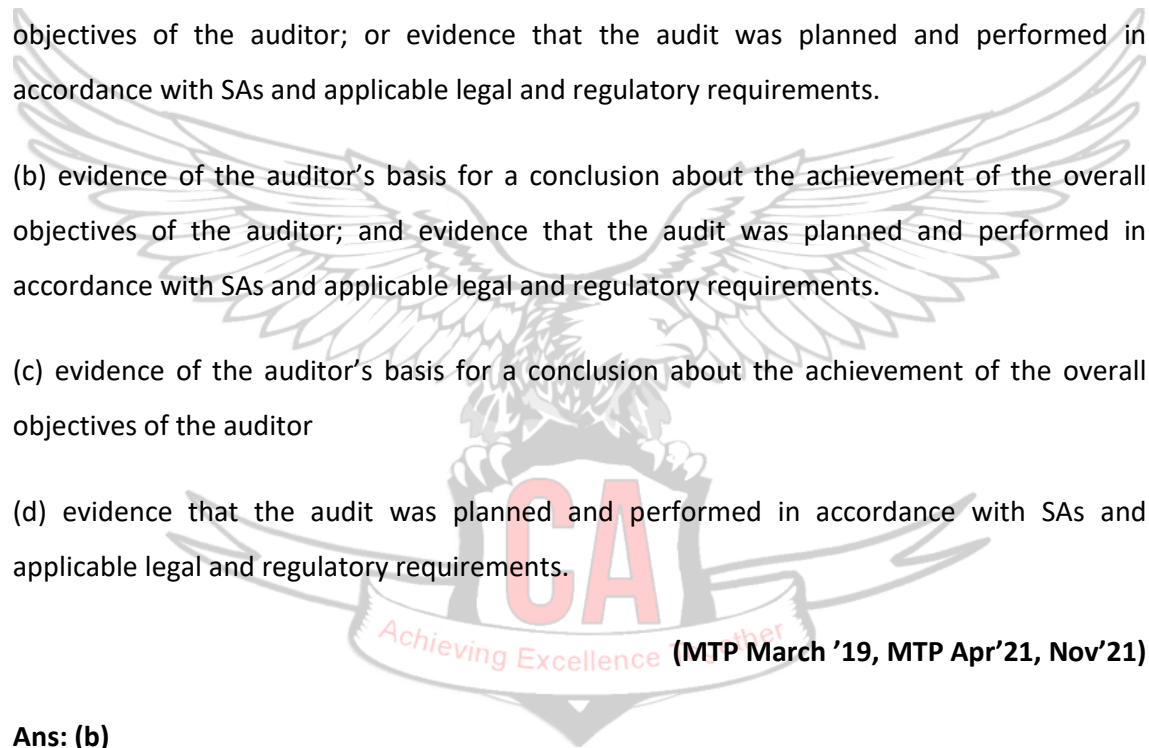
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Thus, Option (a) is the correct answer because it accurately reflects the requirement that audit documentation should be assembled and finalized after the auditor's report is issued, within a reasonable timeframe.

Question 26

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 March '19, MTP Apr'21, Nov'21)

Ans: (b)

Reason

Audit documentation serves two critical purposes:

Basis for the auditor's conclusion: It provides evidence that supports the auditor's conclusions regarding the financial statements, including the achievement of the overall audit objectives, such as the reliability of financial reporting.

Compliance with standards and regulations: It also provides evidence that the audit was planned and performed in compliance with the auditing standards (SAs) and any applicable legal and regulatory requirements. This is essential for demonstrating that the audit followed proper procedures and met professional and legal requirements.

Option (a) is not entirely correct because it combines the two purposes but lacks the connection between both parts clearly, making it less precise than Option (b).

Option (c) is incomplete because it only mentions the evidence of the auditor's conclusion without addressing the requirement for compliance with auditing standards and regulations.

Option (d) is also incomplete because it only mentions evidence of compliance with auditing standards and legal requirements but omits the necessity to document the basis for the auditor's conclusions about achieving audit objectives.

Thus, Option (b) is the correct answer as it fully encompasses both critical purposes of audit documentation: supporting the auditor's conclusions and ensuring compliance with the standards and regulations.

Question 27

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 March '19)

Ans: (c)

Reason

An audit file is not considered a specific piece of audit documentation, but rather a collection of documents that contains the auditor's working papers and other relevant audit records. The audit file serves as a storage for the documentation but is not a type of documentation itself. It contains items such as audit programs, checklists, summaries of significant matters, and other audit evidence, but it is not classified as a "document" in the sense of individual audit records.

Option (a) Audit Programmes are part of audit documentation. They outline the specific procedures and tasks that the auditor plans to perform during the audit.

Option (b) Summaries of significant matters are part of audit documentation. They summarize important issues or findings discovered during the audit process, providing a basis for the auditor's conclusions.

Option (d) Checklists are also part of audit documentation. They help the auditor ensure that all relevant procedures have been performed and no essential steps have been overlooked.

Thus, Option (c) is the correct answer because an audit file is a collection of documentation, not a specific form of audit documentation itself.

Question 28

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

Ans :(a)

Reason

Judging the significance of a matter requires an objective analysis of the facts and circumstances. In auditing, an objective approach ensures that the evaluation is based on facts, evidence, and consistent criteria, free from personal biases or opinions. This helps the auditor form a reliable and consistent judgment about the significance of a matter in the context of the audit.

Option (b) Subjective analysis is incorrect because relying solely on subjective analysis may introduce personal bias, which could lead to inconsistent or unreliable judgments about the significance of an issue.

Option (c) Both subjective and objective analysis is not entirely correct because the correct approach in auditing is to rely primarily on objective analysis rather than mixing subjective elements. Objective analysis is more reliable for determining significance.

Option (d) Qualitative analysis is not the most appropriate in this context because while qualitative factors may be considered, the significance of matters in an audit is best judged through objective criteria, which can be clearly defined and supported by evidence.

Thus, Option (a) is the correct answer because objective analysis ensures that the judgment about significance is based on facts, evidence, and consistent criteria, making it the most appropriate method in an audit.

Question 29

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 April '23)

Ans: (b)

Reason

A completion memorandum or summary prepared by the auditor provides an overview of the significant matters identified during the audit and explains how they were addressed. This document is essential in ensuring that the auditor has properly considered and addressed all relevant issues before concluding the audit. It helps in demonstrating that the auditor has considered key matters, addressed them appropriately, and is in compliance with auditing standards.

Option (a) is incorrect because evidence identified during the audit is not the primary focus of the completion memorandum. The memorandum focuses on significant matters and their resolution, not just the evidence.

Option (c) is incorrect because the completion memorandum should highlight the significant matters, not just the evidence. Evidence is part of the audit documentation but does not form the central point of the completion memorandum.

Option (d) is incorrect because while significant matters are important, the completion memorandum also includes details on how those matters were addressed, not just the matters themselves.

Thus, Option (b) is the correct answer because the completion memorandum describes both the significant matters identified during the audit and the actions taken to address those matters, ensuring a thorough and comprehensive audit process.

Question 30

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 matters
- (b) Audit programme
- (c) Response to external confirmation requests
- (d) Structural engineer's report on strength of building

(MTP Oct '23)

Ans: (d)

Reason

Audit documentation refers to the records that provide evidence of the audit procedures performed, the audit evidence obtained, and the conclusions reached. These documents help the auditor support their findings and ensure the audit was conducted in compliance with auditing standards.

Option (a) E-mail correspondence with CFO of company concerning significant matters is likely to be part of the audit documentation. It reflects communication about significant issues or findings in the course of the audit and can serve as evidence for the auditor's judgment and conclusions.

Option (b) Audit programme is an essential part of audit documentation. It outlines the audit procedures and the tasks the auditor plans to perform during the audit, ensuring that the audit is thorough and complies with auditing standards.

Option (c) Response to external confirmation requests is a common form of audit documentation. Responses to confirmation requests (such as from banks or creditors) are used to verify balances or other significant audit assertions and are vital pieces of evidence.

Option (d) Structural engineer's report on strength of building is not likely to be part of the audit documentation because it is unrelated to the financial records being audited. Although the report may be important for the company's operations (e.g., for insurance purposes or compliance with building codes), it does not directly pertain to the audit of the company's financial statements. Therefore, it is not considered part of audit documentation unless it has a direct bearing on financial statement amounts or disclosures (e.g., related to asset valuation or impairment).

Thus, Option (d) is the correct answer because the structural engineer's report is typically not a part of the audit documentation unless it affects the financial statements, which is not explicitly indicated in this scenario.

Question 31

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)

Reason

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Professional judgment is crucial in determining the form, content, and extent of audit documentation. This judgment involves the auditor's ability to assess the nature, timing, and extent of audit procedures based on the facts and circumstances surrounding the engagement. It also involves evaluating the results of those procedures, particularly in relation to significant matters, to ensure that sufficient and appropriate documentation is created to support the auditor's conclusions and audit opinion.

Option (a) Professional skepticism is essential throughout the audit process but specifically refers to the auditor's mindset of questioning and critically assessing audit evidence. While it influences how auditors approach their work, it does not directly dictate the form, content, and extent of audit documentation.

Option (b) Professional integrity relates to the auditor's ethical obligation to act with honesty and fairness, but it does not specifically govern the details of audit documentation.

Option (d) Professional sincerity is not a standard term used in auditing and does not play a direct role in determining the form, content, or extent of audit documentation. The correct focus in this context is on professional judgment.

Thus, Option (c) is the correct answer because professional judgment directly influences how the auditor determines the documentation requirements for significant matters, ensuring that the audit procedures and results are properly recorded.

Question 32

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 Nov 22)

Answer 32

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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.

Question 33

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 33

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.

(i) 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.

(ii) 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.

(iii) 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.

(iv) 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.

(v) 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 34

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 34

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:

(i) Matters that give rise to significant risks.

(ii) 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.

(iii) Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.

(iv) 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 35

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 35

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 36

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)

Answer 36

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 37

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 37

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 38

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 March '21)

Answer 38

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 nor management has right to access that. Therefore, statement given in the question is incorrect.

Question 39

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

(MTP Sep'22)

The auditor shall prepare audit documentation on a timely basis.

Answer 39

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

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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 40

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 Oct '21)

Answer 40

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:

- (a) The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- (b) 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.
- (c) 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.

(d) 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 41

"Completion Memorandum" is helpful as part of the audit documentation. Explain.

(MTP May 20, PYP May '19)

Answer 41

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 42

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 April '21)

Answer 42

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 43

Electronic payment of Income Tax cannot be made by an assessee from the account of any other person.

(MTP April 22)

Answer 43

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 44

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 March '23)

Answer 44

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 45

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 April '21)

Answer 45

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 46

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 46

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 47

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 47

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 48

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 48

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 49

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 49

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 50

Audit Documentation refers to the record of three items. Explain stating clearly the objective and nature of audit documentation.

(RTP Nov '23)

Answer 50

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.

Topic 8 Quality Control Review and Inspection

Question 51

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.

(Study material)

Ans: (a)

Reason

According to auditing standards, audit documentation should be prepared concurrently with the audit work as it progresses. This ensures that all procedures, findings, evidence, and conclusions are properly recorded and supported in real-time, making it easier to reference and review at later stages of the audit. By preparing documentation as the audit progresses, the auditor can ensure accuracy, completeness, and relevance in the documentation process.

Option (b) Audit documentation has to be prepared 60 days after the date of the audit report is incorrect because there is no requirement to wait for 60 days after the audit report

to prepare documentation. Documentation should be prepared during the audit process, not afterward.

Option (c) Audit documentation has to be prepared when information is required by the regulator is also incorrect. The preparation of audit documentation should not be delayed until a regulator requests it. It should be ongoing throughout the audit engagement.

Option (d) Audit documentation has to be prepared 60 days after completion of audit work is incorrect because the preparation of audit documentation should be done as the audit progresses, not after the audit is completed.

Thus, Option (a) is the correct answer because audit documentation should be prepared simultaneously as the audit progresses to ensure the timely recording and organization of audit work and findings.

Question 52

Audit documentation is owned by: -

- (a) Client
- (b) Auditor
- (c) Team member responsible for documentation
- (d) Regulator

(Study material)

Ans: (b)

Reason

Audit documentation is owned by the auditor. The auditor is responsible for preparing and maintaining the audit documentation as evidence of the audit procedures performed, audit evidence obtained, and the conclusions reached. This documentation supports the auditor's

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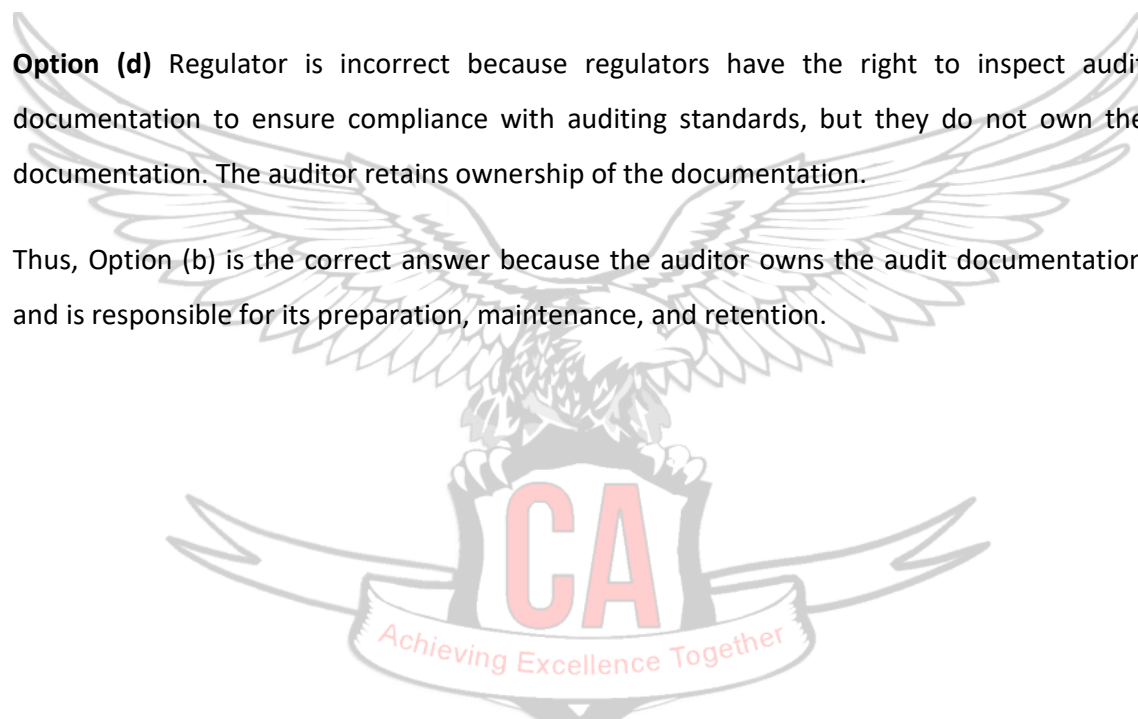
work and serves as a record for review, quality control, and regulatory purposes. It is confidential and is retained by the auditor for the required period under auditing standards, which could vary depending on jurisdiction and regulations.

Option (a) Client is incorrect because, although the client provides information to the auditor, the ownership of the audit documentation belongs to the auditor, not the client.

Option (c) Team member responsible for documentation is incorrect because individual team members may be responsible for creating parts of the documentation, but the overall ownership remains with the auditor, who is accountable for the entire audit process.

Option (d) Regulator is incorrect because regulators have the right to inspect audit documentation to ensure compliance with auditing standards, but they do not own the documentation. The auditor retains ownership of the documentation.

Thus, Option (b) is the correct answer because the auditor owns the audit documentation and is responsible for its preparation, maintenance, and retention.



Chapter 7: COMPLETION AND REVIEW

Topic 1 Communication with Those Charged with Governance

Descriptive Question

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:

- (a) Significant delays in management providing required information.
- (b) An unnecessarily brief time within which to complete the audit.
- (c) Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- (d) The unavailability of expected information.
- (e) Restrictions imposed on the auditor by management.
- (f) Management’s unwillingness to make or extend its assessment of the entity’s ability to continue as a going concern when requested.

Question 2

CA Yash is conducting audit of a company for year 2024-25. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2025. However, it becomes known to the auditor that one of overseas buyers has made a legal claim against the company on 1st June 2025 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, 2024. 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 Yash should proceed to deal with above issue.

(MTP-March 25)

Answer 2

Subsequent Events:

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 the 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 F. S. and the date of the auditor's report as per SA 560.

Auditor's responsibilities regarding subsequent events between the date of the F. S. and the date of the auditor's report are as under:

- Perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the F. S. and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.
- If such subsequent events that require adjustment of, or disclosure in, the financial statements have been identified, it shall be determined whether each such event is appropriately reflected in those financial statements.
- Obtain a written representation from management or those charged with governance that all events occurring subsequent to the date of the F. S. and for which the applicable F. R. framework requires adjustment or disclosure have been adjusted or disclosed.

Question 3

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
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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.

(Study material)

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)

Reason:

When there is a material uncertainty about going concern but adequately disclosed, the auditor issues an unmodified opinion with an emphasis paragraph to highlight the uncertainty.

(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)

Reason:

If a company is not a going concern, financial statements should be prepared on a liquidation basis to reflect the reality of asset realizations and liabilities settlement.

(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)

Reason:

Auditors are responsible for identifying and evaluating subsequent events up to the report date to ensure financial statements reflect all relevant information.

(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)

Reason:

While written representations are ideally unconditional, qualified language can be accepted if the auditor believes the statements come from responsible management who understand the matters involved, ensuring the representations remain reliable for audit purposes.

(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)

Reason:

Auditors must document oral communications with those charged with governance to maintain a clear record for accountability and future reference, ensuring transparency and evidence of communication.

MCQ

Question 4

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.

(Study material)

Ans: (c)

Reason:

Auditors are not required to explain the rationale behind each audit procedure; communication focuses on significant findings, scope, timing, and difficulties, not on the detailed reasoning of audit steps.

Descriptive question

Question 5

In what ways an effective two-way communication between auditor and those charged with governance is important?

(Study material)

Answer 5

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.

