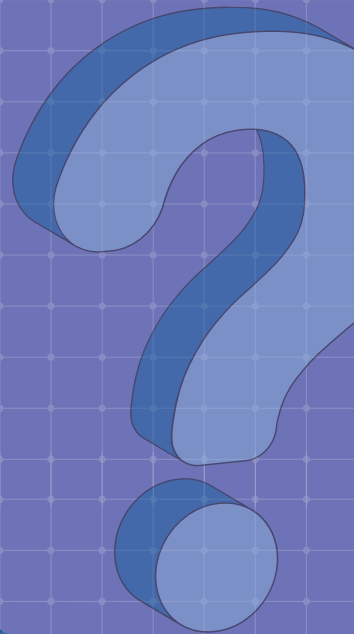


CA INTER

Auditing & Ethics

EXCEPTIONAL QUESTIONS



INDEX

AUDITING & ETHICS

1	NOS Audit	1
2	Ethics & Terms of Engagement	5
3	Audit Report	10
4	Completion and Review	16
5	Documentation	22
6	Audit Evidence	24
7	Different Types of Entities	34
9	Risk Assessment and IC	35
10	Audit of Banks	45
11	Items of Financial Statements	46

1. Nature, Objective and Scope Of Audit

Illustrations From ICAI SM

Illustration 4

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

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

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

Answer

This is an **example of failure of internal controls** within 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, but it is the **very nature of financial reporting that management is responsible for devising suitable internal controls**. This presents an **inherent limitation** of the audit.

Audit is a type of **assurance engagement** under which the auditor **gives an opinion** on whether the financial statements give a true and fair view of the state of affairs of the concern. However, **assurance engagements** are not restricted to audit alone.

Questions From RTP's, MTP's, QP's

Question 1

(RTP Nov '23)

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.

Answer

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 5

(MTP May '23, PYP May '22, RTP Nov '23)

Discuss the following:

CA Jatin is the auditor of JP Ltd. The auditor expressed his opinion on the financial statements without ascertaining as to whether the financial statements as a whole were free from material misstatements. Explain w.r.t SA 200.

Answer

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

- i. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- ii. To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

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

Question 7**(RTP May '23)**

An audit is distinct from investigation. However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor. Discuss.

Answer

Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and an investigation is specifically called upon to check the accounts to determine whether fraud really exists, it takes the character of an 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 the state of affairs, about wrong-doing, or about some wrong having been committed. The auditor seeks to report what he finds in the 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 the auditor has given some findings of serious concern. Such findings may prompt the calling of an investigation.

Question 10

The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. Give one example each for such practical and legal limitations.

Answer:

Example of practical limitation on ability of auditor to obtain audit evidence

An auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.

Example of legal limitation on ability of auditor to obtain audit evidence

Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case

he is not provided with required information, he can **only report**. It is an example of **legal limitation** on auditor's ability to obtain audit evidence.

Question 12**(MTP May '24)**

KST Limited is engaged in manufacturing business. It appoints CA T to provide it an assurance report on its financial statements prepared on the basis of historical financial information. The characteristic of such an engagement is that it involves gathering of sufficient appropriate evidence on basis of which limited conclusions can be drawn up by practitioner. Identify type of engagement. Which are two other features of such an engagement?

Answer:

As given above, the **engagement** involves gathering of **sufficient appropriate evidence** on the basis of which **limited conclusion** can be drawn up. It is a **limited assurance engagement** like review. Other two features of such type of engagement are:

- 1) It provides **lower level of assurance** than **reasonable assurance engagement**.
- 2) It performs **fewer procedures** than **reasonable assurance engagement**.

Question 17**(RTP Sep '24, MTP Jan '25)**

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

Answer:

Audit engagement is an assurance engagement. However, assurance engagements **are not restricted to auditing alone**.

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

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

Question 18**(MTP 2 Sep '24)**

Truthful Products Private Limited is engaged in trading stationery items. During the year 2023-24, there was a huge fire in one storage location of the company resulting in loss of inventories of Rs.5 crores. As a result, the operations of the company were badly affected for about two months. Unfortunately, the insurance claim of the company was rejected due to certain defects in the policy issued and loss was booked by company in the year 2023-24 itself. There was no change in nature of business of company in

relation to the last year. The draft financial statements of the company reflect following information:
(Figures in Rs. crores)

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

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

Answer

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

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

In spite of these unusual circumstances, the auditor has decided to rely upon same tests of details as performed in the previous years. The nature and extent of audit procedures need to be suitably altered considering changed circumstances. He may include substantive analytical procedures to analyse variations and seek necessary explanations from management. In case of doubt about the reliability of information or indications of possible fraud, Standards on Auditing require auditor to determine what modifications or additions to audit procedures are necessary to resolve the matter. CA D, the auditor of a listed company, **shall document the overall audit strategy, the audit plan and any significant changes made** during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

Question 19

(MTP 2 Sep '24)

"Assurance engagement" means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. In this context, give three examples of assurance engagements highlighting difference in nature of assurance provided by such engagements.

Answer:

Refer Concept Notes - Concept 14

2. Ethics & Terms of Engagement

Illustrations From ICAI SM

Illustration 3

CA Raman Gupta is offered appointment as auditor of a company. One of his distant uncles held some shares in the same company. Holding of such shares, by a distant relative, is not prohibited under provisions of law nor does it affect his independence. Before he could accept appointment, he received unfortunate news of death of his uncle who had died without any children. He came to know that he was nominee of these shares having substantial value. It landed him in a tricky situation. What should be proper course of action for him?

Answer

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.

Illustration 7

Chirag, as part of articulated training, is part of an engagement team conducting audit of a company. He has read somewhere that engagement letter issued by auditor to client also includes expected form and content of the auditor's report. He was at a loss to understand how could an auditor include form and content of the report beforehand. Try to help Chirag by making things clear to him.

Answer

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.

Illustration 8

The management of an entity feels that it is not necessary for it to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. Discuss, whether, it is necessary for the management to do so. In case management refuses, why should an auditor not accept the proposed engagement?

Answer

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:

- 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.

Questions From RTP's, MTP's, QP's

Question 8

(MTP May '24)

CA Tripad (engagement partner) based at New Delhi is external auditor of Lap of Nature, a firm, since last three years. The firm is engaged in business of providing tourism services including holiday packages to its club members. It has also provided auditor including his team members free holiday for a week every year in one of its premium resorts in Ooty in the State of Tamil Nadu. The company has also booked free air travel for engagement team members during all these years. Discuss why Chartered Accountant is not acting ethically. How are familiarity threats created in above situation?

Answer

The firm is providing **free hospitality** to **engagement team members** including engagement **partner**. In such circumstances, **fundamental principles** governing professional ethics are violated. Such acts of free hospitality are capable of impairing objectivity of auditor.

The situation given in the question signifies that auditors have formed **relationships** with client where they may end up being **too sympathetic** to the client's interests. Due to **free hospitality** enjoyed by engagement team members, they may take a **sympathetic view** to issues which may have arisen during course of audit. In this way, **familiarity threats** are created in the situation

Question 9

(MTP May 24)

Professional Behaviour is one of the fundamental principles governing professional ethics. Explain its meaning. Also, give example of a situation where a Chartered Accountant fails to follow this principle.

Answer

The Principle of **Professional Behaviour** requires an accountant to comply with **relevant laws and regulations** and avoid any conduct that the accountant knows or should know might **discredit the profession**. A professional accountant shall not knowingly engage in any employment, occupation or activity that impairs or might impair the **integrity, objectivity or good reputation** of the profession, and as a result would be incompatible with the fundamental principles.

Example

A Chartered Accountant 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**. Failure to reply to professional body smacks of lack of **courtesy** and **professional responsibility**. In the given case, Chartered accountant has not followed principle of **Professional Behaviour**.

