

*Dedicated to All  
My Beloved Students*

*With the Blessings of  
My Dear Parents, Brother, Sister,  
Wife and Daughter*



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# PREFACE

Dear students,

It gives me immense joy and pleasure to present a completely updated **CA Inter – Auditing and Ethics Q and A Book strictly** as per **ICAI New Syllabus**.

In this Updated QnA Module we have covered the following:-

- 1) All ICAI Module questions as per New ICAI Syllabus
- 2) Exam paper questions with ICAI suggested answers (upto May 25 exam.)
- 3) All ICAI Model test paper questions with suggested answers.
- 4) New syllabus RTP and MTP questions with suggested answers (upto May 25 exam)

Having been a professor for 12 years and counting, I have observed that, for you to succeed in exam and your professional career you need a great understanding of the concept and its real-life application. Majority students get stuck in the rat race of just passing the exam by any means, this may help you to **pass a competitive exam** but not in the **exam of your professional life**.

I have worked for more than **6 years** in **Big 4's like PWC and Deloitte** in my initial years of professional career and the lessons learned during that time has inspired me to ensure that my students get a **"Practical Approach"** to this so called **"Theoretical world of Strategic Management"**.

The journey of a Chartered Accountant is not a rapid T-20 match. **It is equivalent to a 5-day test match, if you will**. Rather than rushing and blasting through your preparation, it is crucial to be consistent and disciplined. **My cricket coach once said to me something that has stuck with me since my college days – 'Wicket pe bane raho, runs aapne aap ban jaayenge!'**

I wish you all the best and hope that you be greatly benefited from this book!

Happy Learning,

Regards

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**'Failure will never overtake me if my determination to succeed is strong enough!'**

**- Late Dr. A P J Abdul Kalam**

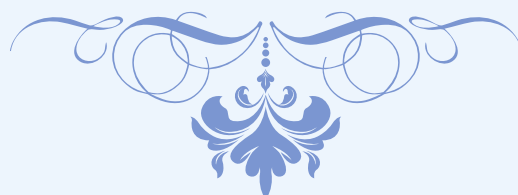


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**"If you want to go fast, go alone.  
If you want to go far, go together."**





# CA INTERMEDIATE

## Auditing and Ethics

### QnA Module

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*RJ = Practical Insight into Theoretical World*



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## CHAPTER

## 1

# Nature, Objective and Scope of Audit

## Case Study 1

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

They are trying to understand new subjects including auditing. Rohit, Gurpreet and Ali have also started attending Live Coaching Classes (LCC) being conducted by Board of studies of ICAI. Goreti has not been able to join Live Coaching Classes yet as she was away on a holiday with her parents. However, she plans to catch it up with her friends very soon. Ali had also joined the classes but he had skipped some lectures.

During one informal get together, their discussions centred around new subject of auditing. They discussed many things regarding its nature, scope, benefits and other general practical issues. Goreti was regular in keeping track of audited results of companies being published in leading newspapers. Her view was that audited financial statements of companies give 100% guarantee to different stake holders. It is the main reason behind so much reliance upon auditing. But she could not understand why wrong doings in financial matters are being discovered after many years have gone by.

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

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

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

**Based upon above, answer the following questions:**

- 1) Gurpreet was of the view that audited financial statements are not a guarantee against probable wrong doings in financial matters of companies. What kind of assurance does audit of financial statements provide?**
  - a) It provides reasonable assurance meaning a moderate level of assurance.
  - b) It provides reasonable assurance meaning a low level of assurance.
  - c) It provides reasonable assurance meaning a high level of assurance.
  - d) It provides reasonable assurance meaning an absolute level of assurance.
  
- 2) Rohit added that auditor can force an employee of the company to provide him required information and documents. Can he do so?**
  - a) Yes, he can do so. It is necessary to obtain audit evidence.
  - b) Yes, he can do so. There are express rights given to him in this respect.
  - c) No, he cannot do so. He can only request for providing him with necessary information and documents. But it cannot be forced by him.
  - d) No, he cannot do so. He has no right of seeking information and documents. Therefore, question of forcing does not arise.
  
- 3) Ali had listened in one of the classes that audit covers all aspects of an entity and concluded that each and every transaction of entity is verified by auditor. Goreti also seemed to be in agreement with him but she was of the view that besides this, it also meant that audit should be so organized to cover all areas of an entity. Which of following statements is appropriate in this regard?**
  - a) Only view of Ali is correct.
  - b) Only view of Goreti is correct.
  - c) Views of both Ali and Goreti are correct.
  - d) Views of both Ali and Goreti are incorrect.
  
- 4) All of them also discussed about benefits of auditing. Which of the following is not a likely benefit of auditing?**
  - a) Since auditing is connected to future events, audited information can be easily relied upon by users.
  - b) Errors or frauds may be discovered during audit.



- c) Government authorities can make use of audited accounts for different purposes.
- d) It can help in bringing out deficiencies in maintenance of financial records.

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

- a) It was wrong on the part of auditor to rely upon fabricated documents. He must have discovered it as the same falls within the scope of his duties.
- b) Although it was wrong on the part of auditor to rely upon fabricated documents, he cannot do anything in the matter. He has to report on the basis of documents provided to him. He has no duty in this regard.
- c) Auditor has to conduct audit by exercising professional skill. But he is not an expert in discovering genuineness of documents. Hence, management consisting of dishonest persons may have led him to rely upon fabricated documents deliberately.
- d) Management cannot mislead auditor due to high level of knowledge and expertise possessed by him. The above is an outlier case-one of the rare odd cases.

#### Answers to Case Study 1:

- 1) c)
- 2) c)
- 3) d)
- 4) a)
- 5) c)

## Case Study 2

Me and You Private Limited has been newly incorporated. The plant of the company has recently started production with the help of funds provided by a bank for purchase and installation of machinery. Further, the company is also utilizing working capital credit facilities from the same bank for meeting its day to day working capital requirements like for purchase of raw materials, labour payment etc. However, just within six months of its operations, the management feels that working capital funds are inadequate and situation is creating liquidity issues in the company.

The management of the company has approached its bankers and requested for enhancement in working capital credit facilities. The bank manager is insisting upon financial statements of the company for half year along with report providing assurance in this respect duly signed by Chartered Accountant as audit is far away. It also requires projected financial statements for coming years along with a report from CA providing assurance regarding these projections to consider request of management.

The management approaches CA P, who has qualified recently and started practising. Reports providing assurance for half yearly results and projected financial statements are sought from CA P. The Management provides necessary information and records to him in this regard.

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

Based on above, answer the following questions:

- 1) The management of company has engaged CA P to issue a duly signed report for half year. Which of the following standards, if any, issued by ICAI are relevant for CA P?
  - a) Standards on Review Engagements
  - b) Standards on Auditing
  - c) Standards on Related Services
  - d) There are no standards for issuing report in such situation.
- 2) Which of the following statements is **MOST APPROPRIATE** in given case situation?
  - a) CA P can assist management in preparation of financial statements of the company. However, issue of a report in such a case is outside the scope of work.
  - b) CA P can assist management in preparation of financial statements of the company and he can issue an audit report.
  - c) CA P can assist management in preparation of financial statements of the company and he can issue a compilation report in this respect.
  - d) The responsibility of preparation of financial statement is of company's management. CA P cannot assist management in preparation of financial statements of the company. However, he can issue a review report

- 3) In the above said scenario for issuance of signed financial statements for half year by CA P, as discussed in last para of Case Study, identify the **MOST APPROPRIATE** statement:
- a) Standard on Quality control (SQC 1) is not applicable as CA P cannot issue audit report.
  - b) Standard on Quality Control (SQC 1) is not applicable as CA P cannot issue review report.
  - c) Standard on Quality Control (SQC 1) is applicable in such type of engagement.
  - d) Standard on Quality Control (SQC 1) is not applicable as CA P is barred from issuing any report in such type of engagement.
- 4) The banker of company has also requested for projected financial statements for coming years along with a report from CA regarding these projections to consider request of management. Which of the following standards issued by ICAI are relevant for CA P in such a situation, if any?
- a) Standards on Review Engagements
  - b) There are no standards for issuing such type of reports.
  - c) Standards on Related Services
  - d) Standards on Assurance Engagements
- 5) Suppose CA P also accepts work of issuing projected financial statements with a report to be signed by him. The management has projected turnover of ₹ 100 crore for the next year, ₹ 150 crore & ₹ 200 crore for following years respectively as compared to present turnover of ₹ 25 crore in current half year. Identify the **MOST APPROPRIATE** statement in this situation:
- a) CA P has to satisfy himself regarding arithmetical accuracy of projected data.
  - b) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover and its consistency with actuals.
  - c) CA P has to satisfy himself regarding arithmetical accuracy of data along with its proper presentation to banker.
  - d) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover, its consistency with actuals, disclosure and presentation.

**Answers to Case Study 2:**

- 1) c)
- 2) c)
- 3) c)
- 4) d)
- 5) d)

## Independent MCQ's

- 1) Which of the following is not an advantage of audit?
  - a) It provides high quality financial information.
  - b) It acts as a moral check on employees.
  - c) It enhances risk of management bias.
  - d) It helps in safeguarding interests of shareholders.
- 2) Which of the following is NOT TRUE about an assurance engagement?
  - a) It relates to providing assurance about historical financial information only.
  - b) The practitioner obtains sufficient appropriate evidence.
  - c) There is some information to be examined by practitioner.
  - d) A written assurance report in appropriate form is issued by practitioner.
- 3) Which of the following is TRUE about Engagement Standards?
  - a) Engagement standards ensure proper rights to practitioners in course of performance of their duties.
  - b) Engagement standards ensure preparation and presentation of financial statements in a standardized manner.
  - c) Engagement standards ensure uniformity by practitioners in course of performance of their duties.
  - d) Engagement standards ensure savings in resources of clients.
- 4) Consider following statements in relation to "Limited assurance engagement":-  
Statement I - It involves obtaining sufficient appropriate evidence to draw reasonable conclusions.  
Statement II - Review of interim financial information of a company is an example of



limited assurance engagement.

- a) Statement I is correct. Statement II is incorrect.
  - b) Both Statements I and II are correct.
  - c) Both Statements I and II are incorrect.
  - d) Statement I is incorrect. Statement II is correct.
- 5) Which of the following is TRUE about Standards on auditing?
- a) These deal mainly with voluntary responsibilities of auditors
  - b) These deal mainly with mandatory responsibilities of auditors.
  - c) Their sole purpose is to help government authorities in augmenting revenues.
  - d) These deal mainly in carrying out audit according to legal provisions.