Topic 2 Subsequent Events

Question 6

PQR Ltd., a manufacturing company, has been facing operational challenges. Recently, they struggled to find essential raw materials due to supply chain disruptions. This shortage has significantly impacted production, leading to delays in fulfilling customer orders. The company's financial health has also deteriorated, with declining cash flows leading to inability to pay creditors on time. Additionally, key financial ratios have worsened, and the company has stopped paying dividends to shareholders due to liquidity concerns.

Given this situation, which of the following is not a financial event or condition that may cast significant doubt on the entity's ability to continue as a going concern?

(a) Adverse key financial ratios.

- (b) Inability to pay creditors on time.
- (c) Shortages of important supplies.
- (d) Arrears or discontinuance of dividends.

(MTP-March 25)

Ans: (c)

Reason:

Shortages of supplies affect operations but do not directly indicate financial instability or doubt about going concern, unlike adverse financial ratios, payment delays, or dividend arrears which reflect financial distress.

Question 7

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 7

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.

Question 8

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 8

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 9

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 9

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 10

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?

Answer 10

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.

MCQ

Question 11

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 March '23, MTP Apr'19)

Ans: (d)

Reason:

When new facts arise after the auditor's report date but before issuance, the auditor must discuss the matter with management and those charged with governance, assess if financial statements need revision, and understand management's plans to address the issue, ensuring accurate and complete reporting

Descriptive question

Question 12

"The auditors should consider the effect of subsequent events on the financial statement and on auditor's report" – Comment according to SA 560.

(MTP Oct 19)

Answer 12

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.

Question 13

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 Nov '21, RTP May 20)

Answer 13

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 14

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 Sep '23, RTP Nov '21)

Answer 14

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 conditions that existed at the date of the financial statements; and
- (b) Those that provide evidence of conditions that arose after 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 15

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 July '21)

Answer 15

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.

MCQ

Question 16

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

(Study material)

Ans: (b)

Reason:

Subsequent events occur after the date of the financial statements but before the auditor's report or issuance of the statements. Events on the date of financial statements are considered part of the reporting period, not subsequent events.

Descriptive Question

Question 17

Discuss meaning of "Date the financial statements are issued" under SA 560.

(Study material)

Answer 17

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.

Question 18

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 substandard 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.

(Study material)

Answer 18

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 19

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.

(Study material)

Answer 19

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 above said 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 20

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 20

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 21

During the audit of Cryst Ltd. for the financial year ended 31st March 2025, the auditor, CA Z was in the process of finalising the audit report dated 30th May 2025. The engagement partner emphasised that CA Z shall perform audit procedure 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 requires adjustment of, or disclosure in, the financial statements have been identified. What audit procedures, in accordance with SA 560, should the auditor CA. Z perform based on risk assessment to identify events occurring between the date of the financial statements and the date of the auditor's report that require adjustment or disclosure?

(RTP Sep. 2025)

Answer 21

Audit procedures relating to 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 in determining the nature and extent of such audit procedures, which shall include the following: -

- (i) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (ii) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- (iii) 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.
- (iv) Reading the entity's latest subsequent interim financial statements, if any.

Topic 3 Going Concern

MCQ

Question 22

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 Oct '23)

Ans: (d)

Reason:

Shortages of supplies affect the entity's operations directly, making it an operating event, while the others relate to financial conditions or support.

Question 23

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 Oct 21, Nov 20, MTP Mar'22)

Ans: (d)

Reason:

A profit turning into a loss due to depreciation is a normal accounting adjustment and does not by itself indicate significant doubt about going concern, unlike management loss, poor financial ratios, or payment defaults.

Question 24

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)

Reason:

While an increase in feed cost impacts profitability, it does not by itself threaten the company's ability to continue as a going concern, unlike severe livestock mortality, government bans, or labor shortages which directly jeopardize operations.

Descriptive Question

Question 25

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 25

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.

MCQ

Question 26

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

(Study material)

Ans: (b)

Reason:

Not being able to modernize affects competitiveness and growth but does not directly threaten the entity's ability to continue operations, unlike financial distress indicators such as delayed payments to creditors or staff.

Descriptive Question

Question 27

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?

(Study material)

Answer 27

(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.

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(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 28

Discuss documentation requirements for an auditor regarding misstatements identified during audit under SA 450.

(Study material)

Answer 28

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.

Topic 4 Written Representations

Question 29

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 29

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.

MCQ

Question 30

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 March '19)

Ans: (d)

Reason:

Written representations are necessary, but not sufficient on their own. They support other audit evidence but cannot replace it, as per SA 580. Auditors must obtain corroborative evidence where possible.

Descriptive Question

Question 31

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 Dec '21)

Answer 31

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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.

Question 32

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)

Answer 32

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 33

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 33

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 34

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 March '23, RTP May'23)

Answer 34

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 35

Explain the objectives of the auditor regarding written representations.

(MTP Nov '21, RTP Nov '19, PYP Jan '21)

Answer 35

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 36

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Written representation in itself is a sufficient and appropriate audit evidence about any of the matters with which they deal.

(MTP March 21)

Answer 36

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 37

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

Written representations are requested from those responsible for the preparation and presentation of the financial statements.

(MTP Sep'22)

Answer 37

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 38

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 38

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.

MCQ

Question 39

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

(Study material)

Ans: (a)

Reason:

As per SA 580, written representations are necessary audit evidence that support other evidence obtained during the audit, but they are not sufficient on their own to draw conclusions about the financial statements.

Question 40

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.

(Study material)

Ans: (b)

Reason:

This statement is false because if management believes the uncorrected misstatements are material, they must be corrected. The auditor should obtain written representation only when management believes the misstatements are immaterial, individually or in aggregate

Descriptive Question

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Question 41

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.

(Study material)

Answer 41

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 42

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?

(Study material)

Answer 42

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.

Topic 5 Internal Control Deficiencies

Question 43

Written representations are to be provided by the management to the auditor when requested. Explain

(RTP Nov '23)

Answer 43

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.

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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 44

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".

(Study material)

Answer 44

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 non-recurring 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 45

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
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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.

(Study material)

Answer 45

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
CARO

Section A

MULTIPLE CHOICE QUESTIONS (MCQS)

Topic 1 Introduction to Audit Report & SA 700

MCQ

Question 1

Eeyore Pvt. Ltd. is incorporated on 1st July, 2017. During the Financial Year ending on 31st March, 2018, the company did not opt for any borrowing at any point of time and have a total revenue of Rs. 60 Lakh. At the year end, it provides the following information regarding its paid-up capital and reserve & surplus-

Particulars	Amount (in Rs.)
Paid-up Capital	
Consideration received in cash for equity shares (including unpaid calls of Rs. 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 Rs. 1 crore as on the Balance Sheet date and which does not have total borrowings exceeding Rs. 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 Rs. 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 Rs. 1.07 crore i.e. more than Rs. 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 Rs. 1.02 crore i.e. more than Rs. 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 Rs. 0.92 crore i.e. not more than Rs. 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 Rs. 0.82 crore i.e. not more than Rs. 1 crore as on the Balance Sheet data

(RTP May '19).

Ans: (c)

Reason:

CARO, 2016 is not applicable because:

Paid-up capital + Reserves & Surplus = Rs. 92 lakh (less than Rs. 1 crore)

No borrowings during the year

Total revenue = Rs. 60 lakh (less than Rs. 10 crore)

Question 2

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 Oct '23)

Ans: (c)

Reason:

CARO, 2020 is applicable to all companies except the following:

One Person Company (OPC) → ✕ (Exempt)

Banking company → ✕ (Exempt)

Insurance company → ✕ (Exempt)

Only PST Industries Ltd. is a regular company (not OPC, bank, or insurer), so CARO, 2020 applies to it.

CARO, 2020 applicable to: PST Industries Limited

Question 3

In case of a fraud involving less than Rs. 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 March '19)

Ans: (a)

Reason:

As per Section 143(12) of the Companies Act, 2013 (read with related rules):

If the auditor detects a fraud involving less than Rs. 1 crore, they must report it to the Audit Committee (if constituted under section 177) or to the Board in other cases.

Hence, option (a) is correct as it covers both scenarios

Topic 2 Responsibility for Financial Statements (SA 200)

Question 4

During the course of audit of a listed company, CA P finds that solar power generating plant capitalized in books for Rs.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 Rs.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 Oct'22)

Ans: (a)

Reason:

The capitalization of a non-existent asset using fake bills is a case of fraud by company personnel (procurement head).

As per Section 143(12) of the Companies Act, 2013, fraud involving Rs. 1 crore or more must be reported to the MCA in Form ADT-4.

Under CARO, 2020, Clause 3(xi)(A) requires the auditor to report any fraud noticed or reported during the year.

Hence, the fraud must be reported both to the MCA and under CARO, 2020.

Question 5

While reporting under CARO, 2020, it is duty of statutory auditor of company to report:

- (a) Fraud of less than Rs. 1 crore committed by officers or employees of company during the year
- (b) Fraud of Rs.1 crore or more committed by officers or employees of company during the year
- (c) Fraud of Rs.5 crore or more committed by officers or employees of company during the year
- (d) Any fraud by the company or on the company noticed or reported during the year

(MTP Oct '23)

Ans: (d)

Reason:

As per Clause 3(xi)(A) of CARO, 2020, the statutory auditor must report:

“Any fraud by the company or on the company noticed or reported during the year.”

There is no monetary threshold specified under CARO for this reporting.

The focus is on the existence of fraud, whether big or small.

Hence, (d) is correct — auditor must report any fraud noticed or reported during the year

Descriptive Question

Question 6

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 Nov 22, MTP Oct '21, PYP Nov '18)

Answer 6

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 clause (x)(b) of Para 3 of CARO, 2020.

Question 7

G Pvt. Ltd. had fully paid up Capital and Reserves of Rs. 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 Rs. 25 lacs. During the year, the company also borrowed Rs. 55 lakh each from a bank and a financial institution independently. It had a turnover of Rs. 850 lakh (other than revenue of Rs. 250 lakh from discontinuing operations). Ascertain whether CARO, 2020 is applicable to the company.

(PYP May'22)

Answer 7

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 Rs. 95 Lakh (Rs. 120 Lakh - Rs. 25 Lakh), borrowings from a Bank and financial institution are (Rs. 55 Lakh + Rs. 55 Lakh) i.e., Rs. 1.10 Crore, turnover {including discontinuing operations (Rs. 850 lakh + Rs. 250 Lakh)} Rs. 1100 Lakh i.e., Rs. 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 8

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 Nov'20, MTP-March'18, MTP-Nov 21, MTP April '21)

Answer 8

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 9

Explain the Reporting requirements the auditor should ensure under CARO 2020 related to PPE and Intangible assets.

(RTP May '22, MTP May 20, PYP May '19, RTP Nov '21)

Answer 9

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

Topic 3 Companies (Auditor's Report) Order (CARO 2020)

Question 10

The head accountant of a company entered fake invoices of credit purchases in the books of account aggregate of Rs. 50 lakh and cleared all the payments to such bogus creditor. How will you deal as an auditor?

(RTP May '20)

Answer 10

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 Rs. 1 crore, however, reporting under CARO, 2016 (**CARO 2020**) is required.

Question 11

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 Oct'22)

Answer 11

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 12

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."

(March 22, MTP March'19, MTP 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 May '23)

Answer 12

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 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 13

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 March '21, PYP Nov '19)

Answer 13
CATESTSERIES.ORG

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 14

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.

(MTP April 19, PYP May '18, PYP Dec'21)

Answer 14

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 15

Discuss which class of companies are specifically exempt from the applicability of CARO 2016 (CARO 2020).

(MTP Oct 19)

Answer 15

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 Schedule III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crores during the financial year as per the financial statements.

Topic 4 Related Party Transactions & Disclosures (CARO Clause xiii)

Question 16

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 April '21, PYP Nov '19)

Answer 16

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 17

State the matters to be included in auditor's report as per CARO, 2020 regarding - Verification of inventory and working capital limits.

(MTP April 22)

Answer 17

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 18

Discuss the reporting requirements as per CARO, 2020, regarding:

(i) Disputed and undisputed statutory dues

(MTP March '23, MTP Aug '18, MTP May 20) and

(ii) internal audit system of the company

(MTP March '23, MTP Sep'22)

Answer 18

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 19

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 19

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 20

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 20

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 21

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 May'22)

Answer 21

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 22

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 Nov 22)

Answer 22

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”.

Topic 5 Going Concern Considerations (SA 570)

Question 23

As per SA 701, the objectives of the auditor are to determine key audit matters and having formed an opinion on the financial statements, communicate those matters by describing them in the auditor’s report. Which factors are taken into account by auditor while determining Key Audit Matters? How Key Audit Matters are communicated in audit report?

(RTP-May 25)

Answer 23

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:

- Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.
- Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty.
- The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined, as stated above, were of most significance in the audit of the financial statements of the current period and therefore are the key audit 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". The introductory language in this section of the auditor's report shall state that:

- (a) Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements [of the current period]; and
- (b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters

Question 24

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)

Reason:

When two or more audit firms are appointed to conduct the audit of the same entity for the same period, they are termed as Joint Auditors as per SA 299 (Revised) – Responsibility of Joint Auditors.

MH and Associates and NR and Associates auditing WZ Limited together = Joint Auditors.

MCQ

Question 25

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 Oct 19)

Ans: (b)

Reason:

"General superiority complexes" among auditors is a disadvantage, not an advantage. It can lead to lack of coordination, conflicts, or inefficiency in a joint audit.

Hence, option (b) is not an advantage of joint audit.

Question 26

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 March '21)

Ans: (c)

Reason:

As per SA 299 (Revised) on Joint Audit of Financial Statements:

If joint auditors disagree on any matter, each can issue a separate audit report stating their own opinion (✓ ☐ option a).

In such a case, each report should make reference to the other auditor's report (✓ ☐ option b).

Hence, both (a) and (b) are correct in case of disagreement.

Descriptive Question

Question 27

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?

Answer 27

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.

Topic 6 Emphasis of Matter Paragraphs (SA 706)

Question 28

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 Nov '19)

Answer 28

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 29

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.

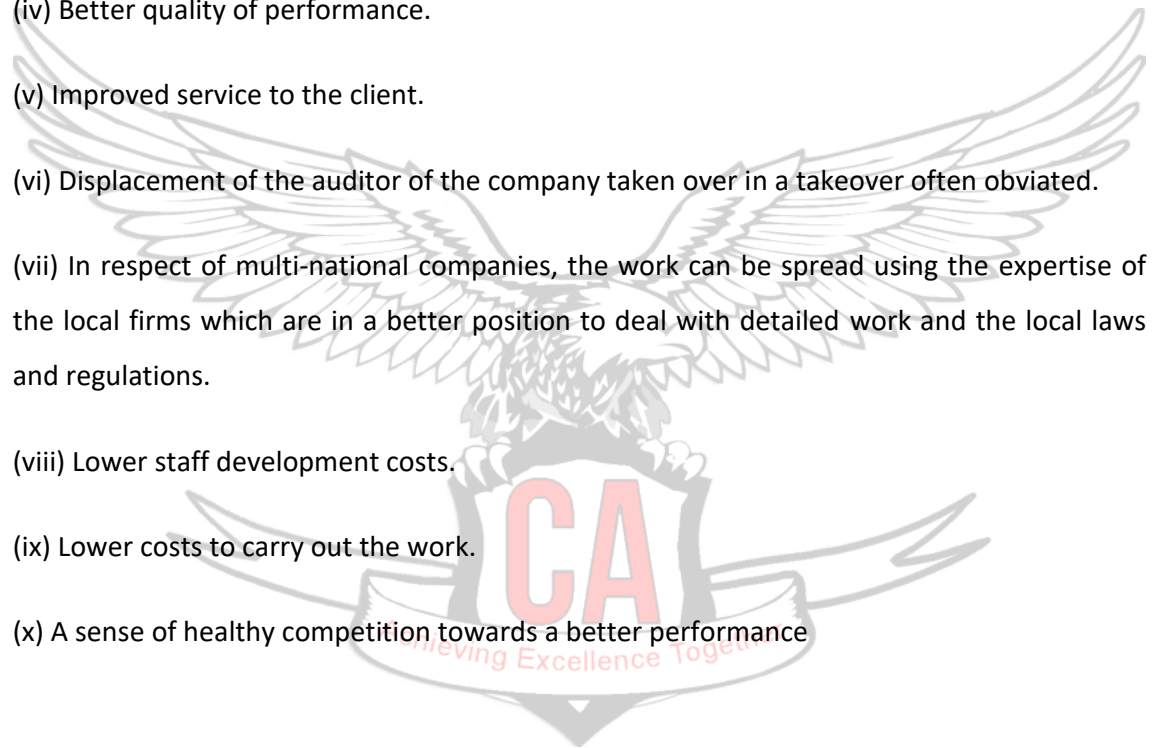
(MTP April '23, RTP Nov '19)

Answer 29

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) 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 30

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 May '19)

Answer 30

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 31

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 Nov 22)

Answer 31

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.

Question 32

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in some circumstances. Explain those circumstances.