SA 210- Agreeing The Terms Of Audit Engagements

Question 6

(MTP Sep '24)

CA H has been offered audit of financial statements of a society engaged in promoting social causes, such as setting up of drug de-addiction centres for misguided youth and rehabilitating such young people by helping them find avenues of gainful employment. However, CA H failed to send audit engagement letter to the society's governing body and proceeded to conduct the audit. In the absence of this letter, the governing body is of the view that purpose of such an audit is to provide absolute assurance against probable errors and frauds in the financial statements. Does it constitute violation of fundamental principles governing professional ethics? State reasons for the same.

Answer

As per SA 210, "Agreeing the Terms of Audit Engagements", the auditor shall agree the terms of the audit engagement with **management** or **those charged with governance**, as appropriate. The agreed terms of the audit engagement **shall be recorded** in an audit engagement letter or other suitable form of **written agreement**. Such a letter includes, inter alia, **objective** and **scope** of audit of **financial statements**. The absence of such a letter leads to **misunderstanding** between auditor and management. As auditor has failed to send engagement letter, the governing body has formed an **improper view** of **objective** and **scope** of **audit** of financial statements.

By not following requirements of SA 210, CA H is not acting ethically. He has violated principle of **professional competence and due care** governing professional ethics. This principle requires an accountant to attain and maintain **professional knowledge and skill** at the level required to ensure that a client or employing organization receives **competent professional service**, based on current technical and professional standards and relevant legislation and **act diligently** and in accordance with applicable technical and professional **standards**. Maintaining professional competence requires awareness of current technical and professional standards. Non sending of engagement letter shows lack of such awareness on part of CA H. Therefore, he has violated said fundamental principle governing professional ethics.

Question 7

(RTP May '24)

CA X has been offered audit of financial statements of TDK Industries, a partnership firm. Prior to accepting proposed offer, he insists upon obtaining an agreement of management regarding acknowledgment of its responsibility of having a proper process in place to ensure that financial statements prepared are free from material misstatements. However, management is of the view that it is auditor's duty to detect material misstatements in financial statements and such an insistence by auditor is totally uncalled for. Whose view is proper? Also discuss reasons for arriving at your conclusion. What should be likely proper course of action for CA X in above situation?

Answer

SA 210 deals with the auditor's responsibilities in agreeing the **terms of the audit engagement** with **management** and, where appropriate, those charged with governance. This includes establishing that certain **preconditions** for an audit, responsibility for which rests with **management** and, where appropriate, those with governance, are present.

The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

- (A) Establishing whether the **preconditions** for an audit are present and
- (B) Confirming that there is a **common understanding** between the auditor and **management** and, where appropriate, those charged with governance of the **terms** of the **audit engagement**.

One of the **preconditions** for an audit is to obtain the **agreement of management** that it acknowledges and understands its responsibility for **preparation of financial statements** and for such **internal control** as is necessary to enable preparation of financial statements that are **free from material misstatements**.

In the given situation, **CA X** is insisting only upon obtaining **agreement of management** regarding acknowledgment of its responsibility for **internal control** to enable preparation of financial statements that are free from material misstatements in accordance with **SA 210. Design, implementation and maintenance of internal control** to ensure preparation of reliable financial statements that are free from material misstatements is **management's responsibility**. He is insisting on obtaining agreement of management regarding acknowledgment of its responsibility. Therefore, **CA X's view is proper**.

In case **management** does not provide such agreement acknowledging its responsibility, the auditor shall **not accept** proposed audit engagement unless required by **law or regulation**.

Question 8

(MTP Jan '25)

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

Answer

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

- (i) The **objective** and **scope** of the audit of the financial statements;
- (ii) The **responsibilities** of the **auditor**;
- (iii) The **responsibilities** of **management**;
- (iv) **Identification** of the applicable **financial reporting framework** for the preparation of the financial statements and
- (v) Reference to the expected **form** and **content** of any reports to be issued by the auditor and a statement that there may be **circumstances** in which a report may differ from its expected form and content.

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

SA 220- Quality Control For An Audit Of Financial Statements

Question 1

(RTP May '23)

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.

Answer

As per **SA 220** "Quality Control for an Audit of Financial Statements", the **engagement partner** shall take **responsibility** for the **overall quality** on each audit engagement to which that partner is **assigned**. The **actions** of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

- a. The importance to audit quality of:

- i. Performing work that complies with professional standards and regulatory and legal requirements;
 - ii. Complying with the firm's quality control policies and procedures as applicable;
 - iii. Issuing auditor's reports that are appropriate in the circumstances; and
 - iv. The engagement team's ability to raise concerns without fear of reprisals; and
- b. The fact that quality is essential in performing audit engagements.

Engagement partner defined

Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

Question 3

(RTP May '24)

"SA 220 is premised on the basis that the firm is subject to SQC 1". What do you understand by given statement in context of audit quality?

Answer

Audit quality is essential to maintain confidence in the independent assurance provided by the auditors. It is responsibility of auditor to maintain high audit quality. SQC 1 and SA 220 both deal with quality control. SQC 1 applies to entire firm. However, SA 220 applies to a particular audit engagement.

Based upon quality control system of firm established in accordance with requirements of SQC 1, quality control policies pertaining to audit engagements are decided by engagement teams. Engagement partner of a team is responsible for quality control procedures of a particular audit engagement in accordance with SA 220.

Therefore, SA 220 is premised on the basis that the firm is subject to SQC 1. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement.

Note: Students are also advised to refer RTP of Paper-2: Corporate and Other Laws for academic updates relating to Company Law and Other Laws.

3. Audit Report

Illustrations From ICAI SM

Illustration 5

CA. Ravi Patnaik is conducting audit of a company for which reporting requirements under CARO, 2020 are applicable. He finds that cash credit facilities amounting to 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?

Answer

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.

Questions From RTP's, MTP's, QP's

SA 700- Forming An Opinion And Reporting On Financial Statements

Question 4

(RTP MAY '22)

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

Answer

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 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;

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

The statement about auditor independence and other ethical responsibilities required by SA 700 (Revised).

Question 8

(RTP Nov '23, MTP Nov '23)

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?

Answer

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:

- States that the **audit** was **conducted** in accordance with **Standards on Auditing**;
- Refers to the section of the **auditor's report** that describes the auditor's **responsibilities** under the **SAs**;
- 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.
- 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)**:

- 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
- Within this section, include a **description** of the matter giving rise to the **modification**.

SA 705- Modifications To The Opinion In The Independent Auditor's Report**Question 5**

(MTP May '24)

CA. S, while conducting audit of an entity is facing the following issues: -

- He has not been provided with necessary support for attending inventory count process of entity as at year end.
- Accounts Manager 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.
- He has been asking for bills on a sample basis for the purpose of verifying expenses, but staff has been making lame excuses.

The matter was brought to knowledge of higher management, but of no avail. The auditor, CA S has come to the conclusion that the possible effects on the financial statements of undetected misstatements would be material and affecting many aspects of financial statements and in such a case, a qualification of the opinion would be inadequate to communicate the gravity of the situation.

How should the auditor proceed in such a situation?

Answer

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 was brought to the **knowledge of management** but no result has been achieved. In such circumstances, auditor should proceed as given here under: -

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:

- 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 auditor withdraws from such an engagement, before withdrawing, 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.

SA 706- Emphasis Of Matter Paragraphs And Other Matter Paragraphs In The Independent Auditor's Report

Question 2

(MTP Nov '22)

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

Answer

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:

1. That the **financial statements of the prior period** were audited by a **predecessor auditor**;
2. The **type of opinion** expressed by the predecessor auditor and, if the opinion was **modified**, the **reasons therefor**; and
3. 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 4

(PYP May '22)

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.