**Answers to the MCQs based Questions:**

- 1) c)
- 2) a)
- 3) c)
- 4) d)
- 5) b)

## Descriptive Questions

### Questions from ICAI Study Material

**Question 1:**

(ICAI SM)

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

**Answer:**

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

**Question 2:****(ICAI SM)**

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

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

**Answer:**

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

**Question 3:****(ICAI SM)**

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

**Answer:**

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

**Question 4:****(ICAI SM)**

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:**

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

**Question 5:****(ICAI SM)**

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

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

**Answer:**

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

**Question 6:****(ICAI SM)**

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

Unable to obtain external confirmations from these debtors, he relied upon sale details to these parties, e-invoices, e-way bills and also traced payments from these parties in bank accounts of the company. He was reasonably satisfied with audit evidence obtained. Is there any other reporting duty cast upon him relating to not following a mandated procedure in one of Standards on Auditing?

**Answer:**

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

**Question 7:****(ICAI SM)**

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

**Answer:**

Choosing of appropriate accounting policies is responsibility of management. The role of auditor lies in evaluating selection and consistent application of accounting policies by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period to period basis.

**Question 8:****(ICAI SM)**

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

**Answer:**

- 1) A three-party relationship involving a practitioner, a responsible party, and intended users an assurance engagement involves above said three parties.
- 2) A practitioner is a person who provides the assurance. The term practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.



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

**Question 9:****(ICAI SM)**

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

**Answer:**

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

**Question 10:****(ICAI SM)**

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

**Answer:**

- 1) The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. For example, an auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.
- 2) 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.
- 3) The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud. It may be engaged in concealing fraud by designing sophisticated and carefully organized schemes which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.
- 4) An auditor is not an expert in authentication of documents. Therefore, he may be led to accept invalid audit evidence on the basis of unauthentic documents.
- 5) It is quite possible that entity may have entered into some transactions with related parties. Such transactions may be only paper transactions and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.

## Questions from ICAI Model Test Paper

**Question 11:**

**(Model Test Paper-1) / (MTP-I Mar.24)**

**The auditor should decide whether relevant information is properly disclosed in the financial statements. Explain with reference to scope of audit.**

**Answer:**

- 1) The auditor should decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.
- 2) It is done by ensuring that financial statements properly summarize transactions and events recorded therein and by considering the judgments made by management in preparation of financial statements.
- 3) The management responsible for preparation and presentation of financial statements makes many judgments in this process of preparing and presenting financial statements. For example, choosing of appropriate accounting policies in relation to various accounting issues like choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.
- 4) The auditor evaluates selection and consistent application of accounting policies by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

**Question 12:**

**(Model Test Paper-1) / (MTP-I Mar.24)**

**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:**

- 1) **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.
- 2) **Example of legal limitation on ability of auditor to obtain audit evidence**
  - a) Management may not provide complete information as requested by auditor.
  - b) There is no way by which auditor can force management to provide complete information as may be requested by auditor.
  - c) In case he is not provided with required information, he can only report.

- d) It is an example of legal limitation on auditor's ability to obtain audit evidence.

**Question 13:****(Model Test Paper-2) / (MTP-II Apr.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 14:****(Model Test Paper-2) / (MTP-II Apr.24)**

Nature of financial reporting itself is one of causes of inherent limitations of audit of financial statements. Explain.

**Answer:**

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

**Question 15:****(Model Test Paper-3) / (Sept.24)**

PD & Co., Chartered Accountants, were appointed as the statutory auditors of MR Limited for the financial year 2023-24. MR Limited included the following clause in the

appointment letter to the auditors: "The Auditor shall be responsible for detecting the frauds that may happen in the company during the financial year 2023-24."

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

**Answer:**

**Scope of Audit in detection of Fraud:**

- 1) In conducting audit of financial statements objectives of auditor, in accordance with **SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing"** is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.
- 2) An audit is not an official investigation into alleged wrongdoing. The auditor does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation.
- 3) Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.
- 4) The scope of audit is general and broad whereas scope of investigation is specific and narrow.
- 5) Thus, inclusion of such a clause in the engagement letter is uncalled for and outside the scope of audit.

**Question 16:**

**(Model Test Paper-4) / (MTP-I July 24)**

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

**Answer:**

- 1) **Audit is distinct from investigation.** Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.



- 2) The objective of audit, on the other hand, is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.
- 3) The scope of audit is general and broad whereas scope of investigation is specific and narrow.
- 4) In the given situation, management of company suspects that some of its employees may be involved in making fraudulent payments on account of dummy workers at its different plants in the country. Such an assignment is in the nature of "investigation".
- 5) Therefore, Mr. P is right in objecting the use of word "audit" in the proposed assignment.

**Question 17:****(Model Test Paper-5) / (MTP-II Aug.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:**

Three examples of assurance engagements are as under:-

**(i) Audit of financial statements**

An audit of financial statements provides 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.

**(ii) Review of financial statements**

Review provides lower level of assurance than audit. Further, review involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up.

**(iii) Examination of prospective financial information**

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. Such type of assurance engagement provides a moderate assurance.

**Question 18:****(Model Test Paper-6) / (MTP-I Nov.24)**

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

**Answer:**

- 1) In the given situation, Standards on Assurance Engagements will be applicable and such type of assurance engagement provides only a **"moderate" level of assurance.**
- 2) 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.
- 3) **"Historical financial information"** and **"Prospective financial information."** The former relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. The latter relates to financial information based on assumptions about occurrence of future events and possible actions by an entity. Therefore, historical financial information is rooted in past events which have already occurred whereas prospective financial information is related to future events.

**Question 19:****(Model Test Paper-7) (MTP-II Dec.24)**

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

**Answer:**

**Benefits and need of Audit:**

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

**Question 20:****(Model Test Paper-8) / (May 24)**

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

**Answer:**

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

**1) Nature of financial reporting:**

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

**2) Nature of Audit procedures:**

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

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

**3) Not in nature of investigation:**

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

**4) Timeliness of financial reporting and decrease in relevance of information over time:**

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

**5) Future events:**

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

## Questions from ICAI RTP, MTP and Past Exam

**Question 21:****(RTP May 24)**

M Motors Ltd is a leading Indian automobile manufacturer with many offerings across commercial, passenger and electric vehicles. The Company is pioneering India's electric vehicle transition and enjoys considerable advantage in one of the fastest growing automotive markets.

GR & Associates have been appointed as its statutory auditors for financial year 2022-23. J and K are newly appointed audit assistants in the firm and are part of engagement

team constituted for purpose of audit of M Motors Ltd. However, they are confused about what such an audit tends to achieve. They perceive audit as a guarantee against possible errors or frauds in financial statements. Do you agree with perception of both the assistants? In this context, outline objectives of an independent audit conducted in accordance with Standards on Auditing.

**Answer:**

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

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

**An analysis of above brings out following points clearly:**

- 1) Auditor's objective is to obtain a reasonable assurance whether financial statements as a whole are free from material misstatement whether due to fraud or error.
- 2) Reasonable assurance is to be distinguished from absolute assurance. Absolute assurance is a complete assurance or a guarantee that financial statements are free from material misstatements. However, reasonable assurance is not a complete guarantee. Although it is a high-level of assurance but it is not complete assurance.
- 3) Audit of financial statements is carried out by the auditor with professional competence and skills in accordance with Standards on Auditing. Audit procedures are applied in accordance with SAs, audit evidence is obtained and evaluated. On the basis of that, conclusions are drawn and opinion is formed. It leads to high level of assurance which is called as reasonable assurance but it is not absolute assurance.
- 4) Misstatements in financial statements can occur due to fraud or error or both. The auditor seeks to obtain reasonable assurance whether financial statements as a whole are free from material misstatements caused by fraud or error. He has to see effect of misstatements on financial statements as a whole, in totality.
- 5) Obtaining reasonable assurance that financial statements as a whole are free from material misstatements enables 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.

- 6) The opinion is reported and communicated in accordance with audit findings through a written report as required by Standards on Auditing.

**Therefore, perception of both assistants is not proper. Auditor of financial statements does not seek to provide guarantee that financial statements are free from material misstatements caused by frauds or errors. He obtains reasonable assurance.**

**Question 22:**

**(RTP May 24)**

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

**Answer:**

- 1) **Standards on Auditing (SAs)** apply in "audit of historical financial information" whereas **Standards on Review Engagements (SREs)** apply in "review of historical financial information". Standards on auditing apply in "**audit**" of historical financial information which is a reasonable assurance engagement whereas Standards on Review Engagements apply in "**review**" of historical financial information which is a limited assurance engagement only.
- 2) "**Historical financial information** means" information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.
- 3) "**Audit**" and "**review**" are two different terms. Audit is a reasonable assurance engagement, and its objective is reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement. However, "review" is a limited assurance engagement, and its objective is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement.
- 4) Standards on Auditing have been issued on wide spectrum of issues in the field of auditing including (but not limited to) overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit evidence, audit sampling, going concern and forming an opinion and reporting on financial statements.
- 5) **Some examples of Standards on Auditing are:**

- a) **SA 200:** Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
  - b) **SA 230:** Audit Documentation
  - c) **SA 315:** Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
  - d) **SA 500:** Audit Evidence
  - e) **SA 700:** Forming an Opinion and Reporting on Financial Statements
- 6) **Examples of Standards on Review engagements are:**
- a) **SRE 2400:** Engagements to Review Historical Financial Statements
  - b) **SRE 2410:** Review of Interim Financial Information Performed by the Independent Auditor of the Entity.

**Question 23:****(RTP Jan.25)**

RST Ltd., a retail company, has set up internal controls requiring all invoices to be stamped and signed by an authorised person in "Goods Receiving Section" of the company stating the date and time of receiving goods in premises to ensure that only those purchase bills are produced for payment for which goods have been actually received. During the audit, the auditor finds that two employees - a purchasing manager and an accounts clerk - have worked together to bypass this control, submitting fake invoices that resulted in payments for goods that were never received. You are required to state the objectives of an audit, as per SA 200, when it comes to ensuring the reliability of financial statements? Also explain, why auditor can provide only reasonable, rather than absolute, assurance that the financial statements are free from material misstatement due to fraud or error in the context of the given situation?

**Answer:**

- 1) In conducting audit of financial statements, objectives of auditor in accordance with **SA 200**, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" are: -
- a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
  - b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.



- 2) The process of audit suffers from certain inbuilt limitations due to which an auditor cannot obtain an absolute assurance that financial statements are free from misstatement due to fraud or error. These fundamental limitations arise due to the factors such as nature of financial reporting, nature of audit procedures, not in the nature of investigation, timeliness of financial reporting and decrease in relevance of information over time and future events.
- 3) Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, the auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.
- 4) One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.
- 5) In the context of RST Ltd., the management designed a control requiring that all invoices be stamped and signed by an authorized person in the Goods Receiving Section to confirm receipt of goods. However, collusion between two employees—the purchasing manager and the accounts clerk—allowed them to bypass this control by submitting fake invoices for payment. Collusion is a significant limitation of internal controls, as it overrides controls designed to prevent such fraud.
- 6) **Given these factors, the auditor cannot provide absolute assurance that the financial statements are entirely free from material misstatements due to fraud or error.**

**Question 24:****(Jan.25)**

XYZ Ltd., a manufacturing company engaged in the production of various types of yarn, is planning to expand its operations into a new geographical market and also add new products. Company has prepared prospective financial information to be presented to potential investors and financial institutions to secure funding for the expansion.