(MTP Aug '18, Sep 22, PYP 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 May'22)

Answer 32

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 33

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 33

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 34

Which of the following is correct:

(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

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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)

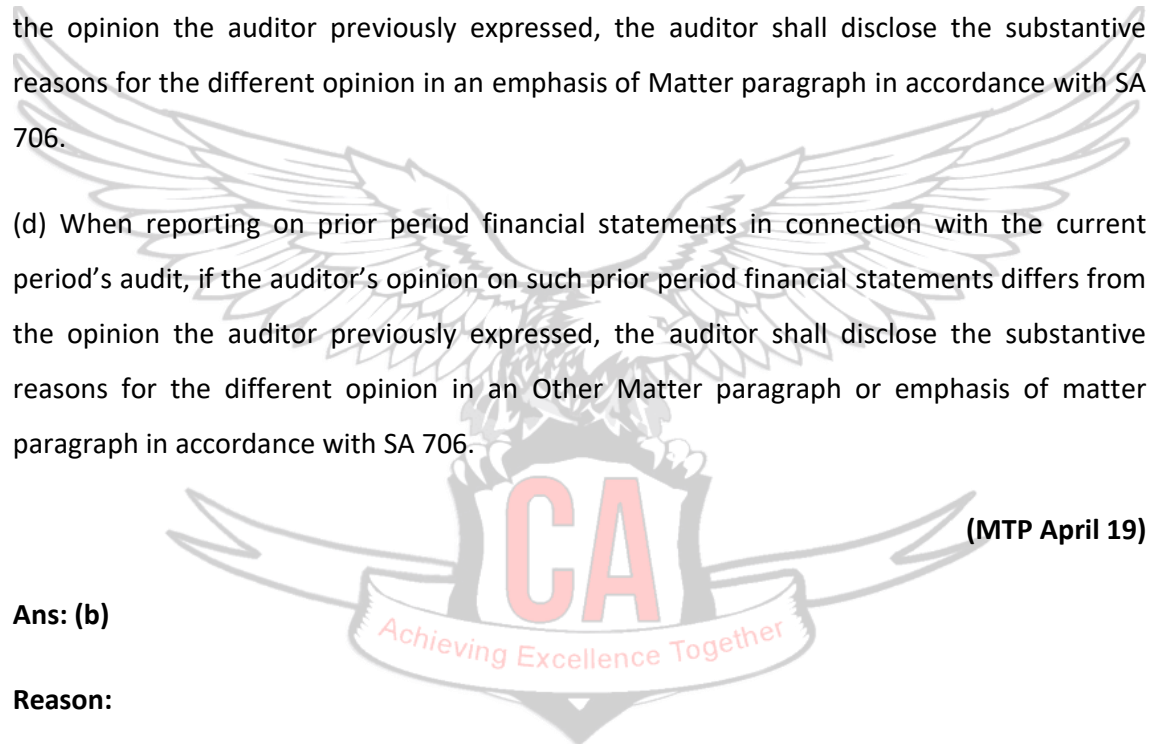
Reason:

As per SA 706 (Revised), when the auditor's opinion on prior period financial statements differs from the opinion previously expressed, the auditor shall disclose the substantive reasons for the difference in an Other Matter paragraph in the current auditor's report.

Other Matter paragraph is specifically used to communicate such information.

Emphasis of Matter paragraph is not appropriate for this purpose.

Hence, option (b) is correct.



Topic 7 Modified Opinions – Qualified, Adverse, Disclaimer (SA 705)

Question 35

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 May'22)

Answer 35

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:

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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”

Question 36

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 36

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 37

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 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 Sep '23)

OR

Mention the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph.

(MTP Nov '21, RTP Nov'22)

Answer 37

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 38

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.

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(MTP April '21 & May 20)

Answer 38

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 39

State clearly the objective of the Auditor as per SA 706. Also define emphasis of matter paragraph and other matter paragraph.

(MTP Oct 20)

Answer 39

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 40

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 March '18, Aug'18, Oct'18, Mar'19)

Answer 40

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 41

The inclusion of an Emphasis of Matter paragraph in the Auditor's Report affects the auditor's opinion.

(MTP March '21, RTP Nov '23)

Answer 41

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 42

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 Sep'22)

Answer 42

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 43

Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?

(RTP Nov'20)

Answer 43

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 Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Question 44

Auditors do not always issue an unmodified opinion on financial statements. In cases where there are material misstatements or limitations in obtaining sufficient audit evidence, a modified opinion may be necessary.

Discuss the types of modified audit opinions an auditor can issue? Explain how these opinions differ based on the concepts of materiality and pervasiveness of the issue.

(RTP Sept 2025)

Answer 44

There are three types of modified opinions, namely:

- (i) A qualified opinion.
- (ii) An adverse opinion.
- (iii) A disclaimer of opinion.

Qualified Opinion:

The auditor shall express a qualified opinion when:

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(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.

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

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.

Topic 8 Structure of Auditor's Report (SA 700)

Question 45

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 misstated 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)

Reason:

When issuing a qualified opinion due to a material misstatement (but not pervasive), the auditor should use the phrase:

"except for the effects of the matter described in the Basis for Qualified Opinion section of our report"

This clearly limits the qualification to the specific issue. Options (b), (c), and (d) use incorrect or less appropriate wording.

Hence, option (a) is the correct phrasing for the opinion paragraph.

MCQ

Question 46

Which of the following is not correct:

- (a) SA 700- Forming an Opinion and Reporting on Financial Statements
- (b) SA 705- Modified Opinion
- (c) SA 701- Communicating Key Audit Matters
- (d) SA 706-Comparative Information

(MTP Oct '20)

Ans: (d)

Reason :

SA 706 deals with Emphasis of Matter Paragraphs and Other Matter Paragraphs,

It does not deal with Comparative Information.

Comparative information is covered under SA 710 - Comparative Information—Corresponding Figures and Comparative Financial Statements.

Hence, option (d) is incorrect.

Question 47

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 Oct 19, Apr 19)

Ans: (d)

Reason :

Forming an auditor's opinion requires both obtaining audit evidence and evaluating its sufficiency and appropriateness to draw conclusions.

Both steps are essential and go hand-in-hand.

Hence, option (d) is correct.

Question 48

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.

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(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 March '19)

Ans: (c)

Reason :

An adverse opinion is expressed when misstatements are both material and pervasive to the financial statements.

A qualified opinion is for material but not pervasive misstatements.

A disclaimer is when the auditor cannot obtain sufficient appropriate audit evidence.

Hence, option (c) is correct.

Question 49

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 Oct 19)

Ans: (c)

Reason :

An audit report expresses an opinion on the financial statements (not just books of accounts) to confirm whether they give a true and fair view of the company's financial position and transactions.

The phrase "true and fair" is standard for audit opinions on financial statements.

Options mentioning "books of accounts" or just "true and correct" are incomplete or inaccurate.

Hence, option (c) is correct.

Question 50

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 Oct '23)

Ans: (c)

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Reason:

The elements of an audit report under SA 700 include:

- Title
- Addressee
- Auditor's opinion
- Basis for opinion
- Management's responsibility
- Auditor's responsibility
- Other information, etc.

Audit strategy is part of the auditor's planning process, not part of the audit report.

Hence, option (c) is not an element of the audit report.

Descriptive Question**Question 51**

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 Nov 22)

Answer 51

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.

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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.

Question 52

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 May'19)

Answer 52

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 53

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 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

Answer 53

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 54

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 Oct '21, March '23, PYP Nov'18)

OR

An auditor is required to make specific evaluations while forming an opinion in an audit report." State those evaluations.

Answer 54

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.

Topic 9 Comparative Information (SA 705 Revised)

Question 55

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 July'21)

Answer 55

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 56

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)

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 56

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 57

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 accounting practices.

(MTP March '18 & March 19 & Oct '18, RTP May'18)

Answer 57

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 58

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 Sep '23, PYP Dec '21)

Answer 58

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 59

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 Aug '18)

Answer 59

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 60

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 March '18, Aug 18, Mar'19 & Oct '18)

Answer 60

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 61

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 April 19, May 20, RTP May '21)

Answer 61

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 62

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 April 19, Apr'21, May'20 & April '23, RTP Nov'18)

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.

Answer 62

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:

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(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 63

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 63

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 64

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 64

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 65

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 65

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.

Topic 10 Key Audit Matters (KAMs)

Question 66

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)

Answer 66

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 67

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 67

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 68

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 July'21)

Answer 68

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

MCQ

Question 69

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 Oct '23)

Ans: (c)

Reason:

An auditor disclaims an opinion when they cannot obtain sufficient appropriate audit evidence and believe that the possible effects on the financial statements could be both material and pervasive.

"Pervasive" means affecting multiple areas or the financial statements as a whole.

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Options (a) and (b) do not specify “pervasive.”

Option (d) contains a typo (“perverse” instead of “pervasive”).

Hence, option (c) is correct.

Question 70

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 Oct 19)

Ans: (a)

Reason:

Non-disclosure of required accounting policies is a material misstatement but usually not pervasive.

Hence, the auditor issues a qualified opinion for such a deficiency.

An adverse opinion is reserved for material and pervasive misstatements.

A disclaimer is for inability to obtain sufficient evidence.

Emphasis of Matter is for matters appropriately disclosed, not omissions.

So, option (a) is correct

Question 71

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 Oct 19, Apr'19 May'20, RTP Nov'19)

Ans: (d)

Reason:

If the auditor cannot obtain sufficient appropriate audit evidence about opening balances, the auditor may either:

Qualify the opinion if the possible effects are material but not pervasive,

Or disclaim the opinion if the possible effects are material and pervasive.

This guidance is in line with SA 705.

Hence, option (d) is correct.

Question 72

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.

Answer 72

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.

Descriptive Question

Question 73

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

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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 73

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 74

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 Jan' 21)

Answer 74

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 75

Distinguish between an adverse opinion and a qualified opinion. Also draft an opinion paragraph for both types of opinion.

(MTP Oct'23)

Answer 75

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 (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, 2023,

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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, 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 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, 2023 and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

Question 76

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?

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Answer 76

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 shall 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 77

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 Jan'21)

Answer 77

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.

Topic 11 Examples of Modified Opinions

Question 78

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 Oct 19)

Answer 78

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 79

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

Answer 79

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.

MCQ

Question 80

Which of the following is incorrect:

- (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);

(MTP April '19)

Ans: (d)

Descriptive Question

Question 81

Communicating key audit matters in the auditor's report is a separate opinion on individual matters.

(PYP May '23)

Answer 81

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".

Question 82

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 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.

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.

(RTPMay'18)

Answer 82

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 83

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 April 19, PYP May'18)

Answer 83

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 84

As an auditor of listed company, what are the matters that the auditor should keep in mind while determining "Key Audit Matters".

(MTP 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 Nov'20)

Answer 84

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 85

Explain clearly the purpose of communicating key audit matters.

(RTP Nov ‘18)

Answer 85

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 86

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 Oct 20, RTP Nov'18)

Answer 86

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 87

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)

Answer 87

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.

MCQ

Question 88

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 certificate
- (c) Each audit report issued under Companies Act, 2013 only
- (d) Each audit report issued under Companies Act, 2013 only and each certificate

(MTP Oct '23)

Ans: (b)

Reason:

As per ICAI guidelines, UDIN must be generated and mentioned on all audit reports as well as all certificates issued by a practicing Chartered Accountant.

Hence, option (b) is correct

Descriptive Question

Question 89

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 sub-section (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 Oct'19)

Ans: (d)

Reason:

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Section 143(1) of the Companies Act, 2013 requires the auditor to report on specific matters like loans and advances, sale of securities below purchase price, and branch audit reports. However, reporting on whether transactions represented merely by book entries are prejudicial is not explicitly a duty under section 143(1).

Hence, option (b) is not a duty under section 143(1).

Topic 12 Reporting on Fraud & Non-Compliance (Section 143)

MCQ

Question 90

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 Oct'19)

Ans: (d)

Reason:

As per Section 143(10) of the Companies Act, 2013:

The Central Government is empowered to prescribe the auditing standards,

Based on recommendations by ICAI,

In consultation with and after examining the recommendations of NFRA.

Hence, option (d) is correct.

Question 91

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 Oct'22)

Ans: (b)

Reason:

The primary objective of UDIN is to prevent forgery or misuse of Chartered Accountants' signatures and to ensure authenticity of documents issued by them — not merely to maintain a registry of services.

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Hence, option (b) is false and therefore the correct answer.

Descriptive Question

Question 92

During the course of audit of PQR Ltd, the statutory auditor CA G came across payments made to various creditors aggregating to Rs. 75 lakhs. On verifying the same it is found that the accounts manager had accounted for fake invoices of credit purchases for Rs. 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 May'23)

Answer 92

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 Rs. 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 Rs. 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.

Question 93

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 Nov'20)

Answer 93

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 Section 143(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 94

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 94

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 95

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 Oct'23)

Answer 95

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 96

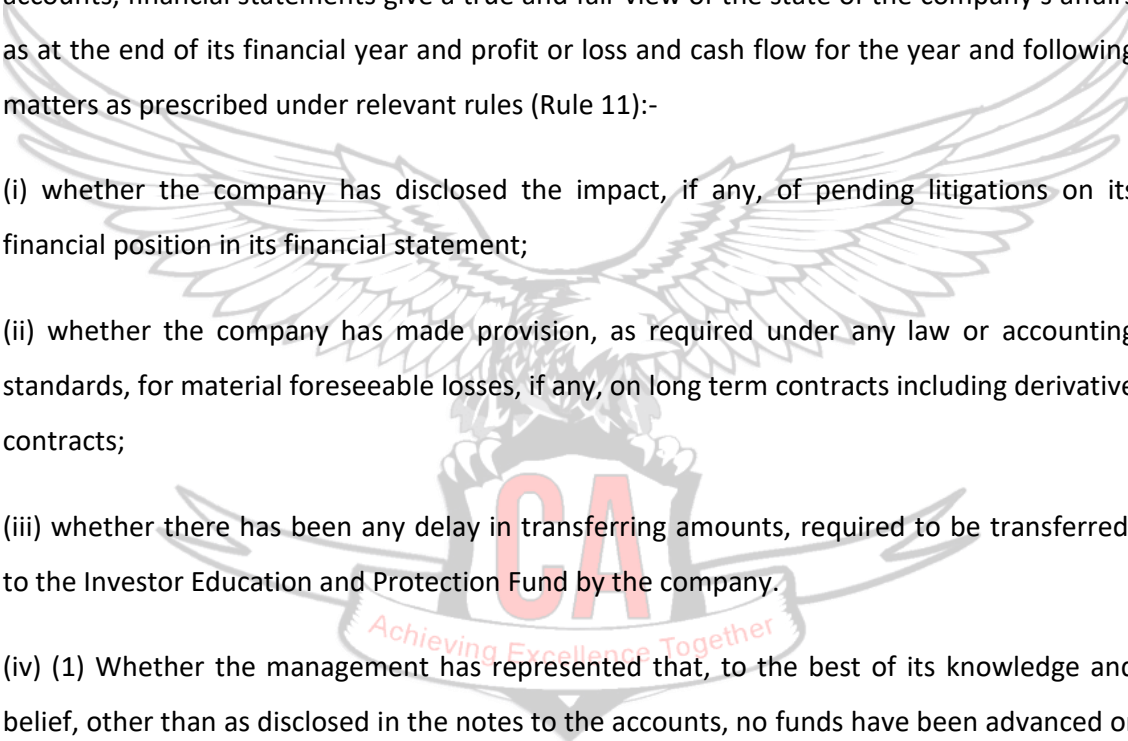
Under provisions of Section 143(2), the auditor shall make a report to the members of the company on the accounts examined by him. Explain along with relevant rule of The Companies (Audit and Auditors) Rules, 2014

(MTP Mar'22)

Answer 96

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 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 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.

Question 97

The auditor's reporting on internal financial control will be applicable with respect to interim financial statements. Discuss

(MTP Apr'21 & Apr'23, PYP Nov'19)

Answer 97

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 98

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 Oct'20)

Answer 98

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 99

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 Aug'18)

Answer 99

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 100

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 Apr’19, RTP May’21)

Answer 100

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.

Topic 13 Joint Auditors & Responsibilities (SA 299)

Question 101

The auditor has to make inquires on certain matters under section 143(1) of Companies Act, 2013. Discuss those matters.

(MTP Oct'20, RTP Nov'18)

Answer 101

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 102

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.

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(MTP Mar22, RTP Nov'22)

Answer 102

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 103

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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 Mar'23, RTP Nov'19)

Answer 103

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 104

Discuss significance of a company auditor's right/power to obtain information and explanation from officers of the company.

(RTP Nov'21)

Answer 104

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 105

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 Dec'21)

Answer 105

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 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 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 106

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 Nov'18)

Answer 106

Incorrect: As per Section 143(9) of the Companies Act, 2013, every auditor shall comply with the auditing standards

Question 107

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.

(Study material)

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)

Reason:

In the case of M/s Persistent & Company, a qualified opinion is appropriate when:

The auditor has obtained sufficient appropriate audit evidence,

But concludes that misstatements are material, yet not pervasive to the financial statements.

This usually happens when there's an identified issue, such as:

Non-compliance with accounting standards,

Incorrect presentation or disclosure, or

Valuation errors,

that do not affect the overall financial statements to a pervasive extent.

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Hence, a "Qualified Opinion" is ideal when the misstatement is material but not pervasive — matching the situation in Persistent & Company as described in the ICAI study material.

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)

Reason (as per ICAI study material):

In the case of M/s Dubious Brothers, the auditor is unable to obtain sufficient appropriate audit evidence, and the possible effects of undetected misstatements could be both material and pervasive.

As per SA 705 (Revised), when the auditor:

- I. Cannot obtain audit evidence, and
- II. Believes the impact could be material and pervasive,

the correct opinion is a Disclaimer of Opinion.

Thus, option (c) is correct — the auditor should issue a Disclaimer, as per the ICAI study material.

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)

Reason:

When there is a change in accounting method that is properly disclosed and acceptable, it does not affect the overall fairness of the financial statements, so an Emphasis of Matter paragraph is sufficient to highlight the change to users.

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)

Reason:

When material misstatements exist but are not pervasive, the auditor issues a Qualified Opinion to highlight the specific issues while confirming that the rest of the financial statements are fairly presented.

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)

Reason:

When financial statements are free from material misstatements and comply with the applicable framework, the auditor issues an Unmodified Opinion, indicating a clean and fair presentation.

Question 108

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

(Study material)

Ans: (c)

Reason:

The phrase "with the foregoing explanation" suggests a reservation or qualification, which is inconsistent with an unmodified (clean) opinion.

Question 109

..... 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.