Answer

Emphasis of Matter Paragraphs in the Auditor's Report: If the auditor considers it necessary to draw users' attention to a **matter** presented or disclosed in the financial statements that, in the auditor's judgement, is of such **importance** that it is fundamental to **users' understanding** of the **financial statements**, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:

- i. The auditor would **not be required to modify the opinion** in accordance with SA 705 as a result of the matter; and
- ii. When SA 701 applies, the matter has **not been determined** to be a **key audit matter** to be communicated in the auditor's report.

In the given case as the **properties obtained** during the year through **barter deals** and **included** in the **PPE** in the **books of accounts** on the basis of **possession letter only**, hence there is a need to add **Emphasis on Matter Paragraph** in the **Auditor's Report**.

The draft of the same is as under:

Emphasis of Matter - **Effect of Properties** obtained through barter deals by the company We draw attention to **Note (Y)** of the **financial statements**, which describes the **effects** of the **properties** obtained through **barter** by the company. Our **opinion** is **not modified** in respect of this matter.

Alternative Solution:

In the given case as the **properties** obtained during the year through **barter deals** and included in the **PPE** in the **books of accounts** on the basis of **possession letter only**, hence there is a need to report the same under Clause i(c) of **Paragraph 3 Companies** (Auditor's Report) Order, 2020.

Matters to be included in **auditor's report** - The auditor's report on the accounts of a company to which this Order applies shall include a **statement** on the following matter, namely:

(i) (c) whether the **title deeds** of all the **immovable properties** (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the **financial statements** are held in the name of the company,

if not, provide the details thereof in the format below:

Description of property	Gross carrying value	Held in name of	Whether promoter, director or their relative or employee	Period held- indicate range, where appropriate	Reason for not being held in name of company* *also indicate if in dispute
1	2	3	4	5	6

The **auditor** should state in the Reason (column 6) for not being held in name of company as follows

"**Properties** obtained during the year through **barter deals** and included in the **PPE** in the **books of accounts** on the basis of possession letter only"

Reporting Requirements Under Companies Act

Question 7

(PYP May '23, MTP Jan '25)

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.

Answer

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.

CARO, 2020

Question 8

(PYP May '22)

G Pvt. Ltd. had fully paid up Capital and Reserves of ₹ 1.20 crore as at the end of F.Y. 2020-2021. During the F.Y 2021-2022, business was interrupted due to Covid restrictions and therefore the company incurred losses to the tune of ₹ 25 lacs. During the year, the company also borrowed ₹ 55 lakh each from a bank and a financial institution independently. It had a turnover of ₹ 850 lakh (other than revenue of ₹ 250 lakh from discontinuing operations). Ascertain whether CARO, 2020 is applicable to the company.

Answer

Applicability of **CARO, 2020** in case of Private Ltd. Company: CARO, 2020 shall apply to every company including a foreign company except- a **private limited company**, not being a subsidiary or holding company of a public company,

- i. having a **paid-up capital** and **reserves and surplus** not more than **one crore rupees** as on the balance sheet date; and
- ii. which does not have **total borrowings** exceeding **one crore rupees** from any **bank** or **financial institution** at any point of time during the financial year; and
- iii. which does not have a **total revenue** as disclosed in **Scheduled III** to the Companies Act (including revenue from discontinuing operations) exceeding **ten crore rupees** during the **financial year** as per the **financial statements**.

Applying the above to the given case, G Pvt. Ltd., its **paid-up capital** and **reserves** are ₹ 95 Lakh (₹ 120 Lakh - ₹ 25 Lakh), borrowings from a Bank and financial institution are (₹ 55 Lakh + ₹ 55 Lakh) i.e., ₹ 1.10 Crore, turnover {including discontinuing operations (₹ 850 lakh + ₹ 250 Lakh)} ₹ 1100 Lakh i.e., ₹ 11 Crore. Since its borrowings and turnover are exceeding the specified limit and therefore it is not exempt from the applicability of CARO, 2020.

Question 10

(PYP Nov '22)

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?

Answer

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 12

(MTP May '24)

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?

Answer

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.

4. Completion & Review

Illustrations From Study Material

Illustration 2

CA Chandni Khanna is going to complete audit of a company within next few days. She has performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings held after date of financial statements, going through books of accounts after date of financial statements to make sure that all subsequent events before signing audit report have been considered by her. Still, she wants to be certain that no such events have been left out. What she should do in such a situation? Also, discuss the rationale of doing so.

Answer

She has already performed necessary **audit procedures** like inquiry of management personnel, reading minutes of meetings after date of financial statements and going through books after date of financial statements.

Now, she should request **management** and, where **appropriate, those charged with governance**, to provide a **written representation** in accordance with SA 580, "Written Representations" that **all events** occurring **subsequent** to the date of the financial statements and for which the applicable **financial reporting framework** requires adjustment or disclosure have been adjusted or disclosed.

The rationale of obtaining written representations is that even **after performing** abovesaid **procedures**, she **may not** come to know all **subsequent events**.

Therefore, it is necessary from an auditor's point of view to obtain **acknowledgment** from **management** in the form of **Written representations** that all such events for which the applicable financial reporting framework requires adjustment or disclosure have been **adjusted or disclosed**.

Illustration 3

(MTP Jan '25)

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:

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.

Questions From RTP'S, MTP'S, QP'S

SA 560- Subsequent Events

Question 2

(RTP May '24)

CA K is statutory auditor of DEMA Private Limited for the year 2022-23. The company has three plants in India. He is nearing completion of audit procedures relating to financial statements for the year under audit and has yet to sign audit report. Meanwhile, a huge fire had broken out in one of plants of the company located near Nashik on 25th June, 2023 damaging substantial part of machinery and work-in-process resulting in loss of about Rs. 5 crores. Unaware of the incident, he is in process of finalizing his report in first fortnight of July 2023. State few audit procedures to be performed by him to obtain sufficient appropriate evidence for identifying such events. Also explain auditor's responsibilities in this situation.

Answer:

In the given situation, a huge fire had broken out in one of plants of company on 25th June, 2023 destroying substantial part of machinery and work-in-process resulting in loss of Rs. 5 crores. The auditor has yet to sign audit report.

Before signing audit report, he should perform following audit procedures to obtain sufficient appropriate audit evidence that all such events have been identified and are appropriately reflected in financial statements: -

- Inquiry of management whether any subsequent events have occurred
- Reading minutes of the meetings of owners, management that have been held after date of financial statements and inquiring about matters discussed at such meetings for which minutes are not available
- Reading entity's latest subsequent interim financial statements
- Obtaining Written representations from management in accordance with SA 580

The situation is an example of subsequent event occurring between date of financial statements and date of audit report requiring disclosure in financial statements. The auditor has a responsibility to obtain sufficient appropriate audit evidence whether such an event requiring disclosure in financial statements is appropriately reflected in financial statements.

SA 570- Going Concern

Question 1

(PYP May '23)

S Ltd., a large textile manufacturing company, due to heavy recession in the market was unable to collect amount of huge receivables in time and also holding large amounts of stock of raw materials and finished goods since last 9 months of the Financial Year 2022-23.

From your primary observations of audit evidence, you feel that there is a material uncertainty existing about going concern.

How will you deal in your audit report?

What will be the effect on your audit opinion in the following situations?

If adequate disclosure of such material uncertainty is already made in the financial statements.

If adequate disclosure of such material uncertainty is not made in the financial statements.

Answer

Use of the Going Concern Basis of Accounting is Appropriate but a **Material Uncertainty** Exists

The identification of a **material uncertainty** is a matter that is important to users' understanding of the financial statements. The use of a separate section with a heading that includes reference to the fact that a material uncertainty related to **going concern** exists alerts users to this circumstance.

a. Adequate Disclosure of a Material Uncertainty is Made in the Financial Statements

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

b. Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements

If adequate disclosure about the **material uncertainty** is not made in the financial statements, the auditor shall:

- i. Express a **qualified opinion** or **adverse opinion**, as appropriate, in accordance with SA 705 (Revised); and
- ii. In the **Basis for Qualified (Adverse) Opinion** section of the auditor's report, state that a **material uncertainty** exists that may cast significant doubt on the entity's ability to continue as a **going concern** and that the **financial statements** do not adequately disclose this matter.