XYZ Ltd. engages a firm of auditors to conduct an assurance engagement on this prospective financial information. During the engagement, the auditors reviewed the assumptions made by XYZ Ltd.'s management and issued a report.

**Explain the key differences between prospective financial information and historical financial information. How does this distinction impact the level of assurance provided in an assurance engagement on prospective financial information?**

**Answer:**

- 1) Difference between "Historical financial information" and "Prospective financial information":** The "Historical financial information" relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. The "Prospective financial information" relates to financial information based on assumptions about occurrence of future events and possible actions by an entity.
- 2) Therefore, historical financial information is rooted in past events which have already occurred whereas prospective financial information is related to future events.**
- 3) 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.**
- 4) Prospective financial information relates to future events. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future- oriented. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved.**
- 5) Therefore, in such assurance engagements, practitioner provides a report assuring that nothing has come to practitioner's attention to suggest that these assumptions do not provide a reasonable basis for the projection.**
- 6) Hence, such type of assurance engagement provides only a "moderate" level of assurance.**

**Question 25:**

**(MTP-I Mar.25)**

**An audit is a reasonable assurance engagement, whereas a review is a limited assurance engagement. Both types of assurance engagements provide assurance to users, but they differ in the degree of assurance offered. In light of this, explain the difference between reasonable assurance engagements and limited assurance engagements, with examples.**

**Answer:****Difference between Reasonable Assurance Engagement and Limited Assurance Engagement:**

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

**Question 26:****(MTP-II Apr.25)**

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

**Answer:**

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

- a) The Nature of Financial Reporting:** The preparation of financial statements involves judgment by management. These judgments may involve subjective decisions or a degree of uncertainty. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.
- b) The Nature of Audit Procedures:** There are practical and legal limitations on the auditor's ability to obtain audit evidence such as:
  - (i) Possibility that management or others may not provide, intentionally or unintentionally, the complete information relevant for preparation and presentation of FS.
  - (ii) Fraud may involve sophisticated and carefully organised schemes.

- c) **Not in the nature of Investigation:** An audit is not an official investigation into alleged wrongdoing. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.
- d) **Timeliness of financial reporting and decrease in relevance of information over time:** Relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost.
- e) **Future events:** Future events or conditions may affect an entity adversely. Adverse events may seriously affect ability of an entity to continue its business.

**Question 27:****(RTP Sept.24)**

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:**

- 1) Audit engagement is an assurance engagement. However, assurance engagements are not restricted to auditing alone. There are other assurance engagements too like review engagements, engagements providing assurance involving prospective financial information, engagements providing assurance on internal controls in an entity. Assurance engagements provide assurance to users.
- 2) The difference is of degree. Whereas an audit provides reasonable assurance which is a high level of assurance, review provides lower level of assurance as compared to audit.
- 3) 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.
- 4) 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.

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

**Question 28:****(RTP May 25)**

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

**Answer:**

- 1) The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. The scope of audit of financial statements includes coverage of all aspects of entity, reliability and sufficiency of financial information and proper disclosure of financial information.
- 2) In the given situation, CA. Dhruv observed that the management consistently applied the same method for valuation of inventory over the past few years, but this year, without proper disclosure, they switched to a different valuation method, which resulted in higher profits.
- 3) Since proper disclosure of financial information is covered under the scope of audit, thus, the auditor should decide whether relevant information is properly disclosed in the financial statements. He should also keep in mind applicable statutory requirements in this regard.
- 4) The management responsible for preparation and presentation of financial statements makes many judgments in this process of preparing and presenting financial statements.
- 5) **For example**, choosing appropriate accounting policies in relation to various accounting issues like choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.
- 6) The auditor evaluates selection and consistent application of accounting policies by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

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

**Question 29:****(RTP Sept.25)**

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

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

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

**Answer:**

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

**1) Coverage of all aspects of entity:**

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

**2) Reliability and sufficiency of financial information:**

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

**3) Proper disclosure of financial information:**

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

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

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

**Question 30:**

**(May 25)**

**Mention any three standards issued under authority of ICAI Council which are collectively known as 'Engagement Standards'.**

**Also mention the purpose of issue of these standards.**

**Answer:**

**Engagement and Quality control Standards:** The following Standards issued under authority of ICAI Council are collectively known as Engagement Standards:

- 1) Standards on Auditing (SAs) which apply in audit of historical financial information.
- 2) Standards on Review Engagements (SREs) which apply in review of historical financial information.
- 3) Standards on Assurance Engagements (SAEs) which apply in assurance engagements other than audits and review of historical financial information.
- 4) Standards on Related Services (SRSs) which apply in agreed upon procedures to information, compilation engagements and other related service engagements.

The purpose of issue of these standards is to establish high quality standards and guidance in the areas of financial statement audits and in other types of assurance services.





## CHAPTER

## 2

# Audit Strategy, Audit Planning and Audit Programme

## Case Study

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

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

A detailed set of instructions has been prepared by her office and it has been handed over to assistants in engagement team. These set of instructions include details of extent of checking and nature of audit procedures to be performed regarding purchases, sales, items of income, items of expenditure etc. During the course of execution of above set of instructions, it has been brought to her notice that company is also producing substantial quantities of scrap generated during manufacturing process. However, no instructions have been given to engagement team in this regard.

Based on above, answer following questions:

- 1) Auditor is fact checking about promoters and key managerial persons. She is also considering competence of staff to perform engagement. What is she trying to do?
  - a) She is establishing audit strategy.
  - b) She is conducting preliminary engagement activities.
  - c) She is designing audit plan.
  - d) She is checking her compliance of ethical requirements.

- 2) Consideration of number and location of branches, requirements of financial reporting framework and expected time of completion are relevant factors primarily for which of the following -
- a) Developing audit plan
  - b) Establishing overall audit strategy
  - c) Designing audit programme
  - d) Designing risk assessment procedures
- 3) Taking into account description of planned inquiry and visit, which of the following statements is TRUE?
- a) Planned inquiry and visit fall in area of audit strategy.
  - b) Planned inquiry and visit are planned risk assessment procedures and fall in field of audit plan.
  - c) The said description is not related to audit planning.
  - d) Planned inquiry and visit fall in scope of audit programme.
- 4) What is detailed set of instructions given to assistants in engagement team known as?
- a) Audit guidelines
  - b) Audit plan
  - c) Audit Programme
  - d) Audit Procedures
- 5) The issue of generation of scrap has been overlooked in detailed set of instructions given to engagement team. What should be proper course of action by CA Simran Kaur?
- a) She should ignore this information as audit has already begun.
  - b) She should modify earlier set of instructions.
  - c) She should leave the matter to wisdom of engagement team.
  - d) She should put the ball in court of management as she was not provided with complete information earlier

**Answers to Case Study**

- 1) b)
- 2) b)
- 3) b)
- 4) c)
- 5) b)

**Independent MCQ's**

- 1) Which of the following is not considered in planning an audit generally?
  - a) Understanding of legal and regulatory framework of an entity
  - b) Need to consider determination of materiality
  - c) Evaluating audit evidence
  - d) Need to consider involvement of expert
- 2) Which of the following is true about audit plan?
  - a) Once an audit plan has been finalized for an engagement, changes cannot be made to it.
  - b) Audit plan includes scope, timing and direction of planned risk assessment procedures.
  - c) Changes in audit plan cannot lead to change in audit strategy.
  - d) Audit plan has to be documented by auditor.
- 3) Which of the following is not included in an audit programme normally?
  - a) Extent of checking
  - b) Date of checking
  - c) Nature or type of procedure
  - d) Planning of risk assessment procedures
- 4) Which of the following is not an advantage of an audit programme?
  - a) It acts as a guide for audit of coming years.
  - b) It fixes responsibility of assistants.
  - c) It serves as a shelter for assistants.
  - d) It serves as a proof of work done by auditor.

- 5) Which of the following is most important principle for formulating an audit plan?
- Gaining knowledge of client's workforce
  - Gaining knowledge of client's business
  - Gaining knowledge of client's vendors
  - Gaining knowledge of tax laws applicable to client

**Answers to the MCQs based Questions:**

- c)
- d)
- d)
- c)
- b)

## Descriptive Questions

### Questions from ICAI Study Material

**Question 1:**

**(ICAI SM)**

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

**Answer:**

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

**Question 2:****(ICAI SM)**

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

**Answer:**

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

**Question 3:****(ICAI SM)**

CA Mary, while planning audit of a company, feels that she would inquire from inhouse legal counsel of the company status of pending litigation matters against the company to identify and assess risks of material misstatements. Considering above description, are you able to identify said procedures? Where these identified procedures are included in planning in accordance with SA-300?

**Answer:**

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

**Question 4:****(ICAI SM)**

CA Shubhendu is statutory auditor of a social media company. Due to change in information technology regulations by government, it has become mandatory for such companies to constitute "grievance redressal mechanism" for users of social media

platform of the company. Failure to comply with regulations can potentially lead to civil and criminal liabilities against the company. Is above factor to be considered by auditor while framing audit strategy?

**Answer:**

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

**Question 5:**

**(ICAI SM)**

Rohit, undergoing practical training, is part of an engagement team conducting audit of a company engaged in manufacturing of paints. He has been provided with audit programme pertaining to sales. It lists out various items to be checked and verified by him including invoices, rate lists, posting in debtors accounts, correlation of invoices with e-way bills on sample basis etc.

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

**Answer:**

**Attitude of Rohit is not proper.**

The assistants should observe matters objectively and bring significant matters to the notice of supervisor/principal. Reasons for cancellation of many e-way bills in month of March need to be looked into. Matter should be informed to engagement partner.

**Question 6:**

**(ICAI SM)**

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

**Answer:**

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

**Question 7:****(ICAI SM)**

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

**Answer:**

- 1) The auditor shall continuously evaluate compliance with ethical requirements including independence.
- 2) **"Independence"** means that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him. Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team.
- 3) If matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action.
- 4) The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:
  - a) Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence
  - b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement and
  - c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation.
- 5) The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action. Besides, consideration for client continuance and compliance with ethical requirements, preliminary engagements activities also include establishing an understanding of terms of engagement.

**Question 8:****(ICAI SM)**

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

**Answer:**

Purported disadvantages of audit programme may be eliminated by imaginative supervision of



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

**Question 9:****(ICAI SM)**

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

**Answer:**

- 1) The auditor shall document:**
  - a) The overall audit strategy
  - b) The audit plan and
  - c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.
- 2) The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.**
- 3) The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.**
- 4) It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.**
- 5) A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.**

**Question 10:****(ICAI SM)**

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

**Answer:**

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

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

**Question 11:****(ICAI SM)**

**The auditor T of Hand Fab Ltd is worried as to management of key resources to be employed to conduct audit. Required - How the audit strategy would be helpful to the auditor?**

**Answer:**

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

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

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

- (i) The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high-risk areas or the involvement of experts on complex matters
- (ii) The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas
- (iii) When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates
- (iv) How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews

**Question 12:****(ICAI SM)**

W, the auditor of SKM Ltd. asks its finance and audit head to prepare audit strategy for conducting audit of SKM Ltd. W also insists him to draw detailed audit procedures. On the request of auditor W completes audit strategy as well as audit procedures as prepared by finance head of the company. Subsequently, auditor realizes that effectiveness of the audit is compromised and it was his responsibility to prepare the overall audit strategy. Comment.