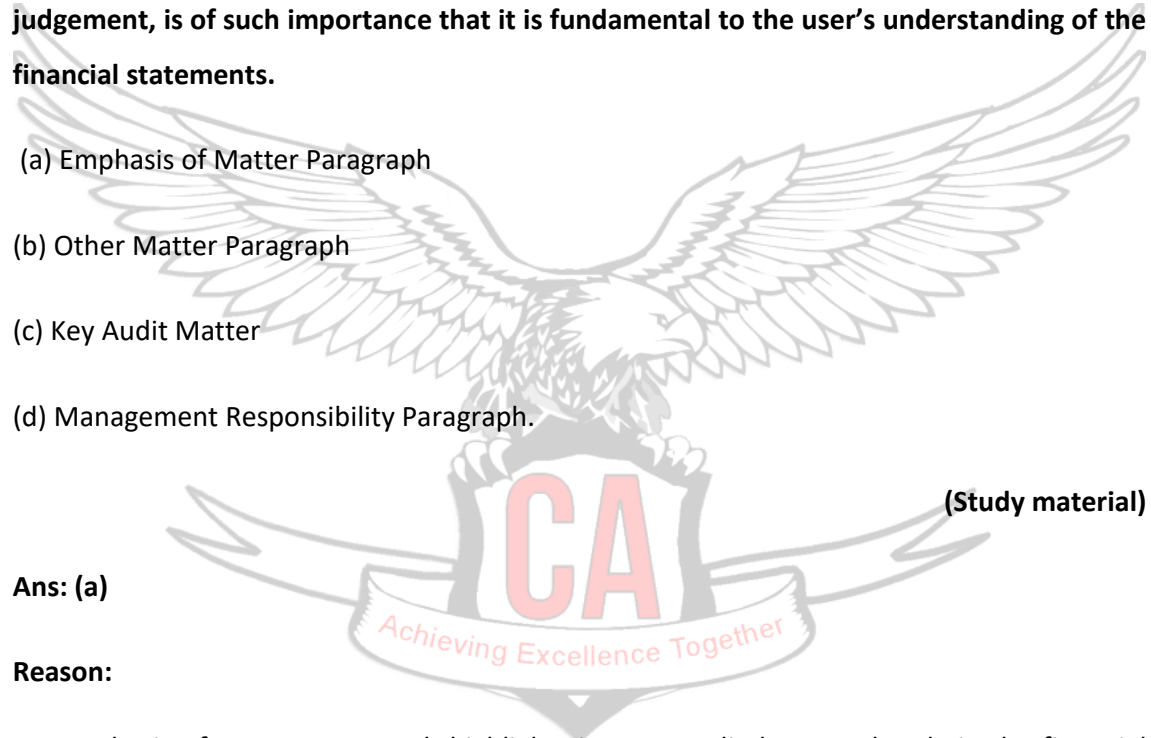
- (a) Emphasis of Matter Paragraph
- (b) Other Matter Paragraph
- (c) Key Audit Matter
- (d) Management Responsibility Paragraph.

Ans: (a)

Reason:

An Emphasis of Matter paragraph highlights important disclosures already in the financial statements that are crucial for users' understanding without modifying the auditor's opinion.

Question 110



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

(Study material)

Ans: (d)

Reason:

Key Audit Matters are communicated in addition to, not as a substitute for, disclosures in the financial statements. Also, they do not replace the need to modify an opinion when required under SA 705

Question 111

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

(Study material)

Ans: (c)

Reason:

SA 705 deals with Modifications to the Opinion in the Independent Auditor's Report, not comparative information. Comparative information is covered under a different standard, SA 710.

Question 112

Responsibilities of Joint Auditors are governed by:

- (a) SA 200
- (b) SA 229
- (c) SA 299
- (d) SA 230

(Study material)

Ans: (c)

Reason:

SA 299 specifically deals with the responsibilities of joint auditors, outlining how they should cooperate and coordinate during the audit.

Topic 14 Evaluation of Financial Statements (SA 540)

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Descriptive Question

Correct/Incorrect

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

Question 113

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.

(Study material)

Answer 113

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 114

There is no need of addressee in the Auditor's report.

(Study material)

Answer 114

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 115

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.

(Study material)

Answer 115

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 116

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.

(Study material)

Answer 116

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 117

Communicating key audit matter in the auditor's report constitutes a substitute for disclosure in the financial statements.

(Study material)

Answer 117

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 118

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.

(Study material)

Answer 118

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 119

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.

(Study material)

Answer 119

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 120

The concept of "joint audit" has legal foothold under the Companies Act, 2013.

(Study material)

Answer 120

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.

Question 121

"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

(Study material)

Answer 121

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 122

“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.

(Study material)

Answer 122

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.

Topic 15 Matters to be Included in the Auditor’s Report

Question 123

Discuss the factors affecting the decision of the auditor regarding which type of modified opinion is appropriate.

(Study material)

Answer 123

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 Qualified opinion
misstated materially

Adverse opinion

Inability to obtain sufficient Qualified opinion
appropriate audit evidence

Disclaimer of opinion

Question 124

Discuss the objective of the auditor as per Standard on Auditing (SA) 705 “Modifications to The Opinion in The Independent Auditor’s Report”.

(Study material)

Answer 124

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 125

"An auditor is required to make specific evaluations while forming an opinion in an audit report." State those evaluations.

(Study material)

Answer 125

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 126

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.

(Study material)

Answer 126

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.

Topic 16 Illustrations on Drafting Audit Reports

Question 127

Discuss which class of companies are specifically exempt from the applicability of CARO 2020?

(Study material)

Answer 127

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 128

ICAI 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.

(Study material)

Answer 128

INDEPENDENT AUDITOR'S REPORT

To the Members of Hotmeals Ltd.

Question 129

ICAI 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.

(Study material)

Answer 129

INDEPENDENT AUDITOR'S REPORT

To the Partners of Richa International

Question 130

ICAI Illustration

CATESTSERIES.ORG

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.

(Study material)

Answer 130

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 131

ICAI 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.

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(Study material)

Answer 131

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 132

ICAI 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.

(Study material)

Answer 132

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 133

ICAI 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.

(Study material)

Answer 133

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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 134

ICAI 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.

(Study material)

Answer 134

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:

Topic 17 Special Reporting Requirements (UDIN, Data Issues)

Question 135

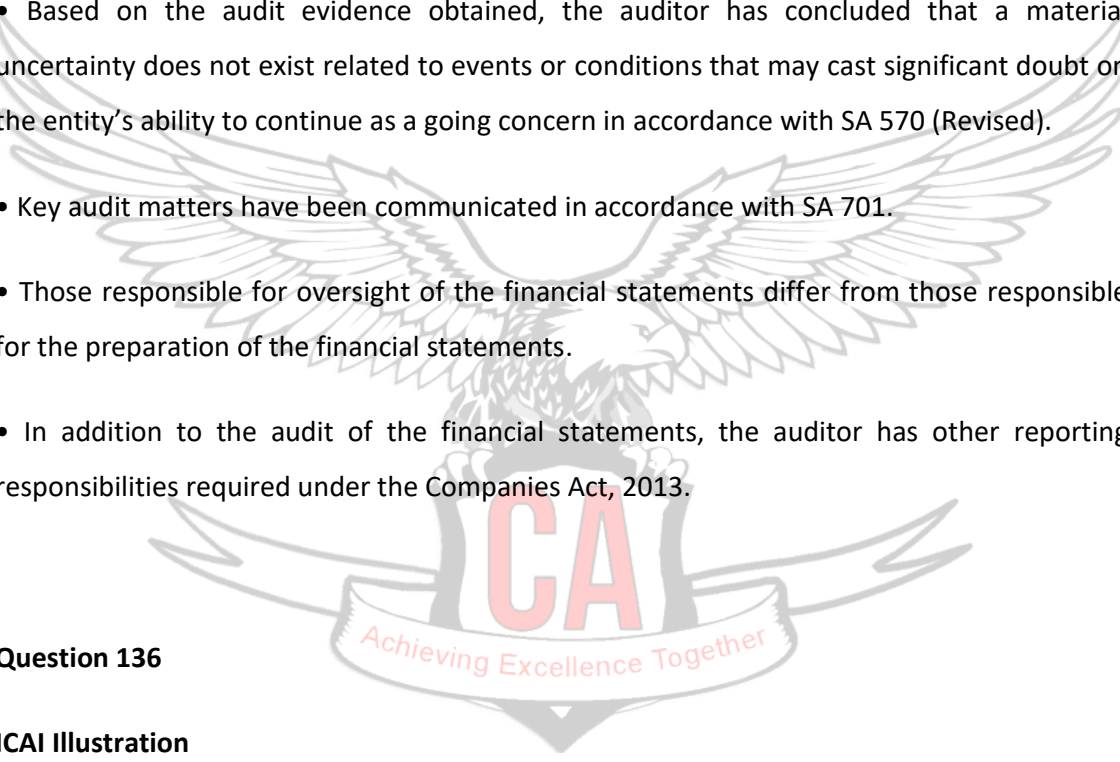
ICAI Illustration

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:

(Study material)

Answer 135

- 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 136

ICAI 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.

(Study material)

Answer 136

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 137

ICAI Illustration

M/s Taj Raj & Associates are the statutory auditors of Porex 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.

(Study material)

Answer 137

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 Porex 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 138

ICAI 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.

(Study material)

Answer 138

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 139

ICAI 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 Rs. 1,00,000/- and the turnover of the company for the year is Rs. 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.

(Study material)

Answer 139

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 140

ICAI 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.

(Study material)

Answer 140

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 141

ICAI 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.

(Study material)

Answer 141

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.

Question 142

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?

(Study material)

Answer 142

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 143

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.

(Study material)

Answer 143

“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 144

CA. Sarasbhai Patel, while conducting audit of an entity, feels that there is an Atmosphere of non-cooperation 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?

(Study material)

Answer 144

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 145

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. Yamin Jain feels it as encroachment of her domain. Discuss the issue.

(Study material)

Answer 145

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 146

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 Rs. 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, Rs. 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?

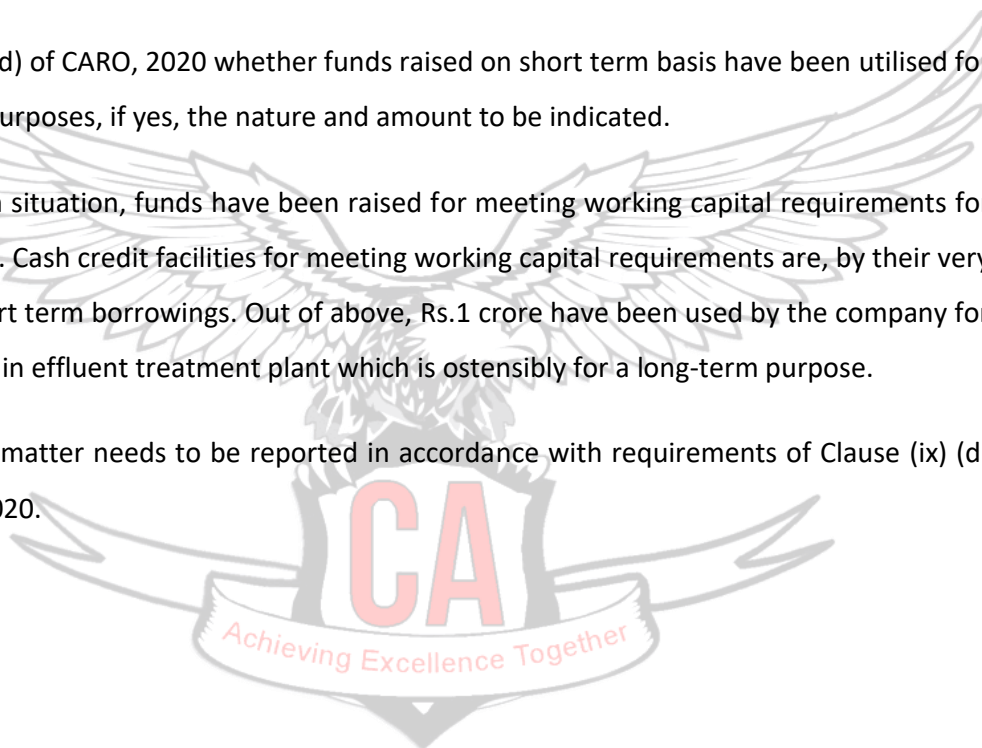
(Study material)

Answer 146

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 Rs. 4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings. Out of above, Rs.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 REPORT

Topic 1 Types of Audit and Scope – Government & Statutory

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.

(Study material)

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)

Reason

A performance audit evaluates the efficiency, effectiveness, and economy of an organization's operations. It is typically focused on assessing whether a program, activity, or department is achieving its objectives and whether resources are being used in an optimal manner.

Given that the office of the Comptroller and Auditor General of India (CAG) is involved in auditing the performance of government programs and activities, performance audits are aimed at determining how well these activities are functioning in terms of their goals and resource utilization.

Option (a) Audit against provision of funds: This type of audit examines whether the funds allocated by the government were used in accordance with the specific provisions and

purposes for which they were allocated. This is typically not the focus of performance audits but could be a part of compliance audits.

Option (b) Propriety audit: A propriety audit involves examining the appropriateness or ethical use of resources. It assesses whether the actions taken were in line with proper or fair principles. While important, this is not the primary focus of a performance audit.

Option (d) Compliance audit: A compliance audit checks whether an entity is following relevant laws, regulations, and policies. While related, it focuses on adherence to rules rather than assessing the performance or effectiveness of the activities.

Thus, Option (c) is the correct answer because performance audit specifically addresses the efficiency, effectiveness, and economy of operations, which aligns with the objectives typically pursued by the CAG in auditing government functions.

(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)

Reason

A performance audit focuses on evaluating the effectiveness, efficiency, and economy of an entity's operations or programs. It involves assessing whether the activities of an organization are achieving their intended outcomes, and whether resources are being used optimally.

In the case of Haryana Power Generation Corporation Limited, if the audit findings pertain to the assessment of how well the company is performing its functions, managing resources, and achieving its objectives (such as energy generation, cost management, and operational efficiency), then the audit is likely a performance audit. This would involve evaluating how effectively the company is using its resources and whether it is meeting its goals.

Option (a) Audit of Government Company: This would focus on financial audits, examining whether the company's financial statements comply with accounting standards and regulations. This is more about financial reporting than performance assessment.

Option (b) Audit against rules and orders: This type of audit would be focused on compliance with specific legal, regulatory, or procedural requirements. It is not necessarily about performance, but about ensuring adherence to rules.

Option (c) Compliance audit: A compliance audit ensures that the company is following laws, regulations, and policies. While compliance is important, it does not assess the effectiveness or performance of operations, which is the focus of a performance audit.

Thus, Option (d) is the correct answer because performance audit directly evaluates how well the company is performing in terms of its operational efficiency, effectiveness, and resource utilization.

(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)

Reason: According to Article 151 of the Constitution of India, the Comptroller and Auditor General of India (CAG) is responsible for auditing and reporting on the accounts of the Union and State governments, including the administration of direct taxes. The CAG's reports are submitted to the President of India, who then tables them in Parliament.

Option (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: This is incorrect because the task force of experts is not authorized to prepare such reports for submission under Article 151. Article 151 specifically pertains to the CAG's role in reporting on financial and taxation matters.

Option (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 (CBDT): This is incorrect because the Central Board of Direct Taxes (CBDT) is responsible for formulating policies regarding direct taxes, but it does not prepare reports under Article 151 for submission to the President.

Option (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: This is also incorrect. Reports under Article 151 are submitted by the CAG, not the CBDT, and the report is submitted to the President, not the Prime Minister.

Thus, Option (a) is the correct answer because the CAG prepares the report on the administration of direct taxes, and it is submitted to the President under Article 151 of the Constitution.

(4) Who is empowered to conduct "supplementary audit" in case of Radial finance Corporation Limited, a government company?

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- (a) Central Government
- (b) Another independent auditor appointed by CAG
- (c) CAG
- (d) Another independent auditor appointed by Ministry of Corporate Affairs

Ans: (c)

Reason

The Comptroller and Auditor General of India (CAG) is empowered to conduct a supplementary audit in the case of a government company, as per the provisions of Section 143(6) of the Companies Act, 2013. The CAG conducts this supplementary audit to ensure that the financial statements of the government company are in compliance with applicable standards and accurately reflect its financial position.

Option (a) Central Government: The Central Government does not conduct a supplementary audit. While the government may have oversight in financial matters, the actual audit is performed by the CAG, not the government directly.

Option (b) Another independent auditor appointed by CAG: The CAG may appoint another auditor, but the supplementary audit itself is conducted by the CAG, not by an auditor appointed by the CAG. The auditor appointed by the CAG assists in the audit process but does not perform the supplementary audit independently.

Option (d) Another independent auditor appointed by Ministry of Corporate Affairs: The Ministry of Corporate Affairs may have regulatory oversight, but it does not appoint an auditor to conduct the supplementary audit for government companies. The supplementary audit is conducted by the CAG.

Thus, Option (c) is the correct answer because the CAG is specifically empowered to conduct the supplementary audit in government companies, including Radial Finance Corporation Limited.

(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)

Reason

In the case of a government company or any other entity where the Comptroller and Auditor General of India (CAG) exercises oversight, the CAG can issue specific directions to the statutory auditor for reporting on particular aspects of the audit work. These directions ensure that the audit covers relevant areas and that any issues specific to government-owned companies or public-sector undertakings (like an insurance company) are properly addressed. The statutory auditor, upon receiving these directions, is required to comment on these specific aspects in their audit report.

Option (a) Such are likely to be comments of test audit carried out by CAG: This is incorrect because test audits are usually conducted to assess the adequacy of the main audit process and aren't specifically tied to the direction given to statutory auditors. The comments of the CAG on test audits wouldn't typically be part of the formal audit report issued by the statutory auditors.

Option (c) Such are likely to be comments of supplementary audit carried out by CAG: This is incorrect because a supplementary audit by the CAG is a review of the financial statements already audited by the statutory auditor. It involves commenting on matters

related to financial reporting and is not primarily focused on directions regarding the audit scope.

Option (d) Such are likely to be comments of statutory auditors in accordance with requirements of Standards on Auditing: While statutory auditors follow Standards on Auditing (SAs), the specific comments mentioned in the question are more likely related to directions issued by the CAG, especially in the context of government companies or entities under its oversight.

Therefore, Option (b) is the most appropriate, as it reflects the role of the CAG in providing directions to the statutory auditor to focus on specific areas of audit and comment on them in the audit report.

Topic 2 Consolidated Fund of India – Concept and Importance

Question 2

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?

(Study material)

Answer 2

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

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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.

Topic 3 Audit of Partnership Firms – Changes in Constitution

Question 3

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.

(Study material)

Answer 3

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 4

You are appointed as an auditor of M/s Shine & Co., a partnership firm. During your review, you observed that:

- The audit appointment was informal and not documented properly.
- The firm started a new business activity which is not covered in the partnership deed.
- Major financial decisions were made without proper records.

As an auditor, briefly explain the matters that should be specially considered by you while auditing the accounts of the partnership firm, M/s Shine & Co.