Question 3

CA B is statutory auditor of Boom Payments Bank for year 2023-24. During the year, banking regulator has imposed restrictions on Bank from accepting new deposits due to non-compliance in conducting KYC in large number of accounts and violation of rules aimed at preventing money laundering. There is material uncertainty regarding probable outcome of such restrictions on ability of Bank to continue as going concern. However, for year 2023-24, auditor has concluded that use of going concern basis of accounting is appropriate. The financial statements of Bank do not make adequate disclosure of material uncertainty due to above events in financial statements. What are implications for auditor's report for year 2023-24 in view of above?

Answer

As described in the situation given in the question, banking regulator has imposed **restrictions** due to non-compliance with regulatory requirements and there is **material uncertainty** of such events or conditions which may cast a significant doubt on ability of **Bank** to continue as **going concern**. However, the **financial statements** of Bank do not make **adequate disclosure** of material uncertainty due to above events in financial statements.

If adequate disclosure about the **material uncertainty** is not made in the financial statements, the auditor shall:

- (i) Express a **qualified opinion or adverse opinion**, as appropriate, in accordance with SA 705.
- (ii) In the Basis for **Qualified (Adverse) Opinion** section of the auditor's report, state that a **material uncertainty** exists that may cast significant doubt on the entity's ability to continue as a **going concern** and that the **financial statements** do not adequately disclose this matter.

Question 4

(MTP Sep '24)

Stay fit Private Limited is a start-up that has been in business for about two years. It runs an application which provides valuable information pertaining to nutrition and helps its clients to access customized healthy food. The company's revenues are expected to grow in the coming period. Although company has reflected net losses in its financial statements for the last two years, it has managed to meet its financial commitments. The financial statements for last two years were prepared on going concern basis of accounting. The management of company wants to follow the same basis of accounting for the current year. Is the view of management appropriate? How does the "going concern" affect the preparation of financial statements?

Answer

As per SA 570, "**Going Concern**", going concern is one of the **fundamental accounting assumptions**. The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of **liquidation** or of **curtailing materially** the scale of the operations.

Under the **going concern** basis of accounting, the **financial statements** are prepared on the assumption that the entity is a going concern and will **continue** its operations for the **foreseeable** future. **General purpose financial statements** are prepared using the going concern basis of accounting, **unless** management either intends to **liquidate** the entity or to cease operations, or has no **realistic alternative** but to do so.

In the given situation, company has reflected **net losses** in financial statements of last two years but is able to meet its **financial commitments** signifying its ability to carry on business/trade. The **revenue** of company is also expected to grow in the **coming period**. It shows that management has neither the intention nor the necessity of **liquidation** or of **curtailing materially** the scale of operations. Therefore, view of the management for following going concern basis of accounting in **current year is appropriate**.

Further, the significance of **going concern** is due to its effect on the preparation of financial statements. Ability or otherwise of an enterprise to be viewed as going concern affects its **preparation of financial statements**. 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 **realise** its assets and discharge its **liabilities** in the normal course of business. When an **enterprise** is **not viewed** as a going concern, the financial statements are prepared on liquidation basis. **For example**, inventories may need to be written down as these may be sold for a lower price. Assets may have to be recorded at the likely prices they will fetch.

SA 580- Written Representations

Question 3

(MTP May '23)

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

When inventory under the custody and control of a third party is material to the financial statements, the auditor can obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by taking written representation from management.

Answer

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:

- Request **confirmation** from the **third party** as to the **quantities** and **condition** of inventory held on behalf of the entity.
- Perform **inspection** or other **audit procedures** appropriate in the circumstances.

Question 5

(RTP Nov '23)

Written representations are to be provided by the management to the auditor when requested. Explain

Answer

Management from Whom Written Representations Requested: SA-580, "Written Representations", the auditor shall request **written representations** from **management** with appropriate responsibilities for the **financial statements** and knowledge of the matters concerned.

Written representations are requested from those **responsible** for the **preparation** and **presentation** of the financial statements. Those individuals may vary depending on the **governance structure** of the entity, and relevant **law** or **regulation**; however, **management** (rather than those charged with governance) is often the responsible party. **Written representations** may therefore be requested from the entity's **chief executive officer** and **chief financial officer**, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those **charged with governance**, are also responsible for the preparation and presentation of the financial statements.

If **management** does not provide one or more of the requested written representations, the auditor shall-

- Discuss** the matter with management;
- 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
- 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 8

(RTP Sep '24)

While conducting audit of BYN Limited, CA Y notices that company has lost one of its key markets along with important customers. Additionally, several highly successful competitors have emerged, impacting business of the company. Despite the existence of material uncertainty, CA Y finds the use of going concern basis of accounting appropriate for preparation of financial statements. The company has also disclosed material uncertainty in notes to accounts adequately. How should he deal with the matter in auditor's report?

Answer

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

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

Question 10**(MTP Jan '25)**

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

Answer

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

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

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

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

5. Documentation

Illustrations From Study Material

Illustration 2

CA Sonali Morarka has completed audit of a listed company. The audit report dated 15th July, 2022 has been issued. However, audit working papers including record of discussions with management, details of audit procedures performed to obtain audit evidence and conclusions reached by her have not been properly assembled. More than six months have elapsed after issue of audit report. Subsequently, she has received a letter from regulator in connection with audit of the company requesting her to share copy of audit file.

The letter has woken up her from deep slumber. She hurriedly assembled audit file and inserted some more papers which were necessary. However, she put current date on these inserted papers and the copy of audit file was sent to regulator. Discuss, the issues involved, in context of "audit documentation".

Answer

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.

Questions From RTP'S, MTP'S, QP'S

Question 6

(RTP Nov '22)

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?

Answer

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 16

(MTP 2 Sep '24)

CA N, statutory auditor of Rock Limited, is in the process of final assembly of audit file. Under what circumstances, a statutory auditor can make changes to audit documentation during final assembly process of audit file? Give a few examples of such changes.

Answer

Changes may 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.

6. Audit Evidence

Illustrations From Study Material

Illustration 2

CA Sooryagaythri is conducting audit of an entity. During the course of audit, she has made oral inquiries from head accountant regarding preparing of bank reconciliations every month as has been laid down by the management. Discuss, whether inquiries as stated above would provide satisfaction to her that controls in respect of preparing bank reconciliations statements have operated effectively.

Answer

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.

Illustration 4

A company has stipulated a control through its automated software that interest @ 12% p.a. is charged in case of those customers who fail to make payment within a month of a sales transaction. The internal auditor of the company finds that during a certain period, software has failed to charge interest due to certain technical glitches. Does reporting of above situation fall in domain of internal auditor's work?

Answer

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.

Illustration 7

CA Jignesh Desai is in midst of audit of a company. The company is fairly large one and has a well - functioning internal audit department. While considering sending out external confirmation requests to trade receivables outstanding as on date of financial statements, he has delegated the process of choosing trade receivables, designing requests and receiving responses from customers to internal audit department. The responses are also received on the mail id of internal audit department. Is approach of CA Jignesh Desai proper?

Answer

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

- Determining the information to be confirmed or requested;
- Selecting the appropriate confirming party;
- 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
- 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**.

Illustration 8

On reviewing schedule of trade receivables of a company, CA Mary finds that in respect of one outstanding balance, the CFO of the company is not willing to allow her to send external confirmation request due to the reason that sending out such request could spoil precariously placed business relations with the customer. On further inquiry, she finds out that there is a dispute going on with the company relating to some quality issues of goods sent to the customer and matter is sub judice. Efforts are also being made by the company for out of court settlement. Reviewing correspondence with the customer, she finds that issue is near resolution and no fraud risk factors exist. Is unwillingness of CFO justifiable?