**Answer:**

- 1) The overall audit strategy and the audit plan remain the auditor's responsibility. It is the auditor who is responsible for establishing overall audit strategy and developing audit plan.
- 2) However, the auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct of the audit engagement.
- 3) When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit.
- 4) Accordingly, approach of W was wrong and he should have prepared overall audit strategy and detailed audit procedures.

## Questions from ICAI Model Test Paper

**Question 13:****(Model Test Paper-1) / (MTP-I Mar.24)**

**Adequate planning benefits the audit of financial statements in several ways. Explain.**

**Answer:**

**Adequate planning benefits the audit of financial statements in several ways, including the following:**

- a) Helping the auditor to devote appropriate attention to important areas of the audit.
- b) Helping the auditor identify and resolve potential problems on a timely basis.
- c) Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
- d) Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- e) Facilitating the direction and supervision of engagement team members and the review of their work.

- f) Assisting, where applicable, in coordination of work done by auditors of components and experts.

**Question 14:** (Model Test Paper-1) / (MTP-I Mar.24)

**Auditor shall develop an audit plan that includes description of audit procedures. Specify requirements in this regard.**

**Answer:**

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

- a) The nature, timing and extent of planned risk assessment procedures
- b) The nature, timing and extent of planned further audit procedures at assertion level
- c) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

**Question 15:** (Model Test Paper-2) / (MTP-II Apr.24)

**Planning includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, certain matters. Discuss those matters.**

**Answer:**

Prior to auditor's identification and assessment of risks of material misstatement, planning includes the need to consider following matters:

- a) The analytical procedures to be applied as risk assessment procedures.
- b) Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- c) The determination of materiality.
- d) The involvement of experts.
- e) The performance of other risk assessment procedures

**Question 16:** (Model Test Paper-2) / (MTP-II Apr.24)

**The ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications. Give three instances to explain.**

**Answer:**

The ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications. Some of the instances are given under:

- a) The entity's timetable for reporting
- b) Organization of meetings to discuss of nature, timing and extent of audit work with management
- c) Discussion with management regarding the expected type and timing of reports to be issued including the auditor's report
- d) Discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- e) Expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

**Question 17:****(Model Test Paper-2) / (MTP-II Apr.24)**

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

**Answer:**

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

**Few examples are listed as under:**

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

**Question 18:****(Model Test Paper-3) / (Sept.24)**

The engagement partner, of a firm of auditors, is explaining to his audit team, undergoing practical training, the inter relationship between audit strategy and audit plan. Discuss the points which the engagement partner will explain to his team in this regard.

**Answer:****Relationship between audit strategy and audit plan**

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

**Question 19:****(Model Test Paper-3) / (Sept.24)**

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

**Answer:**

**Establishing the overall audit strategy- Assistance for the auditor:** Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more

detailed audit plan. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

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

- (i) The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high-risk areas or the involvement of experts on complex matters
- (ii) The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas
- (iii) When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates
- (iv) How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

#### Question 20:

(Model Test Paper-3) / (Sept.24)

M/s. PP & Co, a firm of Chartered Accountants, has been auditing the books of accounts of KALI Ltd. for the past 3 years. The company has recently made some major changes in its business policies. While planning to start the audit for the 4th year i.e. for financial year 2024-25, the audit manager of the firm, as per the routine practice, handed over the previous years' audit programme as it is to the audit team with the instructions to adhere unfailingly to the said audit programme. Evaluate the decision of the audit manager with reference to the use of audit programme.

#### Answer:

##### **Review of the audit programme:**

- 1) There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions.
- 2) Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete



programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.

- 3) The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed.
- 4) Audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work.
- 5) Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.
- 6) In the given situation, Ms. PP & Co., a firm of Chartered Accountants has been auditing the books of accounts of KALI Ltd. for the past 3 years and the Company has recently made major changes in its business policies, therefore, it is very essential to review the audit programme. **Thus, contention of the audit manager to adhere with the instructions of following the same audit programme as per routine practice is not correct.**

**Question 21: (Model Test Paper-4) / (MTP-I July, 24)**

Subodh has recently joined an audit firm as an articled clerk. He was in process of assembling audit working papers in audit file of Cop Limited, as per the instructions of his senior. While assembling, he noticed following working paper in audit file: -

**Timing of Audit Activities**

Activity	Expected Timing
Audit Planning	July 1, 2023 - July 5, 2023
Review by EQCR	July 6, 2023 - July 7, 2023
Audit Field Work	July 10, 2023 - August 20, 2023
Review by Manager	August 21, 2023
Review by Engagement Partner	August 22, 2023 - August 25, 2023
Review by EQCR	August 26, 2023 - August 27, 2023
Response on Audit Memo	August 28, 2023
Review by Partners - internally post response on audit memo	August 29, 2023

Review by EQCR	August 30, 2023
Finalization of Audit Report and Financial Statements	September 01, 2023 - September 02, 2023
Issuance of Audit Report and Financial Statements	September 03, 2023

The above working paper lists certain factors which are considered by the auditor while establishing audit strategy. Explain how these considerations highlighted in above working paper could have helped the auditor?

**Answer:**

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. One of the factors to be taken into consideration while establishing audit strategy relates to ascertaining of reporting objectives of engagement to plan the timing of the audit and the nature of the communications required. Some of the instances are given under:

- The entity's timetable for reporting
- Organization of meetings to discuss of nature, timing and extent of audit work with management
- Discussion with management regarding the expected type and timing of reports to be issued including the auditor's report
- Discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Expected nature and timing of communications among
- Engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

In the given case, working paper highlights that auditor has taken into account expected timelines to plan the audit and nature of the communications required. Since the working paper relates to the statutory audit of a company, the ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications.

**Question 22:**

**(Model Test Paper-4) / (MTP-I July 24)**

Sanjana is of the view that there exist some disadvantages in the use of audit programmes but most of these can be removed by following some concrete steps. Do you agree with her perspective? Comment.

**Answer:**

**The view of Sanjana is appropriate.** Some disadvantages are there in the use of audit programmes but most of these can be removed by following some concrete steps. The disadvantages are: -

- a) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.
- b) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.
- c) Inefficient assistants may take shelter behind the programme i.e., defend deficiencies in their work on the ground that no instruction in the matter is contained therein.
- d) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

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

**Question 23:****(Model Test Paper-5) / (MTP-II Aug.24)**

**CA D is planning an audit of a listed company. List specific documentation requirements in accordance with SA 300 in relation to planning such an audit. How such planning documentation is useful?**

**Answer:**

- 1) The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.
- 2) The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.
- 3) It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs and/or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

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

**Question 24:****(Model Test Paper-5) / (MTP-II Aug.24)**

**M/s TP & Co., a firm of Chartered Accountants, has been conducting audit of KSR Ltd. since last 4 years. KSR Ltd. has diversified their business into newer areas during the last year. The senior member of the audit team handed over the standard audit programme of earlier years to the audit assistants and instructed them to follow the same. The assistants are conducting the audit accordingly. Whether the attitude of the audit assistants is justified? Guide them.**

**Answer:**

In the given situation, the senior member of the audit team handed over the standard audit programme of earlier years to the audit assistants and instructed them to follow the same. The assistant to keep an open mind as follows:

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

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

**Question 25:****(Model Test Paper-6) / (MTP-I Nov.24)**

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

**Answer:**

Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.

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

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

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

**Question 26:****(Model Test Paper-6) / (MTP-I Nov.24)**

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

**Answer:**

**The advantages of an audit programme are:**

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

**Question 27:****(Model Test Paper-7) / (MTP-II Dec.24)**

**"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.

**Question 28:**

**(Model Test Paper-7) / (MTP-II Dec.24)**

**The engagement partner, of a firm of auditors, is explaining to his audit team, undergoing practical training, the inter relationship between audit strategy and audit plan. Discuss the points which the engagement partner will explain to his team in this regard.**

**Answer:**

**Relationship between audit strategy and audit plan:**

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

**Question 29:**

**(Model Test Paper-8) / (May 24)**

**APR & Associates, a Chartered Accountant firm, are appointed as the auditors of Time Ltd. and Bakes Ltd. The volume and nature of business of both the companies are entirely different. CA R is the engagement partner for Bakes Ltd. CA P is the engagement partner for Time Ltd. CA R formulates an Audit Programme for conducting the audit of Bakes Ltd. He suggests CA P to use the same audit programme for Time**

Ltd. But CA P is of the opinion that this audit programme will not be useful for the audit of Time Ltd.

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

**Answer:**

Following matters should be considered generally while preparing an Audit Programme:

- 1) Stay within the scope and limitation of the assignment.
- 2) Prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.
- 3) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
- 4) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.
- 5) Include the audit objectives for each area and sufficient details which serve as a set of instructions for the assistants involved in audit and help in controlling the proper execution of the work.
- 6) Consider all possibilities of error.
- 7) Co-ordinate the procedures to be applied to related items.

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

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

**Question 30:**

(Model Test Paper-8) / (May 24)

B Ltd. is a company manufacturing bed-sheets and pillow covers. They have appointed M/s C & Co., Chartered Accountants, as their auditors. The auditor is establishing audit strategy with his team members. As the work progressed, they came to know that the company has diversified its business and now they are also planning to manufacture wooden furniture. The auditor, in his professional judgement, considers this to be a



significant factor in directing the engagement team's efforts. Give examples of factors that, in auditor's professional judgement, are significant in directing the engagement team's efforts.

**Answer:**

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

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

**Question 31:**

**(Model Test Paper-8) / (May 24)**

CA E is auditor of LM Ltd. Before commencing with current year's audit, he initiated planning for the audit. Planning includes the need to consider certain matters, prior to the identification and assessment of the risk of material misstatements. Enumerate such matters.

**Answer:**

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

- 1) The analytical procedures to be applied as risk assessment procedures.
- 2) Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
- 3) The determination of materiality.
- 4) The involvement of experts.
- 5) The performance of other risk assessment procedures.

## Questions from ICAI RTP, MTP and Past Exam

**Question 32:**

(RTP May 24)

Preliminary engagement activities include certain activities to be performed by an auditor while planning an audit. Discuss such activities briefly. How performing such activities assists an auditor?

**Answer:**

### **Preliminary engagement activities**

Preliminary engagement activities include following activities:

- A) Performing procedures regarding the continuance of the client relationship
- B) Evaluating compliance with ethical requirements, including independence
- C) Establishing an understanding of terms of engagement

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

**Question 33:**

(RTP May 24)

The assistant of CA K is assigned responsibility of drafting "audit programme" relating to purchases appearing in financial statements of "Broad Industries", a partnership firm. The said firm is a GST registered tax payer and is engaged in manufacturing of packing boxes from a special type of paper taxable under GST. Help him by drafting a sample audit programme for purchases.