(RTP Sept 2025)

Answer 4

While auditing the accounts of M/s Shine & Co., a partnership firm, it is important to ensure that they have formal appointment. Further, deviation from the partnership deed, and absence of documentation for key decisions raise concerns about the validity, transparency, and legal compliance of the firm's operations. Thus, the auditor should specially consider the following matters in the audit of accounts of a partnership:

- (i) Letter of Appointment: 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) Partnership Documents: 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) Objects of Partnership: 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) Books of Account: 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) Mutual Interest: 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) Provision for Taxes: 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) Division of Profits: Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

Topic 4 Verification of Fees Concessions in Educational Institutions

Question 5

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?

(Study material)

Answer 5

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.

Topic 5 Multi-State Cooperative Societies – Nature and Accounting Requirements

Question 6

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.

(Study material)

Answer 6

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 Co-operative 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

Topic 1 Nature and Objective of Review Engagements

Question 1

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 May '23)

Answer 1

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.

Question 2

"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 Nov 2018)

Answer 2

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

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 3

Compute the Drawing Power for Cash Credit A/c of S Limited for the month of March 2022 with following information:

(PYP May'22)

(Amount in Rs.)

Stock	50,000
Debtors (Including Debtor of Rs. 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 3

Computation of Drawing Power:

Computation of Drawing Power for CC A/c of S Ltd.

Particulars of current assets		Amount (Rs.)	DP Amt (Rs.)

(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 Rs. 45000 whereas drawing power as per the above working is Rs. 48000. So, drawing power would be restricted to sanctioned limit i.e. Rs. 45000

Question 4

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 May'19)

Answer 4

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 5

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 Rs. 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 Rs. 5 crore (including Rs. 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 Rs. 3 crore (including Rs. 50 lacs outstanding for last 6 months). Trade creditors outstanding as on date are Rs. 2 crore. He calculates DP as on 30.6.23 for Rs. 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 5

The calculation of DP is as under:

Value of stocks as on 30.6.23	Rs. 5.00 crore
Less: value of damaged stocks	Rs. 1.00 crore
Value of stocks considered as on 30.6.23	Rs. 4.00 crore
Less: Trade creditors	Rs. 2.00 crore
Paid stocks	Rs. 2.00 crore
Less: Margin @ 25%	Rs. 0.50 crore
Drawing power for stocks [A]	Rs. 1.50 crore
Value of Trade debtors	Rs. 3.00 crore
Less: Debtors outstanding for more than 90 days	Rs. 0.50 crore
	Rs. 2.50 crore
Less: Margin @ 40%	Rs. 1.00 crore

Drawing power for Book debts [B]	Rs. 1.50 crore
Total drawing power [A+ B]	Rs. 3.00 crore

Accountant's DP calculation is not correct. The drawing power of Rs. 3.00 crore signifies that company can utilize funds to the tune of Rs.3.00 crore only against sanctioned cash credit limit of Rs. 4.00 crore.

Question 6

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 Rs. 300 crores were outstanding as on balance sheet date carrying average interest rate @8% p.a. One articulated clerk in audit team makes quick back of the envelope calculations of interest income of Rs. 24 crores on advances. However, schedule of profit & loss a/c shows interest income on advances for Rs. 10 crores. Discuss any two probable reasons for such variation.

(RTP Nov'22)

Answer 6

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 7

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 7

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 8

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 July '21)

Answer 8

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 9

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 9

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 10

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.

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Answer 10

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 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.

(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.

Topic 2 Understanding Entity & Environment in Review Engagements

Question 11

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 11

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 12

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 Oct'23)

Answer 12

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 13

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 Rs. 50 lakhs. Value of security held in account is Rs. 40 lakhs. The branch has made provision of Rs.7.50 lakhs. Is provision made by branch proper? Discuss.

(MTP Sep '23)

Answer 13

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	Rs. 50 lakhs
Less: Value of security	Rs. 40 lakhs
Unsecured portion	Rs. 10 lakhs
Therefore, outstanding balance of Rs.50 lakhs is secured to the tune of Rs.40 lakhs and balance Rs. 10 lakhs is unsecured.	
Provision calculation	
25% of secured part i.e., 25% of Rs.40 lakhs	Rs. 10 lakhs
100% of unsecured part i.e.,100% of Rs.10 lakhs	Rs. 10 lakhs

Required provision	Rs. 20 lakhs
Therefore, provision made by branch is not proper. It should have made provision of Rs.20 lakhs instead of Rs. 7.50 lakhs.	

Question 14

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 April '23, PYP Dec '21)

Answer 14

Computation of Drawing Power:

(iii) 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.

(iv) 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.

(v) 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.

(vi) 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 15

Explain pledge and set off as the modes of creation of security with respect to advance granted by a bank.

(MTP March '23)

Answer 15

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.

Topic 3 Procedures in Review Engagements (Inquiry, Analytical Procedures)

Question 16

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 March 22, MTP April 19, PYP Nov '18)

Answer 16

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 17

When is an agricultural advance considered as non performing as per the RBI guidelines?

(MTP Oct'22, MTP March 22)

Answer 17

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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 18

Explain the audit approach you would follow to check the Operating Expenses of a Bank.

(MTP Sep’22 & April ’23, RTP May’22)

Answer 18

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 19

"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 Oct '21, RTP May '22, PYP Nov '19)

Answer 19

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-standard assets, Doubtful assets and loss assets which are given below:

Categories of Non-Performing Assets:	Provision required
Substandard Assets: Would be one, which has	15%

remained NPA for a period less than or equal to 12 months	
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)	25% + 100%
Doubtful 1 to 3 Years (D2)	40% + 100%
Doubtful more than 3 Years (D3)	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 20

In case of a Bank, explain the meaning of Funded loans. Also give examples.

(MTP April '21, Oct '21)

Answer 20

Funded loans are those loans where there is an actual transfer of funds from the bank to the borrower.

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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 21

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 Oct 20, RTP May'22)

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 Nov'20)

Answer 21

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

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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 22

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 Oct 18)

Answer 22

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 23

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 March '18, Aug'18, Oct'18, Mar'19)

Answer 23

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 24

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 March '18, March '19)

Answer 24

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 25

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 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 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 25

(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:

1. examining the validity of the recorded amounts;

2. examining loan documentation;

3. reviewing the operation of the accounts;

4. examining the existence, enforceability and valuation of the security;

5. checking compliance with RBI norms including appropriate classification and provisioning;
and

6. 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 26

There are different types of banks prevailing in India. Explain giving examples of such banks.

(MTP March '21)

Answer 26

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.

8. 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.

9. 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.

10. 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.

11. 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.

12. 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.

13. 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:-** Equities Small Finance Bank , AU Small Finance Bank , etc.

Question 27

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 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 May '18)

Answer 27

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

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- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Banker's General Lien
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments

Question 28

M/s JKL & Associates, Chartered Accountants, are the statutory auditors of M/s IBS Bank Limited for the financial year 2024-25. During the audit, they observed the following items included under interest income in the financial statements of the bank:

- An amount of Rs.5 lakh relating to a short-term crop loan, where the instalment was overdue for one crop season.
- An amount of Rs.7 lakh relating to an advance guaranteed equally by the Government of India and the Government of Tamil Nadu, where the instalment has been overdue for more than six months.

From the above facts and details, what should be the correct treatment of the above interest income in the bank's financial statements? State the amount that can be recognised as interest income with appropriate reasoning. Also, determine the amount to be classified as Non-Performing Asset (NPA), with reference to applicable RBI norms.

(RTP Sept 2025)

Answer 28

(b) Classification of Non-Performing Asset (NPA) & Treatment of Interest Income:

(i) **Short-Term Crop Loan:** As per RBI norms, a loan granted for short-duration crops is to be classified as NPA only if the installment remains overdue for two crop seasons.

In the given case, the installment is overdue for only one crop season, hence, the account is not classified as NPA. Therefore, the interest income of Rs. 5 lakh can be recognised in the financial statements.

(ii) Advance Guaranteed Equally by Government of India and Government of Tamil Nadu:

If an advance is guaranteed by the Central Government, it need not be classified as NPA until the guarantee is invoked and repudiated. Thus, Central Government guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets but regarded as NPA for Income Recognition purpose. The situation would be different if the advance is guaranteed by the 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.

In the given case, since the guarantee is shared equally between the Central Government and the State Government (Tamil Nadu), and the installment is overdue for more than 6 months, the portion of loan guaranteed by the Central Government (50%) is not to be classified as NPA unless the guarantee is invoked and repudiated. The remaining 50%, guaranteed by the State Government, must be classified as NPA as the installment is overdue for more than 90 days.

Thus, Amount to be classified as NPA will be Rs. 3.5 lakh (i.e., 50% of Rs. 7 lakh) and amount of interest income to be recognised will be Rs. 5 lakh.

Topic 4 Date of Review Report

Question 29

Explain "Advances under Consortium" in the context of Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

(MTP Nov '21 & MTP Sep '23, PYP Jan '21)

Answer 29

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 30

What are the general requirements of an effective Risk Management System in Banks?

(MTP Sep'22)

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 May '19)

Answer 30

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 31

Explain hypothecation and assignment as the modes of creation of security with respect to advance granted by a bank.

(MTP Oct'22)

Answer 31

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 32

When are following considered as non performing as per the RBI guidelines?

- (i) Government guaranteed advances**
- (ii) Advances to staff**

(MTP March '23)

Answer 32

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Government Guaranteed advances:

1. 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.
2. 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 instalment 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.

Topic 5 Events after the Interim Period Ends

Question 33

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 Nov'20, MTP April '23)

Answer 33

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
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treating an advance as NPA or otherwise. Asset classification would be borrower-wise and not facility-wise.

Question 34

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

Banks recognize income on Non-Performing Assets on accrual basis.

(MTP Sep '23, PYP Nov'18)

Answer 34

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 35

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 Oct '23, RTP Nov'20)

Answer 35

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 36

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 Oct'23)

Answer 36

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 37

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 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)

Answer 37

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.

Topic 6 Special Purpose Framework in Review Engagements

Question 38

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 38

Incorrect: The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Income from nonperforming assets (NPA) is not recognized on accrual basis but is booked as income only when it is actually received

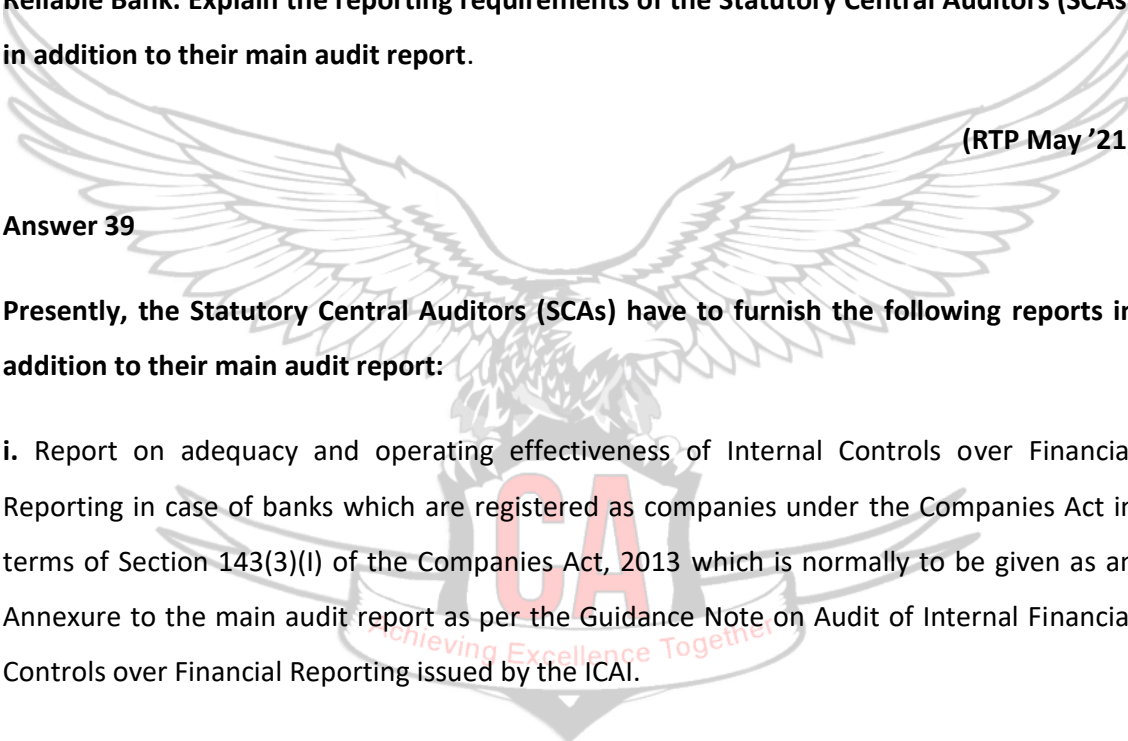
Question 39

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 39

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 40

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 40

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 41

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 41

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 42

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 42

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'.

Topic 7 Handling Material Misstatements in Review Engagements

Question 43

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 May'19)

Answer 43

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 44

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, July'21)

Answer 44

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

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➤ 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 Rs. 80 Lakhs, although outstanding balance in the account is Rs. 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 45

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 May'22)

Answer 45

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 46

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 Nov 22)

Answer 46

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 provision 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	Secured+ Unsecured

months.	
Sub-categories:	
Doubtful up to 1 Year(D1)	25% + 100%
Doubtful 1 to 3 Years (D2)	40% + 100%
Doubtful more than 3 Years (D3)	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, nonperforming loans and agree the outstanding balances with the general ledger.

Question 47

CBC Bank Ltd. has multiple loan accounts classified as Non-Performing Assets (NPAs). During the financial year, some borrowers made partial payments towards their outstanding dues. However, there was no explicit agreement between the bank and the
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borrowers regarding the appropriation of these recoveries i.e., whether they should be adjusted against principal or interest.

The bank's finance team decided to recognise the recovered amount as interest income in its financial statements. However, during the statutory audit, the auditors raised concerns about the treatment of these recoveries.

Discuss the appropriate accounting treatment of partial recoveries in NPAs. Also, explain the principles that banks should follow in recognising interest income from NPAs.

(RTP-May 25)

Answer 47

Accounting treatment of partial recoveries in NPAs:

- In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner.
- The appropriate policy to be followed is to recognise income as per AS 9, "Revenue Recognition", when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted.
- Interest partly/fully realised in NPAs can be taken to income.

Conclusion: It should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

Question 48

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 Rs. 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 Rs.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 Rs.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.

(Study material)

MULTIPLE CHOICE QUESTIONS (MCQS)

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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)

Reason:

In the context of agricultural advances, banks generally follow specific guidelines set by the Reserve Bank of India (RBI) regarding asset classification, particularly with regard to Non-Performing Assets (NPA) and the classification of loans. Agricultural advances may be subject to different norms when compared to regular loans, and the classification depends on factors like repayment schedules and the nature of the loan.

Option (a) The branch has erred in making classification as per RBI norms. It is a “Sub-standard” asset.: This is incorrect because agricultural loans are typically classified under different norms, and if the classification follows the correct RBI norms, there would not be any error in classification. The classification of Sub-standard is typically reserved for loans where repayment is overdue for more than 90 days but less than 1 year.

Option (b) The classification made by branch is proper. However, there are no transactions in account since last 90 days, it is SMA.: While this option could be considered in other scenarios, SMA (Special Mention Account) classification is used primarily for assets that are not yet NPAs but have repayment issues. In the case of agricultural advances, the loan may

not necessarily fall under SMA if the asset classification is correct under the RBI norms for agricultural loans.

Option (d) The branch has erred in making classification as per RBI norms. It is a “Doubtful” asset.: This classification is more severe than Sub-standard and usually applies when the asset remains non-performing for over 1 year. Agricultural loans may not fall into the Doubtful category unless they are overdue beyond the specified period, and this classification would only apply if the branch had made a mistake.

Option (c) is correct because it implies that the classification made by the branch aligns with RBI norms and is accurate for the specific agricultural advance in question. If the asset is classified properly based on the RBI guidelines, no correction is needed.

(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)

Reason

When a bank takes over an account from another bank, the auditor must assess whether the transfer was in line with the prescribed procedures, guidelines, and norms established by the bank and regulatory authorities. This process is scrutinized to ensure that the transfer

of the account, including the related credit facilities, follows due diligence and proper procedures.

Option (a) It is an internal issue of Bank and auditor is not concerned with it.: This option is incorrect. The auditor's role is to ensure that the bank complies with all applicable rules, regulations, and procedures, and this includes reviewing such transactions even if they seem internal to the bank. The auditor must ensure proper documentation and compliance.

Option (b) It is an internal issue of Bank. However, the auditor may, at his discretion, report it.: This option is incorrect because the auditor's responsibility is to ensure compliance with regulations and procedures. If the auditor discovers a potential violation, it is essential for the auditor to report it. Discretion cannot override the duty to report such matters.

Option (d) There is no issue involved as credit facility was properly sanctioned.: This is not correct. Even if the credit facility was sanctioned, the process by which the account was taken over from another bank must be evaluated to ensure it was done following all the laid-down procedures. If there are lapses in the process, the auditor must report them, regardless of whether the credit facility itself was properly sanctioned.

Option (c) is the most appropriate because taking over accounts from other banks can involve a variety of procedural checks, including ensuring that the proper due diligence was performed, the correct documentation is in place, and there was no violation of internal policies. If any serious violations of procedures are found, the auditor is obligated to report it to ensure transparency and compliance with banking regulations.

(3) As regards debit balance of Rs. 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 Rs.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)

Reason:

From an auditor's perspective, a debit balance in a savings account indicates that the account holder has overdrawn the account, and there is no credit balance available to cover the withdrawal. If such a debit balance continues for an extended period, it may be classified as a Non-Performing Asset (NPA) according to the norms set by the Reserve Bank of India (RBI).

Here's why each option is evaluated:

Option (a) The situation does not attract RBI norms on asset classification.: This is incorrect because the RBI's norms on asset classification apply to all types of banking accounts, including savings accounts. A debit balance in a savings account that persists for an extended period may lead to the account being classified as an NPA, depending on the time it remains outstanding.