Answer

In terms of requirements of **SA 505**, if management refuses to allow the auditor to send a **confirmation** request, the auditor shall inquire as to management's reasons for the refusal, and seek **audit evidence** as to their validity and **reasonableness**.

A common reason advanced is the existence of a **legal dispute** or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely **confirmation** request. Further, **fraud risk factors** do not exist. Keeping in view, unwillingness of CFO is justifiable.

Additional Illustrations

Illustration 8

(MTP Jan '25)

While conducting the audit of AB Ltd, the auditor K of KLM and Associates, Chartered Accountants observes that there are large number of Trade payables and receivables standing in the books of accounts as on 31st March. The auditor wanted to send confirmation request to few trade receivables, but the management refused the auditor to send confirmation request. How would the auditor proceed?

Answer:

If **management** refuses to allow the **auditor** to send a **confirmation** request, the auditor shall:

- Inquire as to management's **reasons** for the refusal, and seek **audit evidence** as to their validity and reasonableness;
- 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
- Perform **alternative audit** procedures designed to obtain relevant and reliable **audit evidence**.

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

The auditor also shall determine the **implications** for the audit and the auditor's opinion in accordance with SA 705.

Test Your Knowledge

Question 14

Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Explain

Answer

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..

Questions From RTP'S, MTP'S, QP'S

SA 500- Audit Evidence

Question 3

(MTP Oct '22)

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.

Answer

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 4

(MTP Oct '22)

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?

Answer

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**.

CA Amar should consider the above before using the work of the **management's expert**.

Question 12

(RTP Nov '22)

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.

Answer

If: **audit evidence** obtained from one source is **inconsistent** with that obtained from another; or 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 19

(PYP May '23)

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.

Answer

Examples of **others within the entity** to whom the **auditor** may direct inquiries about the existence or suspicion of fraud include:

- **Operating personnel** not directly involved in the financial reporting process.
- **Employees** with different levels of authority.
- **Employees** involved in initiating, processing or recording complex or **unusual transactions** and those who supervise or monitor such employees.
- In-house **legal** counsel.
- **Chief ethics officer** or equivalent person.
- The person or persons charged with dealing with **allegations of fraud**.

Question 20

Suniti, a CA student, is part of an engagement team conducting audit of a company TIM Private Limited. According to audit programme, she is responsible for verifying purchases and PPE items appearing in books of accounts from records/bills of company. Besides, she has also been entrusted responsibility to obtain written representation from management regarding carrying out of physical verification of inventories during the year. During course of her work, she finds that:

- (i) One purchase bill amounting to Rs. 5.00 lacs pertaining to TIM Industries has been entered in

books of TIM Private Limited.

- (ii) The management has refused to provide a written representation relating to physical verification of inventories during the year. She has brought it to knowledge of engagement partner who has decided to use lack of such a representation as audit evidence.

Discuss whether each of above constitutes audit evidence. State reasoning for your answer.

Answer

Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. **Purchase bill** of Rs. 5.00 lacs pertaining to **TIM Industries** has been entered in books of TIM Private Limited. Therefore, it is contradicting **management's** assertion relating to occurrence of such purchases. Hence, it constitutes **audit evidence**.

Further, the **absence** of information (for example, management's refusal to provide a requested **representation**) is used by auditor, and therefore, also constitutes **audit evidence**. In the given case, management has refused to provide a **written representation** relating to **physical verification** of inventories during the year. Therefore, absence of information is used by auditor and it also constitutes **audit evidence**.

SA 530 Audit Sampling

Question 11

(MTP May '23)

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.

Answer

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 14

(RTP Nov '23)

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.

Answer

As per SA 530, "**Audit Sampling**", the auditor shall evaluate:

- The **results of the sample**; and
- Whether the use of audit sampling has provided a **reasonable basis** for conclusions about the population that has been tested.

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 17

(MTP May '24)

Sanjeev, an articled clerk in an audit firm, is part of an engagement team conducting audit of a company for year 2023-24. It is a small company having a turnover of about Rs.25 crores. During the course of audit, he notices that senior team member has taken following approach for selecting items for testing reflected in financial statements to obtain audit evidence:

- He has selected to test items debited under the head "Machinery repair & maintenance" as expenditure relating to it during year 23-24 has increased considerably as compared to last year.
- Out of purchases, he has selected to test purchases from related parties amounting to Rs. 5 crores.
- He has also selected to test all individual items of expenditure exceeding Rs.5 lakhs.
- Besides, he has also selected amount of Rs.0.50 lakhs debited under head "legal expenses" to know purpose of payment made to external legal counsel.

Sanjeev understands that senior team member is using "audit sampling" for selecting items for testing. Do you agree with him? Which risk is involved in above approach? Discuss with reasons.

Answer

Audit Sampling refers to the application of **audit procedures** to less than 100% of items within a population relevant under the audit such that all sampling units (i.e. all the items in the population) have an **equal chance of selection**.

In the given situation, senior team member is not selecting items for testing by means of **audit sampling**. He is only selecting **specific items from a population**. In accordance with SA 500, one of the means available to auditor for selecting items for testing is "by selecting **specific items**."

Specific items selected may include: -

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

Therefore, Sanjeev's understanding is not proper.

The above approach for selecting items for testing is subject to non- sampling risk. **Non-sampling risk** is the risk that auditor may reach an erroneous conclusion for any reason not related to sampling risk. Like, erroneous conclusion may be reached due to some inappropriate **audit procedure**.

SA 501 - Audit Evidence-Specific Considerations For Selected Items

Question 4

(MTP May '24)

While performing statutory audit of Contra Industries Private Limited, a company engaged in manufacturing and assembling of LED lights, CA Varun has decided to attend physical inventory count process of the company on 30th and 31st March, 2024. The inventories are lying at three different locations - two such locations A and B are in one city and third location C is in another city. Further, company also sends inventories to some service providers for quality control and testing as such facilities are not available with the company.

CA Varun is well-versed with this type of industry and has prepared a list of following matters which could be relevant to him in planning attendance at physical inventory count process for discharging his responsibilities in accordance with SAs: -

- Nature of inventories i.e. LED light components, parts, circuits, panels, body, WIP and finished packed LED lights
- Materiality of inventories at different locations A, B and C
- Stage of completion of work-in-progress
- Maintenance of perpetual inventory system by company
- Materiality of inventories lying with service providers
- Timing of physical inventory counting i.e. year end

There are two important matters which do not find place in above list. Without considering these crucial matters, it would be difficult for the auditor to properly plan his attendance at inventory count process in accordance with relevant SA. Discuss such matters.

Answer

The list given in the question does not contain following important matters: -

- **Whether adequate procedures** are expected to be established and proper instructions issued for **physical inventory counting**. The auditor has to evaluate **management's instructions** for recording and controlling **physical inventory counting**. It is important for the auditor to know beforehand how the **inventory count** will be conducted so as to assess its **effectiveness**.
- The **nature of internal control** related to **inventories** at different locations. It is possible that inventories at one location have **unsatisfactory control** leading to higher risk of material misstatement related to inventories at that particular location.

Question 5

(MTP May '24)

In an initial audit engagement, in the case of inventories, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, in such a case, additional audit procedures become necessary so that auditor may obtain sufficient appropriate audit evidence. Discuss those additional audit procedures.

Answer

In an **initial audit engagement**, in the case of **inventories**, the current period's **audit procedures** on the closing inventory balance provide little **audit evidence** regarding inventory on hand at the **beginning** of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient **appropriate audit evidence**:

- **Observing** a current **physical inventory** count and reconciling it to the opening **inventory quantities**.
- Performing **audit procedures** on the **valuation** of the opening inventory items.