**Answer:**

### **Sample audit programme pertaining to purchases**

Name of Concern: Broad Industries

Financial Year: 20XX-XX

Prepared by: Name of person with date

Reviewed by: Name of person with date

Approved by: Name of person with date

S.No.	Nature of Procedure	Extent of Check	Basis of Sample	Done by
(a)	Vouch few purchase invoices of paper from purchase records of concern.			

(b)	Trace these invoices into account books of concern.			
(c)	Verify few purchase invoices of paper on GST portal.			
(d)	Trace few purchase invoices of paper in stock records to ensure that these have been added to stocks of raw material.			

**Question 34:****(RTP Sept.24)**

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

**Answer:**

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

- i) Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence
- ii) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement and
- iii) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

**Question 35:****(Jan.25)**

AP & Co., Chartered Accountants, are appointed as statutory auditor of Heavy Industries Limited, a listed company engaged in manufacturing of electric vehicles, for the F.Y. 2023-24. As per the recent guideline issued by the regulatory authority, every listed company is required to maintain the digital database of all those personnel who could access the books of the company to avoid Insider Trading. In case of non-compliance, hefty fines may be imposed on the company. CA P is the engagement partner from auditor firm for the audit of Heavy Industries Limited. During planning, CA P

planned that he would inquire from in-house IT Head of the company about the maintenance of the digital database to identify and assess the risk of non-compliance with regulatory guidelines. In the light of above facts, explain :

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

**Answer:**

- (i)
  - a) As per SA 300, "Planning an Audit of Financial Statements", the auditor should establish an overall audit strategy that sets the scope, timing, and direction of the audit, and that guides the development of the audit plan.
  - b) The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, key resources to be employed to conduct audit.
  - c) The auditor shall take following factors into consideration while establishing or framing audit strategy viz. identify the characteristics of the engagement that define its scope, consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts, etc.
  - d) In the given situation, the regulatory guideline requires Heavy Industries Ltd., a listed company, to maintain a digital database of all those personnel who could access the company's books to prevent insider trading. Further, hefty fines may be imposed in case of non-compliance with this guideline. Therefore, it is very essential that auditor while establishing overall audit strategy evaluate whether the company maintains such a database and complies with the regulatory requirement.
  - e) Thus, in view of above, it can be concluded that CA P should incorporate the assessment of digital database maintenance into the overall audit strategy.
- (ii)
  - a) As per SA 300, "Planning an Audit of Financial Statements", planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework, etc.

- b) In the given situation, CA P planned to inquire from in-house IT Head of the company regarding maintenance of the digital database to identify and assess the risk of non-compliance with regulatory guidelines.
- c) Inquiry with the IT Head regarding the maintenance of the digital database is an appropriate procedure to understand whether the company complies with the regulations. This inquiry will help CA P in obtaining a general understanding of the legal and regulatory framework applicable to the company and how the entity is complying with that framework and other risk assessment procedures.
- d) Thus, the planned inquiry with the IT Head is in line with SA 300.

**Question 36:****(Jan.25)**

Z Ltd. engaged ABC & Co., Chartered Accountants, to conduct its statutory audit for the F.Y. 2023-24. The audit team developed an overall audit strategy and plan to address the risk. During the audit, several significant changes occurred, including the discovery of a material misstatement in inventory valuation and changes in the scope of audit procedures due to an unexpected acquisition by Z Ltd. The audit documentation for Z Ltd. should reflect these changes but the auditor of a company failed to document the audit strategy and the audit plan.

As a senior auditor of the firm briefly outline what should be included in the documentation of audit strategy and audit plan and how should the audit documentation address significant changes made during the audit engagement.

**Answer:**

The auditor shall document:

**(i) The overall audit strategy:**

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

**(ii) The audit plan:**

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

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

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

**Question 37:**

**(MTP-I Mar.25)**

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

**Answer:**

**The advantages of an audit programme are:**

- 1) It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.
- 2) It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
- 3) Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.
- 4) Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, such danger is significantly less, and the audit can proceed systematically.
- 5) The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
- 6) The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.
- 7) It serves as a guide for audits to be carried out in the succeeding year.

- 8) A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

**Question 38:****(MTP-I Mar.25)**

Jay & Associates, a Chartered Accountant firm is appointed as an auditor of XYZ Ltd., a manufacturing company with multiple branches across the region. CA Jay, Partner in firm, is conducting the audit of financial statements of XYZ Ltd. for the financial year 2023-24. As the lead auditor assigned to this engagement, Jay is responsible for planning the audit in accordance with SA 300. Briefly explain why it is necessary to plan the audit of XYZ Ltd.'s financial statements?

**Answer:**

Planning an audit is necessary to carry out it effectively in a timely manner. Besides ensuring compliance with professional standards, it helps in performing audit engagement effectively.

**Adequate planning benefits the audit of financial statements in several ways, including the following:**

- 1) Helping the auditor to devote appropriate attention to important areas of the audit.
- 2) Helping the auditor identify and resolve potential problems on a timely basis.
- 3) Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
- 4) Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- 5) Facilitating the direction and supervision of engagement team members and the review of their work.
- 6) Assisting, where applicable, in coordination of work done by others such as experts.
- 7) Therefore, planning an audit ensures that audit risk is reduced to an acceptable low level. When audit work is adequately and properly planned, it reduces the risk of inappropriate opinion by the auditor.

**Question 39:****(MTP-II Apr.25)**

The assistant of CA Bhavik is assigned responsibility of drafting "audit programme" relating to purchases appearing in financial statements of Arya Industries, a partnership firm for F.Y. 2023-24 The said firm is a GST registered taxpayer and is engaged in

manufacturing of packing boxes from a special type of paper taxable under GST. Draft a sample audit programme for purchases.

**Answer:**

**Sample audit programme pertaining to purchases**

Name of Concern : Arya Industries  
 Financial Year : 2023-24  
 Prepared by : Name of person with date  
 Reviewed by : Name of person with date  
 Approved by : Name of person with date

S. No.	Nature of Procedure	Extent of Check	Basis of Sample	Done by
(i)	Vouch few purchase invoices of paper from purchase records of concern.			
(ii)	Trace these invoices into account books of concern.			
(iii)	Verify few purchase invoices of paper on GST portal.			
(iv)	Trace few purchase invoices of paper in stock records to ensure that these have been added to stocks of raw material.			

**Question 40:**

(MTP-II Apr.25)

CA Tina, the auditor of SKY Ltd., asks its finance and audit head to prepare audit strategy for conducting audit of SKY Ltd. CA Tina also insists him to draw detailed audit procedures. In response to the auditor's request, the finance head of the company completes the audit strategy as well as audit procedures. Subsequently, the auditor realises that the effectiveness of the audit is compromised and it was his responsibility to prepare the overall audit strategy. Comment.

**Answer:**

- 1) The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.



- 2) The auditor plans what type of audit procedures are to be performed, their timing and how much work should be done taking into account sample size etc. The overall audit strategy and the audit plan remain the auditor's responsibility.
- 3) It is the auditor who is responsible for establishing overall audit strategy and developing audit plan. However, auditor may discuss elements of planning with entity's management without compromising effectiveness of audit.
- 4) In the given case, CA Tina, auditor of SKY Ltd. asks its finance and audit head to prepare audit strategy and to draw detailed audit procedures.
- 5) On Auditor's request, finance head completes the audit strategy as well as audit procedures.
- 6) In view of above, CA Tina should prepare overall audit strategy and detailed audit procedures. Therefore, approach of CA Tina was wrong.

**Question 41:**

**(RTP Jan.25)**

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

**Answer:**

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

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

**Question 42:**

**(RTP May 25)**

ATL Pvt. Ltd., a leading manufacturing company, appointed CA Atul as an auditor for the year 2023-24. Given the complexity of the company's operations and the need for a systematic approach, he plans to design a detailed audit programme to ensure the

accuracy of financial assertions. As a CA student, if you were assisting CA Atul in constructing this audit programme, what are the points you will keep in mind?

**Answer:**

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

- a) Stay within the scope and limitation of the assignment.
- b) Prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.
- c) Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
- d) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.
- e) Include the audit objectives for each area and sufficient details which serve as a set of instructions for the assistants involved in audit and help in controlling the proper execution of the work.
- f) Consider all possibilities of error.
- g) Co-ordinate the procedures to be applied to related items.

**Question 43:**

**(RTP Sept.25)**

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

**Answer:**

Adequate planning benefits the audit of financial statements in the several ways, including the following:

- 1) Helping the auditor to devote appropriate attention to important areas of the audit.
- 2) Helping the auditor identify and resolve potential problems on a timely basis.
- 3) Helping the auditor properly organise and manage the audit engagement so that it is performed in an effective and efficient manner.
- 4) Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.

- 5) Facilitating the direction and supervision of engagement team members and the review of their work.
- 6) Assisting, where applicable, in coordination of work done by others such as experts
- Therefore, planning an audit ensures that audit risk is reduced to an acceptable low level. When audit work is adequately and properly planned, it reduces the risk of inappropriate opinion by the auditor.

**Question 44:****(May 25)**

M/s YZW & Co., Chartered Accountants, have been appointed as the statutory auditors of First Health Private Limited for the financial year 2024-25. CA Y is the engagement partner for this assignment. First Health Private Limited operates in the business of hospitals and pharmaceuticals, with 60 hospitals and 200 pharmacy stores across the country. The company has a turnover of ₹ 680 crores and PAT of ₹ 32 crores in the current year.

While verifying the assertions about book debts, CA Y was informed about the availability of the client's ledger invoices, debit notes, and credit notes as audit evidence. CA Y accepts these documents as audit evidence, considering them to be "available."

- (i) Is this decision correct, based on the meaning of the term "available"?
- (ii) Also, explain how an auditor should select the most appropriate evidence when testing the accuracy of any assertion to form an opinion.

**Answer:**

- (i)
- 1) In the given situation, M/s YZW & Co., Chartered Accountants, have been appointed as statutory auditor of First Health Private Limited which operates in business of hospitals and pharmaceuticals, with 60 hospitals and 200 pharmacy stores across the country. CA. Y, the engagement partner for this assignment, was informed about the availability of the client's ledger invoices, debit notes, credit notes as audit evidence. He accepted these documents as audit evidence, considering them to be "available".
  - 2) For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to obtain greater satisfaction about the reliability of the assertion.

- 3) The word "available", does not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.
- 4) **In view of the above, it can be concluded that decision of CA. Y to consider clients' ledger invoices, debit notes, credit notes as audit evidence, considering them to be available, is not correct.**

(ii)

- 1) Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.
- 2) In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.
- 3) **An auditor picks up evidence from a variety of fields and it is generally of the following broad types:**
  - a) Documentary examination
  - b) Physical examination
  - c) Statements and explanation of management, officials and employees
  - d) Statements and explanations of third parties
  - e) Arithmetical calculations by the auditor
  - f) State of internal controls and internal checks
  - g) Inter-relationship of the various accounting data
  - h) Subsidiary and memorandum records
  - i) Minutes
  - j) Subsequent action by the client and by others.