Option (c) The situation does not attract RBI norms on asset classification as no credit facility was granted.: This option is incorrect because even though a formal credit facility (like a loan) wasn't granted, the debit balance still represents an asset that the bank has to recover, thus triggering the RBI norms on asset classification. A savings account showing a debit balance for an extended period could still be classified as an NPA.

Option (d) The bank cannot demand excess interest paid to account holder.: This is irrelevant and incorrect in this context. The issue here is related to the classification of the debit balance, not the recovery of excess interest paid to the account holder. The main concern is whether the debit balance qualifies as an NPA.

Option (b) is the most accurate because RBI norms require that accounts with unpaid debit balances beyond a certain period must be classified as Non-Performing Assets (NPA). This classification helps to ensure proper risk management and provisioning by the bank. Therefore, any debit balance like the Rs.1.50 lacs that remains unresolved should be classified as NPA according to RBI's guidelines.

(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)

Reason:

Drawing Power (DP) refers to the amount of funds that a borrower can draw from a financial institution based on the available security and agreed margin requirements. It is typically calculated as a percentage of the value of the primary security, less any margin that the lender requires to protect against fluctuations in the value of the security.

Here's why each option is evaluated:

Option (a) Drawing Power refers to the amount calculated based on primary security less margin as on a particular date.: This is correct. Drawing Power is calculated based on the value of the primary security (like inventory, receivables, etc.), less any margin requirements that the lender sets. It is recalculated periodically, usually on a particular date.

Option (b) It is always less than sanctioned limit.: This is incorrect. Drawing Power is not always less than the sanctioned limit. It is calculated based on the available security and the

margin, so it could be equal to or less than the sanctioned limit, depending on the amount of security provided and the margin required. There may be instances when the DP is exactly equal to the sanctioned limit.

Option (c) It can be different from the sanctioned limit.: This is correct. The Drawing Power may be less than or equal to the sanctioned limit, but it is generally calculated based on available security and may not always equal the limit. The difference between the DP and the limit can exist because the available security might be insufficient to support the full sanctioned limit.

Option (d) Creditors for goods are reduced for the purpose of calculating Drawing Power.: This is correct. Creditors for goods (liabilities or outstanding debts) are typically deducted when calculating the Drawing Power because they represent obligations the borrower must settle and are not part of the assets available for securing the drawing power.

Thus, option (b) is the incorrect statement because Drawing Power is not always less than the sanctioned limit; it can be equal or less, depending on the value of the available security and the margin.

(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)

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Reason:

In accordance with RBI norms on asset classification, loans are classified as Non-Performing Assets (NPA) if the borrower has failed to make repayments for a period of 90 days or more.

Let's evaluate the options:

Option (a) Both Housing loan as well as car loan should be classified as "Non-Performing Assets" in accordance with RBI norms on asset classification.: This option is correct. Both housing loans and car loans can be classified as Non-Performing Assets (NPA) if the borrower defaults on payments for more than 90 days. If payments are overdue beyond the specified period, both types of loans would be classified as NPAs, irrespective of the type of loan (housing or car).

Option (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.: This option is incorrect. Both loans are subject to the same RBI asset classification criteria. If either of the loans (housing or car) is overdue for more than 90 days, they should both be classified as NPAs.

Option (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.: This option is also incorrect. Similar to Option (b), if a loan (whether car or housing) is overdue for more than 90 days, it should be classified as an NPA, not a standard asset.

Option (d) Both Housing as well as car loans should be classified as Standard assets.: This option is incorrect. Standard assets are loans that are not overdue, i.e., they have been paid on time or are performing well. If the borrower defaults for more than 90 days, both loans will be classified as NPAs.

Thus, option (a) is the correct answer, as it aligns with the RBI's asset classification norms for loans that are overdue.

Topic 8 Going Concern Uncertainty in Review Engagements

Question 49

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

(Study material)

Ans: (a)

Reason:

In a bank's Profit & Loss Account, "Interest Earned" typically refers to income generated from the bank's lending activities, such as interest on loans, advances, and other financial assets.

Let's evaluate the options:

Option (a) Discount on Bills: This is the correct answer. The discount on bills is essentially a form of interest earned by the bank. It arises when a bank buys a bill of exchange from a client at a price lower than its face value, earning interest on the difference. This discount is treated as part of "Interest Earned" because it represents income generated through the bank's financing activities.

Option (b) Loan Processing fees: Loan processing fees are not considered part of "Interest Earned." They are typically classified as fee income or non-interest income in a bank's Profit & Loss account. They represent a one-time fee charged for processing the loan, not an interest income earned from lending.

Option (c) Commission on bills for collection: Commission on bills for collection is also non-interest income. It is earned by the bank for acting as an intermediary in the collection of bills and is categorized as fee income rather than interest earned.

Option (d) Credit Card Fees: Credit card fees are typically categorized as fee income or non-interest income. This includes annual fees, late payment fees, or charges for cash advances, but not interest income from lending activities.

Thus, option (a), Discount on Bills, is included in "Interest Earned" because it relates to the interest-like income generated from financing activities, fitting the definition of interest earned for the bank.

Question 50

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

(Study material)

Ans: (b)

Reason:

When auditing advances in a bank, the statutory auditor's primary concerns focus on ensuring that the bank's loan practices are compliant with regulatory standards, accurately recorded, and appropriately managed.

Here's a breakdown of the options:

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Option (a) Appropriate documentation of advances: This is a valid concern for the auditor.

The auditor must ensure that the documentation related to advances (such as loan agreements, approvals, and collateral) is in proper order to validate the legitimacy and compliance of the advances with regulatory norms and bank policies.

Option (b) Ensuring budgeted targets of advances given by bank management: This is not a primary concern for the auditor. While the bank's management may have internal targets for advances, the auditor's focus is on ensuring that these advances are appropriately authorized, documented, classified, and reported, rather than verifying whether the bank meets internal budgeted targets. The auditor does not typically evaluate whether budgeted targets are achieved, as that is an internal management concern rather than an auditing issue.

Option (c) Compliance of sanctioned terms and conditions: This is a valid concern. The auditor must ensure that the bank has complied with the sanctioned terms and conditions of each advance. For example, checking if the advance was made in accordance with the terms approved by the bank's credit committee, ensuring that the loan disbursement was made properly, and confirming that all agreed-upon conditions are met.

Option (d) Operations in advance accounts: This is also a valid concern. The auditor should examine the operations in the advance accounts to verify that there are no unusual or unauthorized transactions, ensuring proper monitoring and control over advances.

Thus, option (b), "Ensuring budgeted targets of advances given by bank management," is not a concern for the auditor during the audit of advances, as it pertains more to internal management goals rather than auditing the accuracy or compliance of the bank's practices.

Question 51

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

(Study material)

Ans: (a)

Reason:

According to the Reserve Bank of India (RBI) norms on asset classification, any amount due to a bank under a credit facility becomes overdue if it is not paid on the due date fixed by the bank.

Here's a breakdown of the options:

Option (a) it is not paid on the due date fixed by the bank: This is the correct answer. According to RBI guidelines, an overdue amount is defined as any amount that is not paid by the due date. Once the payment is not made by the due date, the credit facility is considered overdue, regardless of how many days have passed.

Option (b) it is not paid within 30 days of due date fixed by the bank: This is incorrect. The RBI does not specifically define "overdue" based on a 30-day grace period. The key determinant is the due date itself.

Option (c) it is not paid within 60 days of due date fixed by the bank: This is also incorrect. Similar to option (b), the amount is overdue as soon as it exceeds the due date, without any waiting period specified by the RBI.

Option (d) it is not paid within 90 days of due date fixed by the bank: This option also incorrect because a credit facility is considered overdue as soon as it passes the due date set by the bank, and there is no 90-day period after which an amount becomes overdue.

Thus, the most accurate answer is (a) since it directly relates to the definition of an overdue amount as per the RBI norms.

Question 52

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)

Reason

The appointment of the statutory branch auditor of a nationalized bank follows a specific process defined by the Reserve Bank of India (RBI) guidelines and banking regulations. Here's a breakdown of the options:

Option (a) The appointment is made by bank acting through its board of directors with prior approval of Central govt.: This is incorrect because the Central Government's approval is not required for the appointment of the statutory branch auditor. The RBI's approval is what is necessary.

Option (b) The appointment is made by bank acting through its board of directors with prior approval of RBI: This is the correct answer. According to the guidelines issued by the RBI, the bank's board of directors makes the appointment of the statutory branch auditor, but this appointment requires prior approval from the RBI.

Option (c) The appointment is made by bank acting through its board of directors with prior approval of ICAI: This is incorrect because the Institute of Chartered Accountants of India (ICAI) does not provide approval for the appointment of branch auditors. It is the RBI that approves such appointments.

Option (d) The appointment is made by shareholders in AGM: This is incorrect because the shareholders in the AGM typically appoint the statutory auditor for the company as a whole, but the process for appointing statutory branch auditors of nationalized banks is different and involves the board of directors along with the RBI's approval.

Thus, the correct answer is (b) because the RBI approval is a mandatory requirement for appointing the statutory branch auditor of a nationalized bank.

Question 53

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

(Study material)

Ans: (c)

Reason

In accordance with the guidelines provided by the Reserve Bank of India (RBI) for the recognition of income from non-performing assets (NPAs), the correct approach to recognizing income from these assets is based on the actual recovery, rather than on an accrual basis. Here's why:

Option (a) Income from non-performing assets is recognized on accrual basis: This is incorrect because, under the RBI guidelines, income from NPAs is not recognized on an accrual basis. This would mean that income is not recorded as earned until it is actually received.

Option (b) Income from non-performing assets is never recognized: This is incorrect because income from NPAs is still recognized, but it is recognized only when the recovery is made, not on an accrual basis.

Option (c) Income from non-performing assets is recognized on basis of actual recovery: This is the correct answer. According to RBI guidelines, income from NPAs is recognized only when it is actually received or recovered. This ensures that the bank does not recognize income from assets that are not generating cash flow, avoiding overstatement of income.

Option (d) Income from non-performing assets is recognized only when such assets are upgraded to standard assets: This is incorrect because even if a non-performing asset is upgraded to a standard asset, income can still be recognized on the actual recovery basis, not automatically upon upgrading.

Thus, the correct statement is (c), where income is only recognized when it is actually recovered from the NPA, ensuring the financial statements are not inflated by uncollected income.

Correct/Incorrect

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

Question 54

RBI has been entrusted with the responsibility of regulating the activities of commercial banks only.

(Study material)

Answer 54

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.

Topic 9 Disagreement with Management in Review Engagements

Question 55

In the computerised environment, the auditor need not be familiar with latest applicable RBI guidelines.

(Study material)

Answer 55

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 56

The auditor can assume that the system generated information is correct and relied upon.

(Study material)

Answer 56

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 57

Registered mortgage is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof

(Study material)

Answer 57

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 58

Any amount due to the bank under any credit facility is 'overdue' if it is not paid within 90 days of becoming due.

(Study material)

Answer 58

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.

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Topic 10 Preconditions for Accepting a Review Engagement

Question 59

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

(Study material)

Answer 59

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 60

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.

(Study material)

Answer 60

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 61

Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets.

(Study material)

Answer 61

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 62

Discuss outline of audit approach including audit procedures while auditing “provisions and contingencies” in financial statements of a bank.

(Study material)

Answer 62

For audit of Provisions and contingencies the auditor should :-

1. ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
2. 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.

3. obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
4. 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.
5. 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.

Topic 11 Reporting in Review Engagements

Question 63

Discuss importance of implementation of KYC norms by a bank from perspective of an auditor of bank.

(Study material)

Answer 63

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 64

List out any four points which highlight peculiarities involved in banking operations.

(Study material)

Answer 64

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 65

Is statutory auditor of a bank required to report on the requirements relating to Companies (Auditor's Report) Order, 2020?

(Study material)

Answer 65

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 66

Account of a borrower availing cash credit facility from branch of a bank has become “Out of order.” Discuss the term “Out of order”.

(Study material)

Answer 66

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 67

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

(Study material)

Answer 67

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 68

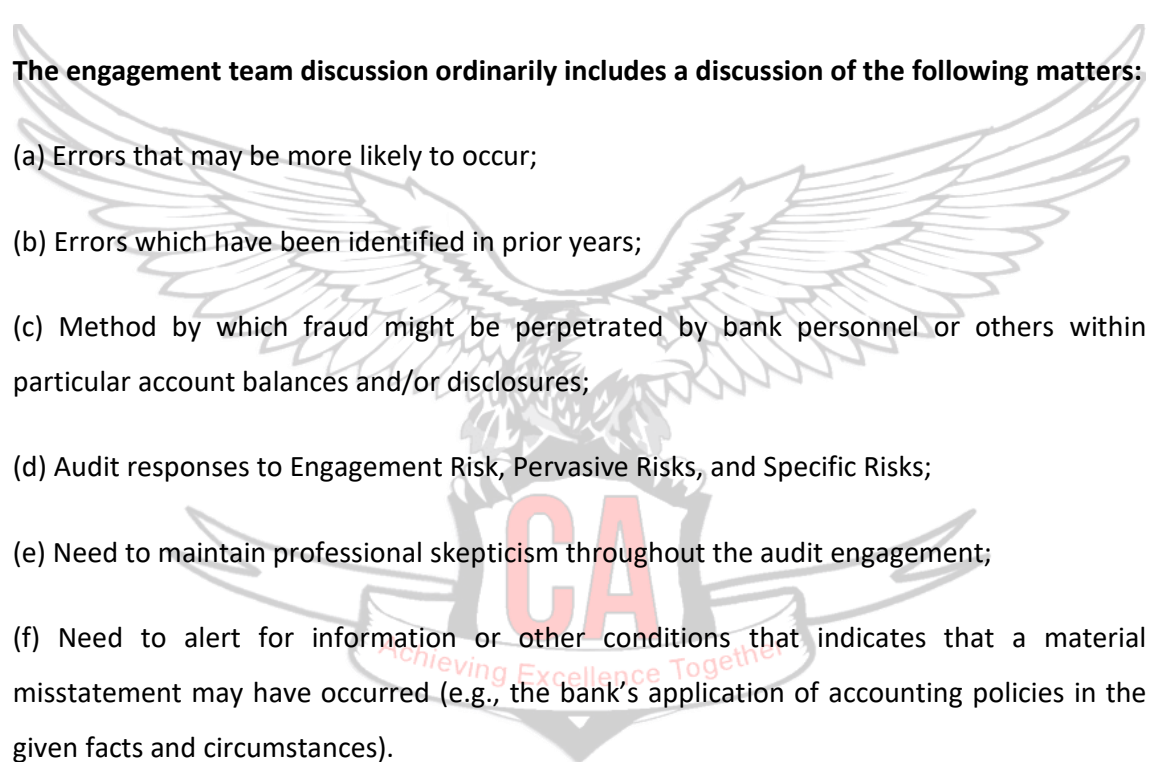
“The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference”. Explain.

(Study material)

Answer 68

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 69

Write a short note on reversal of income under bank audit.

(Study material)

Answer 69

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 70

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.

(Study material)

Answer 70

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 71

Ranjana Ceramic Private Limited is sanctioned a cash credit facility of Rs.100 lacs from a branch of LMO Bank. Besides, branch has also sanctioned a onetime bank guarantee of Rs. 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.

(Study material)

Answer 71

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

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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 72

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.

(Study material)

Answer 72

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 73

CA P is conducting stock audit of a borrower availing cash credit facility of Rs.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: -

(Study material)

Answer 73

Value of stocks as on 31.12.22	Rs. 125 lacs
Less: value of damaged stocks	Rs. 5 lacs
	Rs. 120 lacs
Less: creditors for goods as on 31.12.22	Rs. 50 lacs
Value of Paid stocks	Rs. 70.00 lacs
Less: Margin @ 25%	Rs.17.50 lacs
Drawing power (A)	Rs. 52.5 lacs
Value of debtors as on 31.12.22	Rs. 50 lacs
Less: debtors exceeding 90 days	Rs. 10 lacs
	Rs.40 lacs
Less: Margin @ 40%	Rs. 16 lacs
Drawing Power (B)	Rs. 24 lacs
Drawing Power (A+B)	Rs. 76.50 lacs
The drawing power calculated by CA P is not proper. Drawing Power comes to Rs. 76.50 lacs.	

Question 74

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.

(Study material)

Answer 74

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.

Question 75

Supriya has taken a loan from a bank by pledging her NSC (National Savings Certificate), which is eligible for surrender. The loan account currently shows no signs of repayment delay, and the bank confirms that an adequate margin is available in the accounts. However, the loan has technically become overdue. How should the bank classify this loan account?

- (a) The account must be classified as an NPA due to overdue status.
- (b) The account should not be classified as an NPA since the adequate margin is available in the accounts.
- (c) The account must be written off immediately.
- (d) The account classification depends on the borrower's repayment history.

(RTP Sep. 2025)

Answer: (b) The account should not be classified as an NPA since the adequate margin is available in the accounts.

Reason:

The loan has technically become overdue, but the key point here is that the bank has confirmed that an adequate margin is available in the account. In such cases, the presence of sufficient margin means that the bank has collateral (in this case, the NSC) that can cover the loan amount. As long as the collateral is sufficient and there are no signs of repayment delay, the loan does not need to be classified as a Non-Performing Asset (NPA).

An account becomes an NPA primarily when the borrower fails to repay the loan according to the agreed schedule or when the loan is unlikely to be recovered. Since there is no sign of repayment delay and the collateral margin is adequate, the loan remains classified as standard and not an NPA, despite being overdue.

Chapter 11: ETHICS AND TERMS OF AUDIT ENGAGEMENTS

Topic 1 Quality Control for Audit Engagements (SQC 1)

Question 1

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)

Reason

In the given scenario, Mr. Shoji, who is a partner at Khan & Co., is stepping in to sign the audit report after Mr. Salman, the engagement partner, has passed away. The correct course of action in this case is for Mr. Shoji to review the work done by Mr. Salman before signing the balance sheet.

Here's why:

Option (a) Sign the accounts of Lava Ltd without reviewing the work of his partner: This is incorrect because as the new engagement partner, Mr. Shoji has a responsibility to ensure that the audit work performed is thorough and in compliance with auditing standards. Signing without reviewing would be a violation of professional responsibility.