- Performing audit procedures on **gross profit and cut-off**.

SA 505- External Confirmations

Question 1

(MTP May '22)

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.

Answer

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 2

(MTP May '22, RTP Nov '22)

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?

Answer

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 3

(RTP May '24)

CA J is conducting statutory audit of Gemini Ltd engaged in manufacturing of pharma products. 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, CA J 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 the approach of CA J proper?

Answer

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**.

SA 550- Related Parties

Question 2

(PYP May '22)

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?

Answer

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:

Inspect the underlying **contracts or agreements**, if any, and evaluate whether:

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**;

The terms of the **transactions** are consistent with management's **explanations**; and

The transactions have been appropriately **accounted** for and **disclosed** in accordance with the applicable financial reporting framework; and

Obtain audit evidence that the transactions have been appropriately **authorised** and **approved**.

SA 610 Using The Work Of Internal Auditors

Question 1

CA Z is appointed as statutory auditor of BETA Private Limited for the year 2023-24. There exists an internal audit function in the company headed by its Chief Internal Auditor, CA K. Valuation of trade receivables of company is assessed as area of higher risk by statutory auditor. He wants to take direct assistance of Chief Internal Auditor in respect of above matter. Discuss along with reasons whether it would be proper for statutory auditor to: -

- (i) Assign checking of accuracy of aging of trade receivables to Chief Internal Auditor?
- (ii) Assign evaluation of adequacy of provision based on aging of trade receivables to Chief Internal Auditor?

Answer

In accordance with **SA 610**, the **external auditor** shall not use **internal auditors** to provide **direct assistance** to perform procedures that relate to **higher assessed** risks of material misstatement where the **judgment** required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than **limited**.

In the given situation, **valuation of trade receivables** is assigned as an area of **higher risk** by statutory auditor. Judgment required in checking of **accuracy of aging** of trade receivables is limited. Therefore, external auditor can assign the checking of the accuracy of the aging to **Chief Internal Auditor** providing **direct assistance** as it involves limited judgment.

However, because the **evaluation** of the adequacy of the **provision** based on the aging would involve **more than limited judgment**, it would not be appropriate to assign that latter procedure to Chief Internal Auditor providing **direct assistance**.

7. Different Types of Entities

Questions From RTP'S, MTP'S, QP'S

Question 45**(MTP Jan '25)**

"In establishing the overall audit strategy, the auditor shall, among other considerations, ascertain the nature, timing and extent of resources necessary to perform the engagement". Explain those considerations in detail.

Answer

In establishing the **overall audit strategy**, the auditor shall:

- (i) **Identify the characteristics** of the engagement that define its scope;
- (ii) **Ascertain the reporting objectives** of the engagement to plan the **timing** of the audit and the nature of the **communications** required;
- (iii) **Consider the factors** that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
- (iv) Consider the results of **preliminary engagement activities** and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
- (v) Ascertain the **nature, timing and extent** of **resources** necessary to perform the engagement.

9. Risk Assessment

Illustrations From Study Material

Illustration 6

CA A. Raja is auditor of Build Well Forgings Private Limited having a revenue of Rs. 25 crore. The company has been sanctioned a term loan of Rs. 50 lacs from a bank. However, as at end of the year, only Rs. 1 lac was availed due to delay in procurement of asset. The financial statements of the company do not disclose nature of security against which loan has been taken. Schedule III of Companies Act, 2013 requires disclosure in this respect. Discuss, whether, non-disclosure of nature of security is material for auditor.

Answer

If there is **any statutory requirement of disclosure**, it is to be considered material. Schedule III mandates disclosure of nature of security in relation to loan. The **amount involved is irrelevant**.

Illustration 8

During the audit of same company, CA Smriti is keen to find out whether there exists a proper system of segregation of duties in the company. She wants to be sure that a person responsible for recording a transaction is different from the person authorising it. Discuss what she is trying to do and how its understanding is significant to her as an auditor.

Answer

She is keen to find out whether there exists a proper system of **segregation of duties** in the company. She is gaining an understanding of **internal control** of the company. In particular, she is understanding **"control activities"**. When a person **recording a transaction** is different from one **authorizing** it, she gains confidence that there exists a system for preventing **misstatements**. It helps her in gaining insight into the **internal control** system of the company.

Illustration 10

A Chartered accountant during course of audit of a company finds that cash is not deposited into bank frequently although concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. Discuss what does it represent from auditor's perspective.

Answer

Cash is **not deposited** into bank frequently, although, **concerned staff** of company was required to do so. Further, the official responsible for **ensuring performance** of above function, has also **not paid** any attention to it. It means that control is **not working as planned**. It would not be able to prevent misstatement and very purpose of control is defeated. It represents a **"control deficiency"**.

Additional Illustrations

Illustration 11

XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as ready made garments for all seasons, shoes, gift items, watches etc. There are security tags on each and every item. Moreover, inventory records are physically verified on monthly basis.

Discuss the types of inherent, control and detection risks as perceived by the auditor.

Answer

Inherent Risk: Because items may have been **misappropriated** by employees, therefore, risk to the auditor is that **inventory records** would be **inaccurate**.

Control Risk: There is a **security tag** on each item displayed. Moreover, **inventory** records are physically **verified** on monthly basis. Despite various controls being implemented at the stores, still **collusion** among employees may be there and risk to auditor would again be that inventory records would be **inaccurate**.

Detection Risk: Auditor checks the **efficiency** and **effectiveness** of various control systems in place. He would do that by making **observation**, **inspection**, **enquiry**, etc. In addition to these, the auditor would also employ **sampling techniques** to check few **sales transactions** from beginning to end. However, despite all these procedures, the auditor may not detect the items which have been stolen or **misappropriated**.

Questions From RTP'S, MTP'S, QP'S

Question 9

(MTP Nov '23, Jan '25)

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

Answer

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

Example

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

Question 20

(MTP May '23)

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.

Answer

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 23

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

Answer

- 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 26

(MTP May '22, RTP Nov '23)

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.

Answer

When a business operates in a more automated environment it is likely that we, as auditors, will see several business functions and activities happening within the systems. As an auditor, there is a need to consider the following aspects:

- ⬆ **Computation and Calculations** are automatically carried out (for example, bank interest computation

and inventory valuation).

- ⬆ Accounting entries are posted automatically (for example, sub-ledger to GL postings are automatic).
- ⬆ Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).
- ⬆ Reports used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).
- ⬆ User access and security are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively).

Question 27

(MTP Nov '22)

The auditor should consider relevance of IT in an audit of financial statements. Explain giving reasons.

Answer

The auditor should consider relevance of IT in an audit of financial statements for the following reasons:

- i. Since auditors rely on the reports and information generated by IT systems, there could be risk in the IT systems that could have an impact on audit.
- ii. Standards on auditing SA 315 and SA 330 require auditors to understand, assess and respond to risks that arise from the use of IT systems.
- iii. By relying on automated controls and using data analytics in an audit, it is possible to increase the effectiveness and efficiency of the audit process.

Question 28

(MTP Nov '22)

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

Answer

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

Question 44

(RTP May '23)

It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Explain with the help of example in respect of the procedure for sales.

Answer

It has been suggested that actual operation of the internal control should be tested by the application

of procedural tests and examination in depth. **Procedural tests** simply mean testing of the compliance with the procedures laid down by the management in respect of **initiation, authorization, recording and documentation** of transaction at each stage through which it flows.