**Question 45:**

**(May 25)**

**The auditor shall take into consideration the reporting objectives of the engagement so as to plan timing of different audit procedures and also nature of communications while establishing audit strategy. Give any four instances of reporting objectives.**

**Answer:**

The reporting objectives of the engagement to plan the timing of the different audit procedures and also the nature of the communications while establishing audit strategy are:

- a) The entity's timetable for reporting.
- b) Organisation of meetings to discuss nature, timing and extent of audit work with management.
- c) Discussion with management regarding the expected type and timing of reports to be issued including the auditor's report.
- d) Discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- e) Expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

**Notes:**

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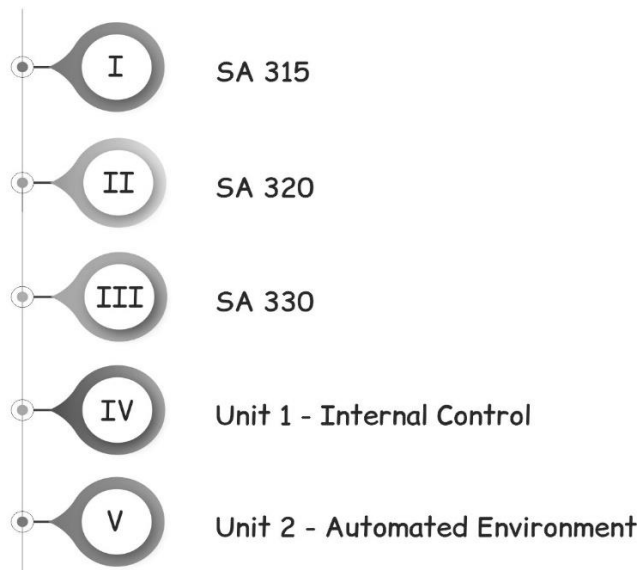
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# Risk Assessment and Internal control

## CHAPTER OVERVIEW:



## Case Study 1

CA Paritosh is auditor of a company. The financial statements of the company have just been received for audit. Following issues have been flagged pertaining to the financial statements of the company for purpose of risk assessment: -

- (i) The revenue of company has fallen from Rs. 50 crore in last year to Rs. 5 crore in current year (for which financial statements have been received for audit) due to lack of demand in the market for company's products.
- (ii) Due to advent of new products in the market, company's products are fast becoming outdated.
- (iii) A large customer having an outstanding balance of Rs. 5 crore has failed to pay to the company despite efforts made by the company.
- (iv) Inventory holding period has increased from 30 days in last year to 90 days.
- (v) The company also gets carried out job operations from third parties. Therefore, parts of inventories are lying with third parties.

Based on above, answer the following questions:

- 1) Regarding drastic fall in revenue of the company, which of the following is an audit risk?
  - a) Fall in revenue would result in fall of profits for the company.
  - b) Drastic fall in revenue may imply that company is not able to carry out its operations in foreseeable future due to lack of demand in the market for company's products. There is a risk that going concern disclosure is omitted to be made in financial statements.
  - c) The company can explore some new line of activity, if demand of its products is falling.
  - d) Fall in revenue would mean lower tax liabilities for the company.
  
- 2) The company's products are getting outdated in the market. Which of the following is an audit risk?
  - a) The company should devise strategies to sell products in the market.
  - b) Inventories may be understated in such a scenario.
  - c) Inventories may be overstated in such a scenario.
  - d) The company should launch a 1+1 free offer for its customers.
  
- 3) A large customer has failed to pay to the company. Identify audit risk from below:
  - a) Receivables may be misstated if irrecoverable debt is not written off.
  - b) Receivables may be overstated if irrecoverable debt is not written off.
  - c) Writing off irrecoverable debt would impact profits of company adversely.
  - d) Failure to recover outstanding debt would impact cash flows of company adversely.
  
- 4) Identify audit risk involved when inventory holding period has increased from 30 days to 90 days.
  - a) There is a risk of overstatement of inventories.
  - b) There is a risk relating to existence of inventories.
  - c) There is a risk that slow movement of stocks would increase tax liability when GST rates are increased.
  - d) There is a risk relating to holding and storage cost of inventories.



5) Part of inventories are lying with third parties. Identify audit risk involved.

- a) There is a risk that third parties do not manufacture according to specifications of the company.
- b) There is a risk that by getting job work done from third parties, company is increasing its costs.
- c) There is a risk that sufficient and appropriate evidence would not be available in respect of quantity and condition of inventories lying with third parties.
- d) There is a risk that sufficient and appropriate evidence would not be available for quality control in respect of inventories lying with third parties.

**Answers to Case Study 1:**

- 1) b)
- 2) c)
- 3) b)
- 4) a)
- 5) c)

## Case Study 2

CA Piyush is understanding internal controls as part of audit exercise of a company. It is a new client. He has studied controls in place in various operational areas of the company. After studying and gaining an understanding of such controls, he has decided to test few controls to actually see whether these are operating as intended by the management. Till now, he has studied controls over inventories and bank. Few of such controls are listed below:

Nature of Control	Control description
Control over inventories	Inventories of the company lying at each location should be insured.
Control over inventories	There should be inventory counts on a regular basis for each location of the company.

Control over Bank operations	Bank reconciliations are to be performed at regular intervals.
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**Based on above, answer the following questions:**

- 1) Which of the following most appropriately describes test of control regarding insurance of inventories?
  - a) Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. The sum insured and period of validity of policy are not relevant.
  - b) Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure adequacy of sum insured by comparing it with value of inventories. Also ensure policy period has not expired.
  - c) Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure policy period has not expired.
  - d) Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. Ensure policy period has not expired.
  
- 2) Which of the following most appropriately describes test of control regarding inventory counts?
  - a) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure.
  - b) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count.
  - c) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count and perform test count.
  - d) Attend inventory count and perform test count.
  
- 3) While testing control over bank reconciliations, it has been noticed that bank reconciliations are not being performed at regular intervals. Identify the most appropriate description of "control deficiency" in this regard:
  - a) Bank reconciliations are not being performed regularly as concerned staff is overburdened.
  - b) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors.

- c) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors. It may result in misstatement of cash and bank balance in financial statements.
  - d) Bank reconciliations are not being performed regularly as concerned staff is overburdened. These should be performed monthly and reviewed by senior accountant.
- 4) Since the company is a new client, which of the following statements is most appropriate?
- a) There is reduced detection risk.
  - b) There is increased detection risk.
  - c) There is no effect on detection risk.
  - d) Detection risk should be increased to lower audit risk.
- 5) Which of the following statements is most appropriate regarding auditor's response to assessed risk of a new client?
- a) More substantive procedures would require to be performed.
  - b) Less substantive procedures would require to be performed.
  - c) There is no effect on substantive procedures.
  - d) There is no effect on substantive procedures as audit risk is low.

**Answers to Case Study 2:**

- 1) b)
- 2) c)
- 3) c)
- 4) b)
- 5) a)

## Independent MCQ's

- 1) Which of the following is true regarding materiality?
- a) It is unaffected by nature of an item.
  - b) It is unaffected by requirements of law or regulations.
  - c) It is not a matter of professional judgment.
  - d) It is not always a matter of relative size.

- 2) The operations of a company are automated substantially. Which of the following statements is most appropriate in this respect?
- a) It results in complex business environment.
  - b) It results in simple business environment and easier audit.
  - c) Automation has no relationship with complexity of business environment.
  - d) It results in simple business environment. However, it increases complexity of audit.
- 3) Who is responsible for maintaining effective internal financial controls?
- a) Statutory auditor
  - b) Audit Committee
  - c) Management
  - d) Shareholders
- 4) Which of the following is not a risk to a company's internal control due to its IT environment?
- a) Potential loss of data
  - b) Inability to access data when required
  - c) Unauthorized access to data
  - d) Processing of large volumes of data
- 5) Which of the following is not an example of "General IT controls"?
- a) Controls pertaining to Disaster recovery plan
  - b) Controls pertaining to batch preparation
  - c) Controls pertaining to data security
  - d) Controls pertaining to validation of input data in an application

**Answers to the MCQs based Questions:**

- 1) d)
- 2) a)
- 3) c)
- 4) d)
- 5) d)

# SA 315 – Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment

## Illustrations & Questions from ICAI Study Material

### Question 1:

(ICAI SM)

Wear & Tear Private Limited is a “start-up” engaged in providing holistic solutions to problem of paddy stubble burning mainly catering to needs of farmers of North western India. Due to importance given by governments to this issue, companies have entered in the market in past few years. Many of these companies have not been successful and have gone bust. As an auditor of the company, can you spot the component of risks of material misstatement involved in above?

### Answer:

It has been stated that many companies engaged in providing holistic solutions to problem of stubble burning have not been successful. It shows that line of activity is inherently risky. Therefore, there is a greater possibility of misstatements.

The component of risks of material misstatement involved is “inherent risk.”

### Question 2:

(ICAI SM) / (MTP-II Apr.25)

A company has devised a control that its inventory of perishable goods is stored in appropriate conditions in a controlled environment to prevent any damages to inventory. Responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. Identify the component of risks of material misstatement involved as an auditor of the company.

### Answer:

The company has devised a control that its inventory of perishable goods is stored in appropriate conditions and responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. There is a possibility that persons given responsibility do not perform their work and report deviations.

The component of risks of material misstatement is “control risk”.

**Question 3:****(ICAI SM) / (MTP-II Apr.25)**

Shree Foods Private Limited is engaged in manufacturing of garlic bread. The auditors of company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that misstatements in revenue recognition are not identified by planned audit procedures. Which risk is being alluded to?

**Answer:**

There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. The risk alluded to it is "detection risk".

**Question 4:****(ICAI SM)**

Jo Jo Limited is planning to list on Bombay Stock Exchange next year. As an auditor of Jo Jo Limited, identify any one reason of increased audit risk due to listing of the company next year.

**Answer:**

Jo Jo Limited is planning to list on Bombay Stock Exchange next year. There is a greater chance of misstatements in the financial statements due to planned listing next year. There could be a possibility of intentional manipulation of financial statements so that good response is received to proposed issue. Therefore, there is increased audit risk i.e., risk of expressing inappropriate opinion by the auditor when financial statements are materially misstated.

**Question 5:****(ICAI SM)**

On perusing financial statements of Jo Jo Limited put up for audit, it is observed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). Identify what kind of risk assessment procedures are being performed by auditor? Has it any relation with listing of the company next year on Bombay Stock Exchange?

**Answer:**

- 1) It is noticed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year).
- 2) The auditor is using "**analytical procedures**" as risk assessment procedures. Current ratio has improved from previous year. There could be a possibility of misstatement in current assets and current liabilities.
- 3) It is possible that improvement in current ratio is artificial due to misstatements and has been done to secure good response to the proposed issue of company next year.