Option (b) Sign the balance sheet after reviewing the work of his partner: This is the correct answer. Even though Mr. Salman has completed the audit work, Mr. Shoji, as the new engagement partner, is still responsible for ensuring the audit was properly performed. He must review the work done by his partner to confirm that all audit procedures were appropriately followed before signing the financial statements.

Option (c) Withdraw the audit as the person who has performed the audit is no more: This is incorrect. The death of the engagement partner does not necessarily require the audit to be withdrawn, provided that the work was completed properly and the new partner reviews it adequately.

Option (d) Issue an adverse report: This is incorrect because an adverse report is issued when the auditor concludes that the financial statements are materially misstated, which is

not mentioned in this scenario. There is no indication that such an issue exists in the audit of Lava Ltd.

Therefore, the proper course of action is for Mr. Shoji to review Mr. Salman's work and ensure the audit was performed according to the required standards before signing the balance sheet.

Question 2

_____ 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)

Reason

The correct answer is SQC 1 (Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services), which requires firms to establish policies and procedures for the retention of engagement documentation. According to SQC 1, the retention period for audit documentation is typically seven years from the date of the auditor's report (or the date of the group auditor's report if later). This period is set to ensure that sufficient records are available for future reference, including regulatory reviews or subsequent audits.

Here's why the other options are incorrect:

Option (a) SA 220, audit evidence, six years: This is incorrect. SA 220 is related to the quality control for audits of financial statements, focusing on the quality control procedures that a firm needs to follow in individual audits, but it doesn't prescribe the retention period for audit documentation.

Option (b) SA 200, audit documentation, seven years: This is incorrect. SA 200 deals with the overall objectives of the auditor and the conduct of the audit, including the auditor's responsibility to obtain sufficient audit evidence. However, the retention period for audit documentation is not specified in this standard.

Option (d) SA 230, documentation, six years: This is incorrect. SA 230 provides guidance on audit documentation, such as what should be included in audit files, but it does not prescribe a specific retention period of six years. The retention period for audit documentation is usually defined by the firm's policies in accordance with SQC 1.

Therefore, SQC 1 is the correct reference for the retention period of audit documentation, and it mandates a retention period of seven years.

Question 3

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 March '21)

Ans: (c)

Reason

According to SQC 1 (Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services), the retention period for audit documentation ordinarily is no shorter than seven years from the date of the auditor's report. This is to ensure that the audit documentation remains accessible for review, reference, and for meeting regulatory requirements or legal proceedings if necessary.

Here's why the other options are incorrect:

Option (a) ten years: This is incorrect. SQC 1 specifies a minimum retention period of seven years, not ten. While firms may choose to retain documentation for longer periods in some cases, the standard specifies seven years as the minimum.

Option (b) five years: This is incorrect. A retention period of five years would be shorter than the requirement stated in SQC 1, which specifies seven years.

Option (d) four years: This is incorrect. The standard specifies seven years as the minimum retention period, not four years.

Thus, the correct retention period according to SQC 1 is seven years from the date of the auditor's report.

Question 4

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 Oct 19)

Ans: (d)

Reason

As per SQC 1 (Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services), audit documentation is the property of the auditor. This means that the auditor owns the documentation created during the audit process, including working papers, audit files, and other related documentation.

Here's why the other options are incorrect:

Option (a) audit documentation is the property of the management: This is incorrect. Audit documentation is not owned by the management. The auditor is responsible for the documentation, even though it may be reviewed by management.

Option (b) audit documentation is the property of those charged with governance: This is incorrect. While those charged with governance may have access to the audit documentation, the ownership still lies with the auditor, not the governance bodies.

Option (c) audit documentation is the property of the management or those charged with governance: This is incorrect. The ownership of audit documentation rests with the auditor, not with management or those charged with governance.

Thus, SQC 1 clearly specifies that audit documentation is the property of the auditor, unless otherwise specified by law or regulation.

Question 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

(MTP March '21)

Ans: (b)

Reason

In the context of completed engagements, the procedure designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures is known as Inspection.

Explanation:

Inspection refers to the process of reviewing completed audit engagements to evaluate whether the firm's quality control policies and procedures have been followed. This includes reviewing the working papers, audit documentation, and final reports to ensure the audit was conducted in accordance with the applicable standards and regulations.

Here's why the other options are incorrect:

Option (a) Monitoring: Monitoring is the overall process of evaluating the quality control system's effectiveness and is a broader concept than inspection. Monitoring is ongoing and focuses on evaluating whether the quality control policies are working effectively over time.

Option (c) Subsequent Audit Procedures: This refers to procedures performed in a subsequent period (after the audit period), usually to follow up on issues or new information. It's not directly related to compliance with quality control policies for completed engagements.

Option (d) Compliance Procedures: This term refers to the audit procedures designed to assess compliance with specific laws and regulations during the audit. It is not specifically about evaluating quality control policies and procedures for completed engagements.

Thus, Inspection is the correct term for reviewing completed engagements to ensure compliance with quality control procedures.

Question 6

CA Ramesh has been the auditor of XYZ Ltd. for the past 10 years. Over these years, he has built a personal relationship with Mr. Rajan, CEO of the company. During the audit, CA Ramesh discovers several discrepancies, but he feels uncomfortable reporting these issues due to his personal relationship with Mr. Rajan. He has also accepted gifts from the company on several occasions. As a result, CA Ramesh is concerned about the impact of his long-standing relationship with Mr. Rajan on the audit report. Which threat to independence exists in the given case?

- (a) Self-interest threat.
- (b) Familiarity threat.
- (c) Self-review threat.
- (d) Advocacy threat.

Ans: (b)

Reason

The situation described in the question presents a familiarity threat to CA Ramesh's independence.

Reason:

A familiarity threat occurs when an auditor develops a personal relationship with an individual in the audited entity (in this case, Mr. Rajan, CEO of XYZ Ltd.) to such an extent that the relationship becomes a significant factor in their judgment or objectivity. Over time, this familiarity may lead the auditor to be less inclined to identify issues or report problems due to the close personal relationship. The auditor may feel uncomfortable raising concerns or criticizing the management of the company because of their long-standing connection, affecting the objectivity of the audit report.

Here's why the other options are incorrect:

Option (a) Self-interest threat: This occurs when the auditor has a financial or personal interest that could influence their objectivity or decisions during the audit. For example, if the auditor stood to gain personally from a favorable audit result, this would be a self-interest threat. However, in this case, the concern seems more related to a personal relationship, not a direct financial interest.

Option (c) Self-review threat: This occurs when the auditor is in a position of reviewing their own work or judgment. For example, if the auditor had been involved in preparing the financial statements or making significant accounting decisions, they may be biased in reviewing their own work. In this scenario, the issue is more about the auditor's relationship with management rather than reviewing their own work.

Option (d) Advocacy threat: This occurs when an auditor is in a position of promoting or advocating for the interests of the client to the extent that their independence is compromised. For instance, if the auditor were to advocate for a company's financial reporting stance to external parties, this would be an advocacy threat. However, the situation described in the question does not involve the auditor advocating for the company's interests, but rather struggling with a personal relationship affecting their objectivity.

Thus, the correct answer is (b) Familiarity threat, as CA Ramesh's long-standing relationship with the CEO compromises his ability to remain objective in the audit process.

Question 7

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 March '23)

Answer 7

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:

1. How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
2. Processes for complying with applicable engagement standards.
3. Processes of engagement supervision, staff training and coaching.
4. Methods of reviewing the work performed, the significant judgments made and the form of report being issued.

5. Appropriate documentation of the work performed and of the timing and extent of the review.

6. Processes to keep all policies and procedures current.

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 May'18).

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

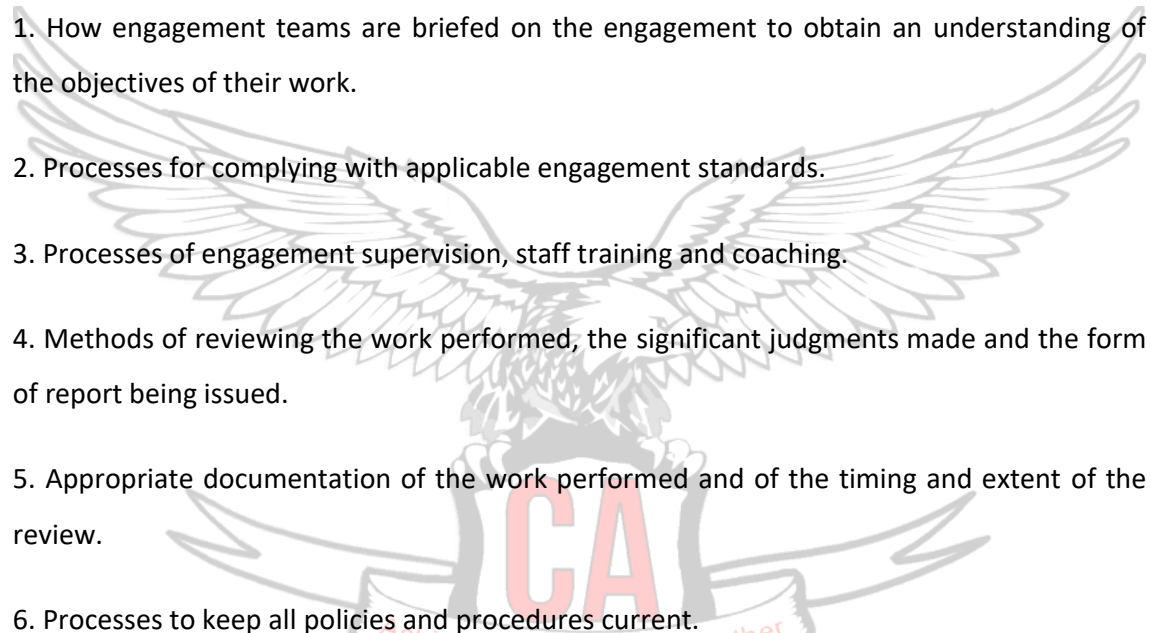
Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials. Explain the matters to be addressed in this context.

(RTP May '21)

Answer 9

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:

1. How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
 2. Processes for complying with applicable engagement standards.
 3. Processes of engagement supervision, staff training and coaching.
 4. Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
 5. Appropriate documentation of the work performed and of the timing and extent of the review.
 6. Processes to keep all policies and procedures current.
- 

Question 10

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

(MTP March '18, March'19, PYP Nov '19, RTP Nov '19)

Answer 10

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

1. Deleting or discarding superseded documentation.
2. Sorting, collating and cross referencing working papers.
3. Signing off on completion checklists relating to the file assembly process.
4. 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 11

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 Oct 19, RTP Nov '18)

OR

How does SQC 1 ensure that independence in engagements is not breached by an audit firm?

Answer 11

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 12

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 May 20)

Answer 12

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 13

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 Oct’22, RTP Nov ’19 & Nov ’20)

Answer 13

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 14

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 14

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 15

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 ushant, CFO of the company, was her class mate. In fact, both of them had tarted 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.

(Study material)

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)

Reason

In this situation, the most appropriate action is to accept the proposed offer but assign the engagement to a different partner other than CA Sukanya.

Explanation:

Option (a), "The above discussion is irrelevant in context of proposed offer," suggests that the matter isn't important, but it overlooks any potential conflict of interest or independence issue, which could make the discussion highly relevant.

Option (b), "The proposed offer should be accepted by the firm. The engagement team may be headed by CA Sukanya for better coordination and results," is not appropriate because if the discussion involves a potential conflict of interest (e.g., Sukanya having personal relationships or prior involvement with the client), having her lead the team could impair the independence of the audit and potentially compromise objectivity.

Option (c), "The proposed offer should be accepted by the firm. The engagement team may be headed by a different partner of the firm," is the correct choice. If there are potential independence concerns or a risk of biased judgment due to Sukanya's relationship with the client (for example, personal relationships, prior involvement, or a long-standing professional connection), the engagement should be handled by a different partner to avoid any conflict of interest, ensuring that the audit remains objective and independent.

Option (d), "The matter is too trivial to be reported by CA Sukanya to other partners of the firm," is incorrect because any potential issue related to independence or professional ethics should be reported, regardless of how trivial it may seem. Ignoring such matters could lead to violations of auditing standards or professional ethics.

Thus, Option (c) is the most appropriate choice because it addresses the need to manage the potential conflict of interest or lack of objectivity by assigning a different partner to head the engagement.

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)

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Reason

In this scenario, the audit firm is being requested to be visibly associated with the company's new services, which could lead to a situation where the auditor advocates for the company's interests. This is a classic case of advocacy threat.

Explanation

Option (a), "Self-interest threat," involves situations where the auditor's financial or personal interest could influence their judgment. This is not the issue in this case, as the concern is about promoting the company's services, not about personal financial gain.

Option (b), "Familiarity threat," arises when an auditor becomes too familiar with the client over time, which might impair objectivity. While familiarity threat can be a concern if the auditor has been working with the company for a long time, this specific scenario is more about the auditor's involvement in promoting the company's services, which is more aligned with an advocacy threat.

Option (c), "Self-review threat," occurs when an auditor is put in a position of reviewing their own work or decisions, potentially impairing objectivity. This does not apply here, as the concern is about promoting the company's services, not reviewing one's own audit work.

Option (d), "Advocacy threat," is the correct answer. This occurs when the auditor is asked to promote or support the client's position, product, or services, which could compromise their objectivity and independence. If the audit firm becomes visibly associated with the company's new services, it may inadvertently take on an advocacy role, which could impair their impartiality in the audit process.

Thus, Option (d) is the most appropriate choice because the request for the audit firm to be visibly associated with the company's new services creates an advocacy threat, where the auditor might be seen as supporting or promoting the company's interests.

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)

Reason

The fundamental principle of professional behaviour requires auditors to act with courtesy and respect towards others in the profession, including responding to communications from other auditors. In this case, Walker & Co. has failed to reply to communications from Das & Co., which reflects a lack of professional behaviour.

Explanation:

Option (a), "Objectivity," relates to the auditor's ability to make decisions free from bias, conflict of interest, or undue influence. It is not directly relevant to the failure to respond to communication between auditors.

Option (b), "Professional behaviour," is the correct answer. This principle obligates auditors to maintain a high standard of conduct in their professional interactions. By not responding to communications, Walker & Co. is not demonstrating the appropriate level of **professionalism** expected in their interactions with other firms. A failure to reply to such communications can be seen as unprofessional and disrespectful, and it reflects poor professional behaviour.

Option (c), "Professional competence and due care," refers to the requirement to carry out work with the necessary skill and care. While it is important for auditors to act competently, this principle does not specifically address the issue of communication with other auditors.

Option (d), "Integrity," relates to being honest and straightforward in all professional and business relationships. The failure to respond to communications does not directly reflect dishonesty, so integrity is not the most applicable principle in this scenario.

Thus, Option (b) is correct because the failure to respond to communications between auditors violates the principle of professional behaviour.

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)

Reason

The fundamental principle of professional competence and due care requires auditors to maintain the necessary knowledge and skill to perform their work competently and to act diligently in accordance with applicable technical and professional standards.

In this case, Das & Co. has failed to advise the company regarding the audit of consolidated financial statements, which suggests a lack of diligence and expertise in carrying out their duties as auditors. This indicates that they have not fulfilled their responsibility to provide the necessary professional advice and services with the appropriate level of competence.

Explanation:

Option (a), "Professional behaviour," refers to acting in a manner that promotes the profession's reputation and integrity. While failing to advise the company could reflect poorly on Das & Co.'s professionalism, the issue here is more about competence and diligence, so professional behaviour is not the most applicable principle.

Option (b), "Integrity," involves being honest and straightforward in all professional and business relationships. Failing to advise the company does not necessarily imply dishonesty, so integrity is not the key principle violated in this case.

Option (c), "Objectivity," refers to auditors remaining impartial and avoiding bias in their work. While objectivity is crucial in all audit-related tasks, the issue here is more about competence and fulfilling their professional duty to advise, rather than any bias or conflict of interest.

Option (d), "Professional competence and due care," is the correct answer. Failing to advise the company on the audit of consolidated financial statements demonstrates a lack of the required knowledge and diligence in performing the audit engagement, thus violating this principle.

Therefore, Option (d) is the most appropriate answer because Das & Co. have failed to exercise the necessary professional competence and due care.

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)

Reason

A self-review threat arises when an auditor is in a position where they have to review their own work or judgments, thus impairing their objectivity. If auditors offer IT services (e.g., implementation of IT systems, software development, or other IT-related consulting services) to the company they are auditing, there is a risk that the auditors will later have to audit their own work, leading to a self-review threat. This could undermine the objectivity and independence of the audit.

Explanation:

Option (b) - Advocacy threat: This occurs when an auditor becomes too closely aligned with the interests of the client, such as promoting the client's position or acting as an advocate for them. Offering IT services does not necessarily lead to the auditor advocating for the company, making this option less relevant in this case.

Option (c) - No threat: This is incorrect because offering IT services by auditors could lead to significant independence and objectivity concerns, which constitutes a threat to the auditor's impartiality.

Option (d) - Both self-review and advocacy threats: While a self-review threat is indeed a concern, an advocacy threat is less likely to arise directly from offering IT services. The primary risk here is the self-review threat, making option (a) more appropriate than option (d).

Thus, the most appropriate answer is (a), as the primary concern here is the self-review threat.

Question 16

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.

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(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.

(Study material)

Ans: (a)

Reason

As per SQC 1, the retention and assembly of audit documentation must be done within a specific time frame. The appropriate timeframe for completing the assembly of engagement files is within 60 days after the date of the auditor's report. This ensures that the documentation is finalized while the details of the audit work are still fresh and easily accessible for review or further reference, especially in case of any future issues or regulatory requirements.

Explanation:

Option (b) - Engagement files should be completed before date of auditor's report: This is incorrect. Engagement files should be completed after the audit report is issued, not before, as certain documentation may require finalization after the audit procedures are concluded.

Option (c) - Engagement files should be completed in not more than 60 days after completion of an engagement: This is close, but it is not the most accurate statement. The 60-day period is calculated from the date of the auditor's report, not the completion of the engagement.

Option (d) - Engagement files should be completed on date on which audit report is signed: This is incorrect. The engagement files can be finalized within 60 days of the auditor's report, not necessarily on the exact date the report is signed.

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Thus, Option (a) is the most appropriate answer because it aligns with the prescribed guidelines in SQC 1 for the assembly and retention of audit documentation.