For example, the procedure for **sales** requires the following:

1. Before acceptance of any **order** the position of **inventory** of the relevant article should be known to ascertain whether the order can be executed in time.
2. An **advice** under the authorisation of the **sales manager** should be sent to the party placing the order, **internal reference number**, and the acceptance of the order. This advice should be prepared on a **standardized form** and copy thereof should be forwarded to **inventory section** to enable it to prepare for the execution of the order in time.
3. The **credit period** allowed to the party should be the **normal credit period**. For any special credit period a **special authorisation** of the sales manager would be necessary.
4. The **rate** at which the order has been accepted and other terms about **transport, insurance, etc.**, should be clearly specified.
5. Before deciding upon the **credit period**, a reference should be made to the **credit section** to know the **creditworthiness** of the party and particularly whether the party has honored its commitments in the past.

Question 52

(RTP May '23)

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.

Answer

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 55

(PYP Nov '22)

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?

Answer

Control Environment:

The control environment includes:

- i. The **governance** and **management functions** and
- ii. The **attitudes, awareness, and actions** of those charged with governance and management.
- iii. The control environment sets the **tone** of an organization, influencing the control **consciousness** of its people.

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

- a. Management has created and maintained a culture of **honesty** and **ethical behavior**; and
- b. The **strengths** in the control environment elements collectively provide an appropriate **foundation** for the other components of **internal control**.

Question 62

(PYP May '22)

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?

Answer

Understanding and Documenting Automated Environment: When a business operates in a more **automated environment** it is likely that auditor will see several business functions and activities happening within the systems. Consider the following aspects instead of:

- i. **Computation** and **Calculations** are automatically carried out (for example, bank interest computation and inventory valuation).
- ii. **Accounting entries** are posted automatically (for example, sub-ledger to GL postings is automatic).
- iii. **Business policies** and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).
- iv. **Reports** used in business are produced from systems. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).
- v. **User access** and **security** are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively).

Companies derive benefit from the use of **IT systems** as an enabler to support various business operations and activities. Auditors need to understand the relevance of these IT systems to an audit of financial statements.

While it is true that the use of IT systems and automation benefit the business by making operations more **accurate, reliable, effective** and **efficient**, such systems also introduce certain new risks, including **IT specific risks**, which need to be considered, assessed and **addressed** by **management**.

To the extent that it is relevant to an audit of **financial statements**, even auditors are required to understand, assess and respond to such risks that **arise** from the use of IT systems.

From the above discussion, it is quite apparent that it is **necessary** for an auditor to understand the automated environment.

Alternative Solution

Understanding and Documenting Automated Environment: In an audit of financial statements, an auditor is required to understand the entity and its business, including IT as per SA 315. Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.

Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment:

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

The understanding of a company's IT environment that is obtained should be documented. From the above discussion, it is quite apparent that it is necessary for an auditor to understand the automated environment.

Question 64

(PYP Nov ' 22)

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?

Answer

Access Security in Automated Environment:

Objective of access security: The objective of Access Security is to ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

Activities:

- i. **Security Organization & Management**
- ii. **Security Policies & Procedures**
- iii. **Application Security**
- iv. **Data Security**
- v. **Operating System Security**
- vi. **Network Security** - internal network, perimeter network
- vii. **Physical Security** - access controls, environment controls
- viii. **System Administration & Privileged Accounts** - Sysadmins, DBAs, Super users

Question 67

(MTP May '24)

Given below is a table containing Column A and Column B. Column A contains description of certain controls in an automated environment. Complete Column B by stating appropriate type of control.

Column A (Description of control in an automated environment)	Column B (Type of control)
Reasonableness checks	?
Controls over Data centre and network operations	?
Controls over application system acquisition, development and maintenance	?
Program change controls	?

Answer

Column A (Description of control in an automated environment)	Column B (Type of control)
Reasonableness checks	Application controls
Controls over Data centre and network operations	General IT controls
Controls over application system acquisition, development and maintenance	General IT controls
Program change controls	General IT controls

Question 68

(MTP May '24)

Internal Control Questionnaire is a comprehensive series of questions concerning internal control. A company is engaged in business of manufacturing of chemicals. It has two plant locations in city "A" and one plant location in city "B" involving huge value of assets. Building at three locations is owned by the company. The company earns handsome profits and does not want to suffer losses due to business interruptions. It has a dedicated department for looking after insurance matters. As an auditor, prepare an internal control questionnaire concerning this department for obtaining staff responses.

Answer**Internal Control Questionnaire**

- Are **competitive quotes** obtained from different insurers?
- Is **comprehensive insurance cover** obtained for fire, flood, burglary, earthquake risks etc.?
- Are all three **locations** in city A and B covered?
- Are all **assets** consisting of building, plant & machinery and inventories covered?
- Is there an adequate procedure to ensure that **assets acquired** between two renewal dates are also covered by insurance?
- Is there an **official** who decides on value for which policies are taken?
- Does officer who decides on policy value **review periodically** adequacy of insurance cover?
- Is loss-of-profits **insurance cover** taken?
- Have there been any instances of **rejection of claims**?
- Are **pending claims** followed-up with insurers?

Question 72

(MTP May '24)

On reviewing internal control over accounting for sales as part of statutory audit of A Ltd, auditor finds certain deficiencies in segregation of duties, authorization of sales orders, preparation of invoices, preparation and authorization of debit/credit notes etc. and non-following of standard procedures as stipulated by the management. The auditor finds these lapses to be significant deficiencies in internal

control over sales.

He points it out to the management in a one-liner as under: -

"Instructions on internal control related to sales are not properly followed by the staff."

Is above communication by the auditor proper?

Answer

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 following the standard **instructions/ procedures** specified in relation to various aspects of sales as **stipulated** by the management. It should explain that such a **significant deficiency** can lead to **misstatement** of **revenue** and trade receivables 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**.

Question 79

(MTP Jan '25)

SA 330 states that auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to operating effectiveness of relevant controls. Briefly discuss when such tests are to be designed and performed in accordance with SA 330?

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

Answer

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

- (i) The auditor's assessment of **risks of material misstatement** at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the **nature, timing** and **extent** of substantive procedures) or
- (ii) **Substantive procedures** alone cannot provide sufficient appropriate audit evidence at the assertion level.

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

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

Question 80

(MTP Jan '25)

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

Comment, whether the auditor should assess all the internal controls or limit the assessment to only

those considered relevant by the auditor during the audit. Also, discuss the factors influencing the auditor's judgment on the relevance of controls.

Answer

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

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

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

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

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

10. Audit of Banks

Questions From RTP's, MTP's, QP's

Question 34**(MTP Jan '25)**

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

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

Answer

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

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

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

11. Items of Financial Statements

Illustrations From Study Material

Illustration 2

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.

Answer

It shall be shown under the head "**Borrowings**" and classified as **Short-term secured borrowings** specifying nature of **security**. The above said **outstanding amount** shall be further sub-classified under heading "**Loans repayable on Demand**" from **Banks**. As per requirements of **Schedule III of Companies Act, 2013**, where loans have been **guaranteed by directors** or others, **aggregate amount** of such loans under each head shall be disclosed.

Illustration 4

An auditor of a company is focusing upon revenues of a company. In this regard, besides performing usual detailed checking of sales, he wants to perform substantive analytical procedures in respect of sales. Discuss how he can perform such procedures.

Answer

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**.

Test Your Knowledge

Question 1

How will you vouch and/or verify the following:

- a. Goods sent out on Sale or Return Basis.

Answer

- 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.

Question 2

How will you vouch/verify the following:

- b. Goods sent on consignment.
- c. Foreign travel expenses.
- d. Receipt of capital subsidy.
- e. Provision for income tax.

Answer

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 **authorization** 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. (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. (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

Question 3

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

Answer

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. (ii) **Payments or advance payments of income-tax** should also be verified with the **notice of demand** and the **receipted challan** acknowledging the amount paid.
- iii. The **interest** allowed on **advance payments** of income-tax should be included as **income** and **penal interest** charged for **non-payment** should be debited to the **interest account**.
- iv. Nowadays, **electronic payment** of taxes is also in trend. **Electronic payment** of taxes means payment of taxes by way of **internet banking facility** or **credit** or **debit cards**.
- v. The entity can make **electronic payment** of taxes also from the account of any other person. However, the **challan** for making such payment must clearly indicate the **Permanent Account Number (PAN)** of the assessee on whose behalf the payment is made. This should be checked by the **auditor**.