**Question 6:****(ICAI SM)**

Discuss how “analytical procedures” performed as “risk assessment procedures” can be useful to an auditor.

**Answer:****1) The risk assessment procedures shall include the following:**

- a) Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error.
- b) Analytical procedures.
- c) Observation and inspection.

**2) Analytical Procedures:**

- a) Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.
- b) Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, relationship between sales and square footage of selling space or volume of goods sold.
- c) Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
- d) However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist.
- e) Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

## Question 7:

(ICAI SM)

**"Risk of material misstatement consists of two components" Explain clearly defining risk of material misstatement.**

**Answer:****1) Definition of Risk of Material Misstatements:**

**SA 200** states that risk of material statement is the risk that the financial statements are materially misstated prior to audit. It simply means that there is a probability of frauds or errors in financial statements before audit.

**2) The risk of material misstatement at assertion level comprises of two components i.e., inherent risk and control risk.** Both inherent risk and control risk are the entity's risks and they exist independently of the audit of financial statements. Inherent risk and control risk are influenced by the client. These are entity's risks and are not influenced by the auditor.

**3) Inherent risk:**

- a) Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements before consideration of any related controls as described in **SA 200**.
- b) There is always a risk that before considering any existence of internal control in an entity, a particular transaction, balance of an account or a disclosure required to be made in the financial statements of an entity have a chance of being misstated and such misstatement can be material. This risk is known as inherent risk.

**4) Control risk:**

- a) In accordance with **SA 200**, control risk is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- b) Control risk is a risk that internal control existing and operating in an entity would not be efficient enough to stop from happening, or find and then rectify in an appropriate time, any material misstatement relating to a transaction, balance of an account or disclosure required to be made in the financial statements of that entity.



## Question 8:

(ICAI SM)

"The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement"" Explain

Answer:

- 1) Standards on auditing do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement".
- 2) However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.
- 3) The assessment of the risks of material misstatement may expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.
- 4) It can be concluded from the above that: **Audit risk = Risks of material misstatement X Detection risk**
- 5) Since risks of material misstatement is a function of inherent risk and control risk, it can also be shown as: **Audit risk = Inherent risk X Control risk X Detection risk**

## Question 9:

(ICAI SM)

A Partnership Firm of Chartered Accountants HT and Associates was appointed to audit the books of accounts of Wind and Ice Limited for the financial year 2020-21. There was a risk that HT and Associates would give an inappropriate audit opinion if the financial statements of Wind and Ice Limited are materially misstated. State the Risk mentioned in the question

Answer:

The risk mentioned in the question is known as **Audit Risk**, because risk that auditor of a company will give an inappropriate audit opinion if the financial statements of that company are materially misstated is known as Audit Risk.

## Question 10:

(ICAI SM)

The auditor of ABC Textiles Ltd chalks out an audit plan without understanding the entity's business. Since he has carried out many audits of textile companies, there is

no need to understand the nature of business of ABC Ltd. Advise the auditor how he should proceed.

**Answer:**

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The auditor should proceed accordingly.

**Question 11:**

**(ICAI SM)**

While auditing the books of accounts of Heavy Material Limited for the financial year 2022-23, a team member of the auditor of Heavy Material Limited showed no inclination towards understanding the business and the business environment of the above mentioned company. Is the approach of team member of the auditor of Heavy Material Limited correct or incorrect? Also give reason for your answer.

**Answer:**

The approach of team member of the auditor of Heavy Material Limited is incorrect because understanding the business and the business environment of company whose audit is to be conducted is very important, as it helps in planning the audit and identifying areas requiring special attention during the course of audit of that company.

**Question 12:**

**(ICAI SM)**

Prince Blankets is engaged in business of blankets. Its major portion of sales is taking place through internet. Advise the auditor how he would proceed in this regard as to understanding the entity and its environment.

**Answer:**

While understanding entity and its environment, internet sales is being perceived as risky area by the auditor and thereby would be spending substantial time and extensive audit procedures on this particular area.

## Questions from ICAI Model Test Paper

**Question 13:**

**(Model Test Paper-1) / (MTP-I Mar.24)**

The objective of an auditor in accordance with SA 315 is to identify and assess risks of material misstatement at financial statement level and assertion level. Which specific activities an auditor is required to perform for the purpose of identifying and assessing risks of material misstatement?

**Answer:**

For the purpose of identifying and assessing the risks of material misstatement, the auditor shall:

- a) **Identify risks** throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements.
- b) **Assess the identified risks**, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions.
- c) **Relate the identified risks to what can go wrong** at the assertion level, taking account of relevant controls that the auditor intends to test and
- d) **Consider the likelihood of misstatement**, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

**Question 14:**

**(Model Test Paper-2) / (MTP-II Apr.24)**

Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit. State few areas in which such an understanding is helpful to auditor.

**Answer:**

- 1) Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit.

- 2) The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:
- a) Assessing risks of material misstatement of the financial statements
  - b) Determining materiality in accordance with **SA 320**
  - c) Considering the appropriateness of the selection and application of accounting policies
  - d) Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions
  - e) Developing expectations for use when performing analytical procedures
  - f) Evaluating the sufficiency and appropriateness of audit evidence obtained such as the appropriateness of assumptions and of management's oral and written representations.

**Question 15:****(Model Test Paper-4) / (MTP-I July 24)**

CA Tina, while inspecting financial statements of a company, notices that gross profit ratio of company has increased from 14% in year 2022-23 to 24% in year 2023-24. Considering the above, she has assessed the risk of material misstatement to be high with respect to assertions relating to revenue and various direct expenses. CA Tina wants to know few possible reasons which could have led to abnormal jump in gross profit ratio.

During the discussion among engagement team members, her junior Ms. Tisha, expressed her view that detection risk in this engagement should be kept at high level.

- (i) List out a few possible reasons which could have led to abnormal jump in gross profit ratio.
- (ii) Do you agree with viewpoint of Tisha? Provide reasons for your answer.

**Answer:**

- (i) In the given case, risk of material misstatement has been assessed as high in respect of assertions relating to revenue and various direct expenses due to increase in gross profit ratio of company from 14% in year 2022-23 to 24% in year 2023-24.  
Few possible reasons which could have led to abnormal jump in gross profit ratio include:
  - a) Overvaluation of inventories
  - b) Overstatement of revenues
  - c) Understatement of direct expenses

(ii)

- a) SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.
- b) Tisha is of a view that detection risk in this engagement should be kept at high level whereas in the given situation, risk of material misstatement has been assessed as high for assertions relating to revenue and direct expenses.
- c) Therefore, detection risk has to be kept at low level so that a material misstatement in these assertions does not remain undetected.
- d) Therefore, view of Ms. Tisha is not proper.

**Question 16:**

**(Model Test Paper-4) / (MTP-I July 24)**

While conducting the audit of Zeena Limited, CA E is trying to obtain understanding of different components of internal controls of the company. Such an understanding is necessary and is required to be documented in accordance with Standards on Auditing. In this context, how he shall obtain understanding of the risk assessment process of the company and how is this understanding important for the auditor?

**Answer:**

CA E, the auditor of Zeena Limited, shall obtain an understanding of whether the entity has a process for:

- a) Identifying business risks relevant to financial reporting objectives
- b) Estimating the significance of the risks
- c) Assessing the likelihood of their occurrence
- d) Deciding about actions to address those risks

The entity's risk assessment process forms the basis for the risks to be managed. If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Risks can arise or change due to factor such as new technology, new business models, products or activities, changes in operating environment etc. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

Question 17:

(Model Test Paper-5) / (MTP-II Aug.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 ₹ 1.80 lakhs (net of TDS, TDS = ₹ 0.20 lakhs) and bank interest of ₹ 2.70 lakhs (net of TDS, TDS = ₹ 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 ₹ 5 lakhs. The company has shown above incomes under head "Other income" for consolidated amount of ₹ 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:

- 1) 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.
- 2) 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).
- 3) 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
- 4) Few examples of misstatements are:
  - a) Charging of an item of capital expenditure to revenue or vice-versa.
  - b) Difference in disclosure of a financial statement item vis-à-vis its requirement in applicable financial reporting framework.
  - c) Selection or application of inappropriate accounting policies.

- d) Difference in accounting estimate of a financial statement item vis-à-vis its appropriateness in applicable financial reporting framework.
- e) Intentional booking of fake expenses in statement of profit and loss.
- f) Overstating of receivables in the financial statements by not writing off irrecoverable debts.
- g) Overstating or understating inventories.

**Question 18:****(Model Test Paper-5) / (MTP-II Aug.24)**

While planning the audit of Me Limited, CA M has planned nature, timing and extent of risk assessment procedures to identify and assess risks of material misstatements. How risk should be assessed by the auditor CAM? It is also well known that assessment of risks is a matter of professional judgment.

Which specific matters are not included in audit risk? Additionally, CA K, one of the team members of CA M, is of the view that Materiality and Audit Risk are only considered at planning stage of an audit. Comment.

**Answer:**

- 1) The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.
- 2) **Audit risk** is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.
- 3) For the purpose of the Standards on Auditing, **audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not.** This risk is ordinarily insignificant.
- 4) In the given case, CA K is of the view that materiality and audit risk are only considered at planning stage of an audit.
- 5) The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.
- 6) **Thus, the view of CA K is not correct.**

**Question 19:****(Model Test Paper-7) / (MTP-II Dec.24)**

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

**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.**

Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments.

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

**Question 20:****(Model Test Paper-8) / (May 24)**

**CA Q is the engagement partner for the audit of a Departmental store. As a part of the risk assessment procedure, he wants to make inquiries of the management and others**



within the entity. What kind of information can the auditor get by inquiring from the following?

- (i) Internal audit personnel
- (ii) In-house legal counsel
- (iii) Marketing or sales personnel
- (iv) Information systems personnel

**Answer:**

**Inquiries of Management and Others Within the Entity:**

- (i) **Inquiries directed toward internal audit personnel** may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- (ii) **Inquiries directed toward in-house legal counsel** may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract.
- (iii) **Inquiries directed towards marketing or sales personnel** may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- (iv) **Inquiries directed to information systems personnel** may provide information about system changes, system or control failures, or other information system-related risks.

### Questions from ICAI RTP, MTP and Past Exam

**Question 21:**

**(RTP May 24)**

Satrange Foods Private Limited is engaged in manufacturing of pickles. The auditors of the company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that misstatements in revenue recognition are not identified by planned audit procedures. Identify and explain that particular risk in detail.

**Answer:**

- 1) There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. Such a risk is referred to as "detection risk".

- 2) **SA 200** defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.
- 3) **For example**, auditor of a company uses certain audit procedures for the purpose of obtaining audit evidence and reducing audit risk, but still there will remain a risk that audit procedures used by the auditor may not be able to detect a misstatement which by nature is material, then that risk is known as detection Risk.
- 4) **Detection risk comprises sampling and non-sampling risk.**
  - a) **Sampling risk** is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. It simply means that the sample was not representative of the population from which it was chosen.
  - b) **Non-sampling risk** is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Like an auditor may reach an erroneous conclusion due to application to some inappropriate audit procedure.