Question 17

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.

(Study material)

Answer 17

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.

Topic 2 Agreeing the Terms of Audit Engagements (SA 210)

Question 18

Sigma Ltd. has approached CJK & Associates to appoint them as their auditor for a period of 5 years in accordance with provisions of the Companies Act, 2013. The prospective client company is new to audit firm. SQC 1 requires that a firm before accepting engagement should inquire vital information about the client which helps firm to decide

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about integrity of client. Apart from integrity, obtaining such vital information about client is helpful to audit firm in deciding about which other matters? Which matters would be considered by audit firm with regard to integrity of client?

(MTP-March 25)

Answer 18

Matters to be considered by audit firm with regard to integrity of client:

A firm before accepting an engagement should acquire vital information about the client. Such information should help firm to decide about:

- Integrity of Client
- Competence (including capabilities, time and resources) to perform engagement
- Compliance with ethical requirements

With regard to the integrity of a client, matters that the firm considers include, for example:

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

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- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

Question 19

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 Nov 22)

Answer 19

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.

Question 20

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)

Answer 20

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 21

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 Oct 20)

Answer 21

Incorrect: As per SA 210 “Agreeing the Terms of Audit Engagements”, the Audit engagement letter is sent by the auditor to his client.

Question 22

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 April 19)

OR

It is important for the auditor that each party should be clear about the nature of the engagement.

(MTP May 20)

Answer 22

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 23

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 April '21)

Answer 23

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 24

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 24

Incorrect: SA 210 requires the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.

Question 25

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 Sep'22, PYP Dec'21)

Answer 25

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 26

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How application of professional skepticism throughout audit is helpful in reducing audit risk?

(Study material)

Answer 26

Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

1. Overlooking unusual circumstances.
2. Over generalising when drawing conclusions from audit observations.
3. 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 27

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.

(Study material)

Answer 27

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 28

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.

(Study material)

Answer 28

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 29

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?

(Study material)

Answer 29

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 30

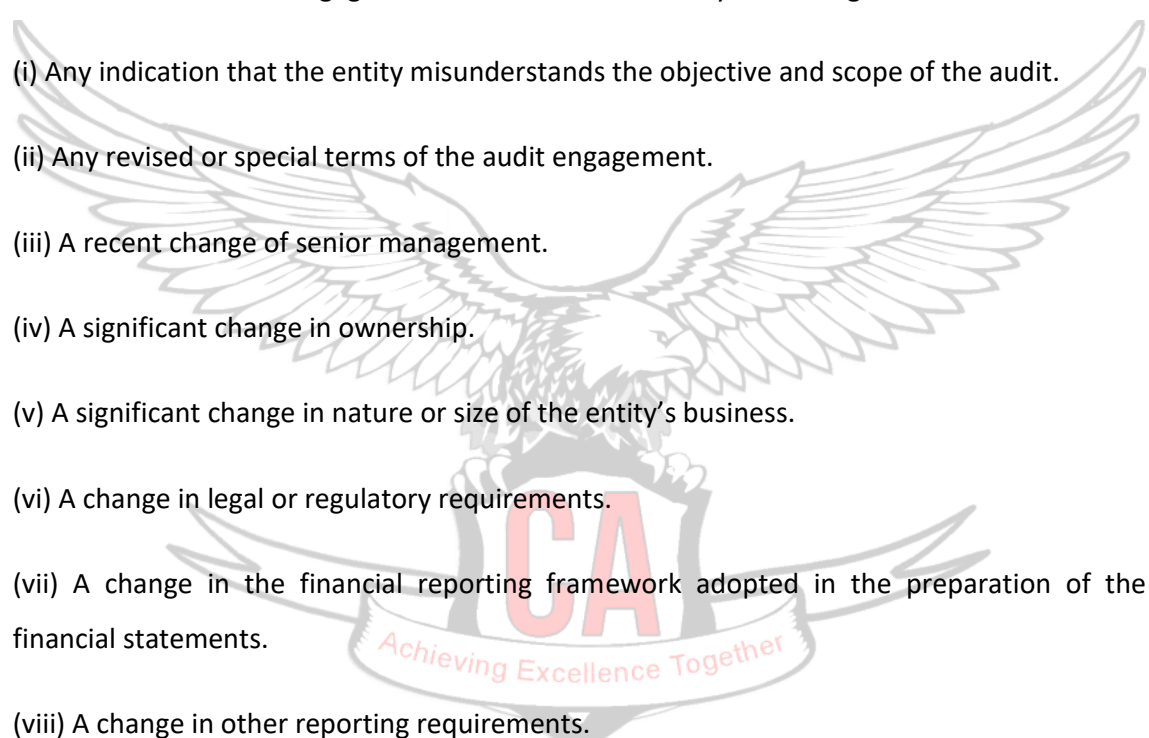
CA Rohit is conducting the audit of Taste Ltd., a food production company, for the last two years. Before commencing the audit for the year, he observed that the company has undergone a major shift in its product line by expanding into pharmaceuticals. Besides this, the company is now subject to new regulatory reporting requirements. These developments were not present at the time of accepting the initial audit engagement. CA Rohit is of the view that there is no need to issue a new audit engagement letter. Examine whether the viewpoint of CA Rohit is appropriate in accordance with the relevant Standards on Auditing.

(RTP Sept 2025)

Answer 30

As per SA 210, "Agreeing the terms of audit engagements", recurring audit is an audit which is performed by an auditor over years. In case of 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.

In the given case, Taste Ltd., a food production company, has undergone a major shift in its product line by expanding into Pharmaceuticals and the company is also subject to new regulatory reporting requirements. In view of the abovementioned factors, it is appropriate to revise the terms of the audit engagement in accordance with SA 210. Thus, the viewpoint of CA Rohit regarding no need for issuance of a new engagement letter is not correct, CA Rohit is required to send the revise audit engagement letter.

Topic 3 Acceptance and Continuance of Client Relationships

Question 31

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 Nov '21, RTP May'18)

Answer 31

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.

Question 32

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 May '19)

Answer 32

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 33

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.

(Study material)

Ans: (c)

Reason

SA 220 (Quality Control for an Audit of Financial Statements) and SQC 1 (Quality Control for Firms that Perform Audits and Reviews of Financial Statements) are both related to ensuring quality in audit engagements, but the relationship between them is crucial.

SQC 1 applies to the firm level, requiring firms to establish a system of quality control for their audits and reviews.

SA 220 is focused on the individual engagement level (audit engagements). It deals with the specific responsibilities of the engagement team to maintain quality in individual audits.

SA 220 is designed with the understanding that the firm has already implemented the broader quality control measures outlined in SQC 1. Thus, the correct premise is that SA 220 is applied on the assumption that the firm is subject to the broader quality control system defined in SQC 1.

Explanation of other options:

Option (a) - SA 220 applies at the level of firm: This is incorrect. SA 220 applies to individual audit engagements, not to the firm as a whole. The firm's broader quality control system is defined in SQC 1.

Option (b) - SQC 1 is premised on the basis that firm is subject to SA 220: This is incorrect. SQC 1 applies to the firm as a whole and is a prerequisite to ensuring quality in individual audit engagements. SA 220 builds on the foundation laid by SQC 1, not the other way around.

Option (d) - SA 220 applies to all engagements: This is partially correct, but misleading. SA 220 applies specifically to audit engagements and not to all types of engagements (e.g., reviews, non-audit services).

Thus, Option (c) is the most accurate because SA 220 is premised on the assumption that the firm has implemented the quality control systems outlined in SQC 1.

Question 34

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?

(Study material)

Answer 34

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.

Question 35

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?

(Study material)

Answer 35

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.

Topic 4 Engagement Partner's Responsibilities (SA 220)

Question 36

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 Aug '18)

Answer 36

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 37

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 Aug '18, RTP Nov'20 & May '23, PYP Nov'19)

Answer 37

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 38

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?

(Study material)

Answer 38

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.

Topic 5 Fundamental Principles of Professional Ethics

Question 39

There is a very thin difference between advocacy threats and intimidation threats to an auditor while performing his duty.

(PYP July '21)

Answer 39

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.

Question 40

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 40

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 41

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 Oct'22)

Answer 41

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 42

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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 42

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 43

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 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 Jan'21)

Answer 43

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 44

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 Oct 19)

Answer 44

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.

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Question 45

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 March '23)

Answer 45

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 46

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 46

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 47

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 Oct '23, PYP Nov 22)

Answer 47

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 48

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)

Reason

The fundamental principles governing professional ethics, especially for accountants and auditors, are defined by global standards such as those from the International Federation of Accountants (IFAC) and the Institute of Chartered Accountants of India (ICAI). These principles guide the ethical behavior and decision-making of professionals in their practice.

The fundamental principles include:

(a) Professional competence and due care: This principle requires that professionals maintain the skills and knowledge necessary to perform their duties competently and diligently. It emphasizes the need for continuous learning and adherence to professional standards.

(b) Integrity: This principle stresses the importance of being honest, straightforward, and transparent in all professional and business dealings, avoiding misrepresentation or fraud.

(c) Objectivity: Objectivity requires that professionals make decisions free from bias, conflicts of interest, or undue influence from external parties. It ensures impartiality in professional judgments.

(d) Safeguards to independence, while extremely important in practice, is not itself considered one of the fundamental principles. Instead, safeguards refer to procedures or actions taken to protect and maintain the independence of auditors and other professionals. These safeguards are put in place to prevent threats to the professional's objectivity and integrity, such as conflicts of interest.

Fundamental principles are the core ethical values that guide professionals.

Safeguards are practical measures or controls designed to prevent violations of these principles, particularly in situations where independence might be threatened.

Therefore, the correct answer is (d) Safeguards to independence, because it is not considered a fundamental principle but rather a protective measure to uphold the fundamental principles.

Question 49

Briefly outline how principles-based approach differs from rules-based approach to ethics.

(Study material)

Answer 49

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 50

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.

(Study material)

Answer 50

Failure to reply to professional body smacks of lack of courtesy and professional responsibility. The principle of “Professional behaviour” is disregarded.

Question 51

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?

(Study material)

Answer 51

“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 52

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?

(Study material)

Answer 52

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 53

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?

(Study material)

Answer 53

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.

Topic 6 Threats to Independence and Safeguards

Question 54

Write a note on “Self-review threats”

(RTP Nov ‘19)

Answer 54

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 55

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 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 April '21, RTP Nov '19, RTP May'23, PYP, Nov '20)

OR

Discuss few guiding principles which are behind safeguards to eliminate threats to auditor's independence.

(RTP Nov '21)

Answer 55

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 56

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 April 19)

Answer 56

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 57

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 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 Aug '18, RTP May'22)

Answer 57

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 58

"Independence of mind and independence in appearance are interlinked perspectives of Independence of auditors." Explain.

(PYP May '19)

Answer 58

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 59

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.

(Study material)

Ans: (b)

Reason:

To establish the preconditions for an audit, certain basic elements must be in place to ensure the audit can be carried out effectively and in accordance with relevant auditing standards. These elements are essential for the auditor to accept and conduct the engagement.

Let's analyze each option:

(a) Acceptability of financial reporting framework: This is necessary because the audit can only proceed if the company follows an acceptable financial reporting framework (e.g., Indian GAAP, IFRS) that the auditor can assess against. Without an acceptable framework, the audit would not be meaningful.

(c) Acknowledgment from management of providing access to persons within the company: This is a precondition because auditors need unrestricted access to the company's personnel, records, and information to perform the audit effectively. Management's acknowledgment is essential for the audit's success.

(d) Acknowledgment of management in understanding its responsibility for the preparation of financial statements: This is a key precondition for an audit because it establishes that the management understands and acknowledges its responsibility for preparing accurate financial statements, which is a foundation for the auditor's role in expressing an opinion on those statements.

(b) Acknowledgment of cooperation from management in designing audit procedures: While cooperation from management is important for the audit process, it is not an explicit requirement to establish the preconditions for an audit. The auditor designs the audit

procedures independently, and while cooperation can facilitate the process, it is not a formal precondition to initiate an audit.

Thus, the correct answer is (b) because the acknowledgment of cooperation from management in designing audit procedures is not a necessary precondition for starting an audit.

Question 60

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.

(Study material)

Answer 60

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 “self-review” threat.

Topic 7 Documentation and Retention of Audit Files

Question 61

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.

(Study material)

Answer 61

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 62

Case Scenario

Mohan & Associates were offered the statutory audit of Simi Pvt. Ltd. for the financial year 2024–25. In line with professional requirements, the firm communicated with the outgoing auditor, Veer & Co., to inquire whether there were any professional or other reasons that would preclude them from accepting the appointment. However, no response was received from Veer & Co. for the same.

During the audit, Mr. A, a partner of Mohan & Associates, relied solely on a management representation letter to support the accounting treatment of certain tax matters that were under appeal and no additional audit procedures were performed to verify the appropriateness of management's treatment of these matters in the financial statements, which may raise concerns regarding the sufficiency and appropriateness of audit evidence obtained.

As Simi Pvt. Ltd. had recently appointed a new accountant who lacked adequate knowledge of the accounting standards applicable to the company, the management requested Mr. A to assist with accounting and bookkeeping services. However, Mr. A declined the request, recognising that providing such services could impair his independence as an auditor.

Meanwhile, Mr. Raj, an investor in Simi Pvt. Ltd., placed full reliance on the audited financial statements, believing they indicated a strong financial position. He assumed that the audit guaranteed the safety of his investment, without any risk of loss.

While finalising the audit documentation, Mr. A prepared the working papers in physical form, under the belief that paper documentation was mandatory.

Based on the above facts, answer the following MCQs:

1. The previous auditors, Veer & Co. did not reply to the communication of Mohan & Associates. Which fundamental principle of professional ethics is not followed by them?

(a) Objectivity.

(b) Integrity.

(c) Professional behaviour.

(d) Professional competence and due care.

Answer: (c)

Reason:

As per the Code of Ethics for Professional Accountants, auditors are expected to act with professional courtesy and cooperation, especially when transitioning engagements. A failure to respond to a legitimate and professional communication from the incoming auditor reflects unprofessional conduct.

This situation does not directly involve:

Integrity – which relates to honesty and truthfulness,

Objectivity – which involves avoiding conflicts of interest or bias,

Professional competence and due care – which refers to maintaining skills and applying diligence.

Instead, it is a lack of professional behaviour, which encompasses acting in a manner consistent with the profession's values and standards, including cooperating during change of auditors.

(c) Professional behaviour.

2. The auditor did not carry 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 auditor in such a situation?

(a) Professional Skepticism.

(b) Objectivity.

(c) Integrity.

(d) Professional Behaviour.

Answer: (a)

Reason:

The auditor relied solely on a management representation letter without performing additional checks, showing a lack of questioning attitude and critical evaluation — which is essential under professional scepticism.

Audit standards require auditors to verify significant or uncertain matters like tax appeals through appropriate procedures, not just accept management's word.

3. Mr. A was requested to provide accounting & bookkeeping services to Simi Pvt. Ltd. Identify the type of threat to Independence that may be involved in acceptance of such an engagement.

(a) Self- interest threat.

(b) Self- review threat.

(c) Confidentiality.

(d) Intimidation threat.

Answer: (b)

Reason:

A self-review threat occurs when an auditor is asked to evaluate or audit work that they themselves have previously prepared or been involved in .

In this case:

Mr. A was requested to provide accounting and bookkeeping services to Simi Pvt. Ltd.

If he had accepted, he would have been involved in preparing the financial records , which are later subject to his own audit.

This creates a situation where he may be unconsciously biased in favor of his own work, reducing objectivity and impairing independence.

Hence, accepting such a role would result in a self-review threat .

4. Mr. Raj is confident that investment made by him is completely secure and there is no risk of any loss. Select the correct statement in this regards:

(a) Audited Financial statements provide absolute assurance therefore money invested by Mr. Raj is absolutely safe.

(b) Audited Financial statements provide reasonable assurance. It doesn't guarantee complete accuracy.

(c) Neither (a) nor (b) is correct.

(d) Both (a) and (b) are correct.

Answer: (b) Audited Financial statements provide reasonable assurance. It doesn't guarantee complete accuracy.

Reason:

An audit provides reasonable assurance , not absolute assurance , due to inherent limitations like sampling, judgment, and the potential for undetected fraud. Therefore, audited financial statements do not guarantee that investments are completely safe or that there is no risk of loss.

Investor confidence should not be equated with a guarantee of investment safety.

5. Mr. A was preparing the documents and audit file in physical (paper) form, believing that it is compulsory to do so. Is Mr. A's understanding, correct? Identify the correct statement regarding the form of an audit file.

- (a) Audit file should be kept in both physical & electronic form.
- (b) Audit file should be kept in physical form only.
- (c) Audit file may be kept in physical or electronic form.
- (d) Audit file should be kept in electronic form only.

Answer: (c) Audit file may be kept in physical or electronic form.

Reason:

As per SA 230 – Audit Documentation , the auditor is required to prepare and retain audit documentation that supports the basis for the conclusions reached and provides evidence that the audit was conducted in accordance with auditing standards.

However, there is no mandatory requirement that the audit file must be maintained only in physical (paper) form .

Audit documentation can be kept:

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- In physical (paper) form , or
- In electronic form (such as PDFs, spreadsheets, or audit software), provided it is:
- Legible ,
- Accessible , and
- Retained for the required period (typically at least 7 years under legal frameworks like the Companies Act).

Hence, Mr. A's belief that paper documentation is compulsory is incorrect.

Topic 8 Professional Skepticism

Question 63

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 Sep '23, RTP Nov'20, PYP, Nov' 19)

Answer 63

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:

1. Audit evidence that contradicts other audit evidence obtained.
2. Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
3. Conditions that may indicate possible fraud.
4. Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
5. Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:
6. Overlooking unusual circumstances.
7. Over generalising when drawing conclusions from audit observations.
8. 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 64

There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance. Explain.

(Oct 20)

Answer 64

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."

Topic 9 Preconditions for an Audit (SA 210)

Question 65

Preconditions for an audit have not been defined in SA 210 “Agreeing the Terms of Audit Engagements.”

(RTP Nov ‘19)

Answer 65

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.

Topic 10 Changes in Engagement Terms

Question 66

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 Nov’19)

Answer 66

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 67

"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 Mar'22)

Answer 67

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.