- vi. It is not necessary for the entity to make payment of taxes from his own account in an **authorized bank**. While vouching such **e-payment**, the **auditor** should cross verify the payments of taxes through the **receipted challan** along with **PAN No /TAN No.** etc.

Question 4

How would you vouch/verify the following:

- Advertisement Expenses.
- Sale of Scrap.

Answer

a. Advertisement Expenses:

- Verify the **bills/invoices** from **advertising agency** to ensure that **rates** charged for different types of advertisement are as per the **contract**.
- See that the advertisement relates to **client's business**.
- Inspect** the **receipt** issued by the agency.
- Ascertain the **nature of expenditure** - **revenue** or **capital expenditure** and see that it has been recorded properly.
- Ascertain the **period** for which payment is made and see that **prepaid amount**, if any, is carried to the **balance sheet**.
- See that all **outstanding advertisement bills** have been **provided for**.

b. Sale of Scrap:

- Review the **internal control** as regards **generation, storage and disposal** of scrap.
- Check whether the organization is maintaining **reasonable record** for generation of scrap.
- Analyze** the **raw material used, production and generation pattern** of scrap and compare the same with figures of **earlier year**.
- Check the **rates** at which scrap has been sold and compare the rate with **previous year**.
- Vouch** sales, with **invoices raised, advertisement for tender, rate contract** with scrap dealers.
- Ensure that there exists a proper **control procedure** to identify scrap and good units and they are not mixed up and sold as scrap.
- Make an overall **assessment** of the value of **realization** from scrap as to its **reasonableness**.

Questions From RTP'S, MTP'S, QP'S

Question 44

(MTP May '24)

Tisa Industries Private Limited has prepared its financial statements for year 2023-24. The financial statements and notes to accounts show following information and disclosure in respect of trade receivables of the company: -

S. No.	Particulars	Amount (in Rs. lacs)
1.	Trade Receivables	240.00

Trade receivables ageing schedule.

Outstandings for following periods from due date of payment
(in Rs. lacs)

Particulars	Less than 1 year	1-2 years	2-3 years	More than 3 years	Total
MSME	150.00	30.00	10.00	XXX	190.00
Others	40.00	XXX	XXX	XXX	40.00
Disputed dues- MSME	XXX	XXX	XXX	XXX	XXX
Disputed dues- others	10.00	XXX	XXX	XXX	10.00

You are part of engagement team conducting audit of the company. Point out discrepancies including omissions in above disclosure. (Do not prepare another table).

Answer

The above disclosure is not in accordance with requirements of **Division I of Schedule III of Companies Act, 2013**. The discrepancies are as under: -

- (1) The Company has **wrongly disclosed** information for **trade receivables** in a manner which is applicable for **trade payables**.
- (2) No **distinction** between **MSME** and other trade receivables is required.
- (3) Trade receivables are to be **categorised** into undisputed and disputed **trade receivables** as under: -
 - **Undisputed trade receivables considered good**
 - **Undisputed trade receivables considered doubtful**
 - **Disputed trade receivables considered good**
 - **Disputed trade receivables considered doubtful**
- (4) **Aging** is to be reflected for each of above categories in respect of outstandings for the following periods from due date of payment
 - **for less than 6 months**
 - **6 months-1 year**
 - **1- 2 years**
 - **2-3 years**
 - **more than 3 years**
- (5) Following information is also required to be disclosed: - Trade receivables shall be **sub-classified** as:
 - (a) **Secured, considered good**
 - (b) **Unsecured, considered good**
 - (c) **Doubtful.**
- (6) **Allowance for bad and doubtful debts** shall be disclosed under the relevant heads separately.
- (7) **Debts due by**
 - **directors** or other officers of the company or any of them either severally or jointly with any other person or
 - **firms or private companies** respectively in which any director is a partner or a director or a member should be separately stated.

Question 50

(RTP May '24)

Following is extract of notes to accounts of financial statements of STU Private Limited listing some ratios. Discuss, whether disclosure, given in following manner meets requirements of Schedule III of the Companies Act, 2013. Ignore other ratios which are not listed in extract given below:

Name of ratio	31.3.2023	31.3.2022
Current ratio	2.50	2.30
Inventory turnover ratio	3.00	6.00
Trade receivables turnover ratio	1.75	5.00
Net profit ratio (in%)	13%	10%

Answer:

The disclosure given in the question does not meet requirements of **Schedule III to Companies Act, 2013**. Schedule III requires that the company shall explain the items included in **numerator** and **denominator** for computing the ratios. Further explanation shall be provided for any change in the ratio by more than **25%** as compared to the preceding year.

In the given table, the company has not explained the items included in **numerator** and **denominator** for computing ratios. Further, variations in ratios as compared to preceding year are as under: -

Name of ratio	31.3.23	31.3.22	Variation
Current ratio	2.50	2.30	8.69%
Inventory turnover ratio	3.00	6.00	50%
Trade receivables turnover ratio	1.75	5.00	65%
Net Profit ratio (in%)	13%	10%	30%

As calculated above, there is change in **inventory turnover ratio**, **trade receivables turnover ratio** and **net profit ratio** by more than **25%** as compared to preceding year. Therefore, **explanations** for such changes have also to be provided where there are changes by more than 25% as compared to preceding year.

Question 52

(MTP 2 Sep' 24)

CDE Private Limited, a manufacturing company, had made investment in shares of some blue-chip companies. Additionally, it had temporarily deposited some of its extra funds in fixed deposits with a scheduled bank. Dividend from shares amounting to Rs.1.80 lakhs (net of TDS, TDS = Rs.0.20 lakhs) and bank interest of Rs.2.70 lakhs (net of TDS, TDS = Rs.0.30 lakhs) were credited in bank account of the company. During the year 2023-24, it has also sold some shares resulting in net gain of Rs.5 lakhs. The company has shown above incomes under head "Other income" for consolidated amount of Rs.9.50 lakhs in the statement of Profit and Loss. No other information is furnished in the financial statements put up for audit. As the auditor of the company, discuss whether the above situation constitutes "misstatement" in the financial statements of the company. Also state, few examples of misstatements.

Answer

Misstatement refers to a difference between the amount, **classification**, **presentation**, or **disclosure** of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

In the given situation, there is a difference in **amount** to be recorded as well as in **disclosure** of a financial statement item from what is required in accordance with applicable financial reporting framework. The company should have recorded **gross amount** of **dividend** and **interest** amounting to ₹ 2.00 lakhs and ₹ 3.00 lakhs respectively in its financial statements in accordance with **AS 13**. Therefore, amount recorded under head "**Other income**" should have been for ₹ 10 lakhs (2 lakhs+3 lakhs+5 lakhs).

Further, in accordance with disclosure requirements of Schedule III of the Companies Act, 2013, other income shall be classified in the above situation as: -

- (a) Interest Income of ₹ 3 lakhs
 - (b) Dividend Income of ₹ 2 lakhs
 - (c) Net gain on sale of investments of ₹ 5 lakhs
- Few examples of misstatements are:
- Charging of an item of capital expenditure to revenue or vice-versa.
 - Difference in disclosure of a financial statement item vis-à-vis its requirement in applicable financial reporting framework.
 - Selection or application of inappropriate accounting policies.
 - Difference in accounting estimate of a financial statement item vis-à-vis its appropriateness in applicable financial reporting framework.
 - Intentional booking of fake expenses in statement of profit and loss.
 - Overstating of receivables in the financial statements by not writing off irrecoverable debts.
 - Overstating or understating inventories.

Question 58

(MTP Jan '25)

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

Answer

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

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

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