**Question 22:****(MTP-I Mar.25)**

Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority.

Explain the same in view of above.

**Answer:****Inquiries of Management and Others within the Entity:**

Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority.

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

- b) Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- c) Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract.
- d) Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- e) Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- f) Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system- related risks.

**Question 23:****(MTP-II Apr.25)**

**Identify and briefly explain the component of risks of material misstatement involved in the following situations:**

- (i) GHK Private Limited is a start-up engaged in providing comprehensive solutions to the issue of paddy stubble burning, mainly catering to the needs of farmers of North-western India. Due to the importance given by governments to this issue, companies have entered the market in the past few years. Many of these companies have not been successful and have gone bust.
- (ii) A company has devised a control that its inventory of perishable goods is stored in appropriate conditions in a controlled environment to prevent any damage to inventory. Responsibility is fixed on two people to monitor the environment using sensors and to report on deviations.
- (iii) Shree Foods Private Limited is engaged in the manufacturing of garlic bread. The auditors of the company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that the misstatements in revenue recognition are not identified by planned audit procedures.

**Answer:**

- (i) It has been stated that many companies engaged in providing holistic solutions to problem of stubble burning have not been successful. It shows that line of activity is inherently risky. Therefore, there is a greater possibility of misstatements. The component of risks of material misstatement involved in given situation is "inherent risk."
- (ii) The company has devised a control that its inventory of perishable goods is stored in appropriate conditions and responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. There is a possibility that persons given responsibility do not perform their work and report deviations. The component of risks of material misstatement involved in given situation is "control risk".
- (iii) There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. The risk alluded to it is "detection risk".

## SA 320 – Materiality in Planning and Performing an Audit

### Illustrations & Questions from ICAI Study Material

**Question 24:****(ICAI SM)**

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.

**Question 25:****(ICAI SM)**

One of the team members of auditors of Highly Capable Limited was of the view that Materiality and Audit Risk are only considered at planning stage of an audit. Comment as an auditor

**Answer:**

The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

**Question 26:****(ICAI SM)**

Is materiality required to be documented by the auditor? What factors have to be considered in this regard?

**Answer:**

**Yes, materiality is required to be documented by the auditor.**

The audit documentation shall include the following amounts and the factors considered in their determination:

- a) Materiality for the financial statements as a whole
- b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures
- c) Performance materiality and
- d) Any revision of (a)-(c) as the audit progressed

## Questions from ICAI Model Test Paper

**Question 27:****(Model Test Paper-5) / (MTP-II Aug.24)**

CA Y, statutory auditor of a company, is in process of determining materiality for financial statements while planning audit. Since materiality is a matter of professional judgment and is affected by auditor's perception of financial information needs of users of financial statements, he is reasonably making certain assumptions about users of financial statements. Which reasonable matters are likely to be assumed by him in respect of users?

**Answer:**

The auditor's determination of materiality is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for CA Y, the auditor, to assume that users: -

- a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence
- b) Understand that financial statements are prepared, presented and audited to levels of materiality
- c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events and
- d) Make reasonable economic decisions on the basis of the information in the financial statements.

**Question 28:****(Model Test Paper-7) / (MTP-II Dec.24)**

Calen Retail Ltd. is preparing its annual financial statements, and the auditors are tasked with determining materiality. The company has used revenue as the benchmark, as it is a key indicator of performance. However, Calen Retail has recently opened new stores and closed underperforming ones, which could significantly affect both revenue and profitability. As per given case, what factors should the auditors consider when selecting the most appropriate benchmark for materiality?

**Answer:**

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

**Factors that may affect the identification of an appropriate benchmark include the following:**

- a) The elements of the financial statements like assets, liabilities, equity, revenue, expenses.
- b) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused.

**For example,** for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets.

- c) The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates, the entity's ownership structure and

the way it is financed. For example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings.

d) The relative volatility of the benchmark.

## SA 330 – The Auditor's Responses to Assessed Risks

### Questions from ICAI Model Test Paper

**Question 29:** (Model Test Paper-6) / (MTP-I Nov.24)

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:**

- 1) The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when: -
  - a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures) or
  - b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.
- 2) 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.
- 3) 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 30:****(Model Test Paper-7) / (MTP-II Dec.24)**

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Discuss the matters the auditor may consider in determining the extent of test of controls

**Answer:**

Matters the auditor may consider in determining the extent of test of controls include the following:

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

## Unit 1-Internal Control and Unit 2-Automated Environment

### Illustrations & Questions from ICAI Study Material

**Question 31:****(ICAI SM)**

Auditor GR and Associates, appointed for audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditor does not think that it would be necessary to understand internal controls. Advise the auditor in this regard.



**Answer:**

- 1) The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit.
- 2) It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

**Question 32:****(ICAI SM)**

The team member of the auditor of Simple and Easy Limited was of the view that understanding the internal control of the company would not help them in any manner in relation to audit procedures to be applied while conducting the audit.

**Answer:**

The view of the team member of the auditor is incorrect because understanding the internal control of the company would help the auditor and his team members in designing the nature, timing and extent of audit procedures to be applied while conducting the audit of the company.

**Question 33:****(ICAI SM)**

Mr. Y, one of the team member of the auditors of What and Where Limited was very keen in knowing whether the internal control of the company would safeguard the company's assets. Advise Mr. Y.

**Answer:**

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

**Question 34:****(ICAI SM)**

Mr. H, a team member of the auditor of There and Here Limited was of the view that evaluation of internal control of the company would help in identifying the areas where internal control is weak. Advise

**Answer:**

The review of internal controls will enable the auditor to know what are the areas where control is weak and where it is excessive.

**Question 35:****(ICAI SM)**

In order to evaluate the Internal Control of Your and My Limited, a team member of the auditors used a method according to which, number of questions relating to internal control of the company were required to be answered by the employees of the company. After obtaining the answers there was a discussion relating to those answers between team member of the auditor and employees of the company for a clear picture. State the method of evaluation of internal control.

**Answer:**

The method of evaluation of internal control used in the above question is known as **Internal Control Questionnaire** because in questionnaire method, a number of questions relating to internal control of a company are required to be answered by employees of that company and when answers to the questions are obtained, there is a discussion relating to those answers between team members of the auditors and employees of that company for a clear picture.

**Question 36:****(ICAI SM)**

Healthy and Useful Limited is into small manufacturing as well as trading business. For the purpose of evaluating the internal control of Healthy and Useful Limited, a team member of the auditors of the company used a method according to which the whole description of internal control that was operating in the said company was to be recorded. Identify the method of evaluation of internal control as mentioned above

**Answer:**

The method of evaluation of internal control referred above is known as **Narrative Record** because in Narrative Record method, a whole description of internal control operating in an entity is recorded. Narrative Record method is also appropriate for small manufacturing as well as trading business as is mentioned in the question above case.

**Question 37:****(ICAI SM)**

CA Smriti is auditor of a company. As part of audit, she is going through company policies and practices regarding employee recruitment, training, orientation and related matters. She seems to be very much interested in finding out whether company hires best candidates from applicant pool. Identify what she is trying to do? How gaining knowledge about this aspect is useful to her as an auditor?

**Answer:**

The study of company policies and practices regarding employee recruitment, training, orientation and related matters including hiring of best candidates is part of understanding HR function of the company. It, in turn, helps in understanding control environment of the company. By gaining such a knowledge, she can better understand internal control of the company.

**Question 38:****(ICAI SM)**

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.

**Question 39:****(ICAI SM)**

Zomba Products Private limited is a small company. The control systems in the company are rudimentary. How, you as an auditor of the company, would proceed to evaluate internal control of the company?

**Answer:**

In a small company, control systems are basic and not formalized. Therefore, auditor should proceed to evaluate internal control using narrative record.

**Question 40:****(ICAI SM)**

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".

**Question 41:**

**(ICAI SM)**

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

**Answer:**

**These two categories of control over IT systems are interrelated.**

The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems.

**Question 42:**

**(ICAI SM)**

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

**Answer:**

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

- a) Check completeness of data and population that is used in either test of controls or substantive audit tests.
- b) Selection of audit samples - random sampling, systematic sampling.
- c) Re-computation of balances - reconstruction of trial balance from transaction data.
- d) Repperformance of mathematical calculations - depreciation, bank interest calculation.
- e) Analysis of journal entries

- f) Fraud investigation.
- g) Evaluating impact of control deficiencies.

**Question 43:****(ICAI SM)**

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

**Answer:**

- 1) Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.
- 2) Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.
- 3) Significant risks are inherent risks with both a higher likelihood of occurrence and a higher magnitude of potential misstatement. The auditor assesses assertions affected by a significant risk as higher inherent risk.
- 4) The following are always significant risks:
  - a) Risks of material misstatement due to fraud
  - b) Significant transactions with related parties that are outside the normal course of business for the entity.

**Question 44:****(ICAI SM)**

**The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting” Explain.**

**Answer:**

- 1) The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting.
- 2) Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It helps in assessing the effectiveness of controls on a timely basis. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.
- 3) It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions. Management accomplishes monitoring of

controls through ongoing activities, separate evaluations, or a combination of the two.

- 4) Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
- 5) Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

#### Question 45:

(ICAI SM)

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

#### Answer:

- 1) 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 behaviour and
  - b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.
- 2) **What is included in Control Environment? The control environment includes:**
  - a) The governance and management functions and
  - b) The attitudes, awareness, and actions of those charged with governance and management.
  - c) The control environment sets the tone of an organization, influencing the control consciousness of its people.

#### Question 46:

(ICAI SM)

**Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control.**

#### Answer:

#### **Objectives of Internal Control**

- 1) Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives.

- 2) The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit.
- 3) Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.
- 4) **Objectives of Internal Control are :**
  - a) transactions are executed in accordance with managements general or specific authorization;
  - b) All transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;
  - c) Assets are safeguarded from unauthorised access, use or disposition; and
  - d) The recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

## Questions from ICAI Model Test Paper

**Question 47:**

(Model Test Paper-1) / (MTP-I Mar.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 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 48:****(Model Test Paper-2) / (MTP-II Apr.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**

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



**Question 49:****(Model Test Paper-2) / (MTP-II Apr.24)**

**It is important to carry out the Tests of Controls for checking effectiveness of internal control over sales as a part of the debtors' audit procedure. In above context, state the points which need to be considered in respect of trade receivables.**

**Answer:**

It is important to carry out Tests of Controls for checking the effectiveness of internal control over sales as a part of the debtors' audit procedure. Following points need to be considered in respect of trade receivables:

- 1) Only bona fide sales lead to trade receivables.
- 2) All such sales are made to approved customers.
- 3) All such sales are properly recorded in the books of accounts.
- 4) Once recorded, the debtors can be settled only by receipt of cash or on the authority of a responsible official.
- 5) Segregation of duties at every point in sales transaction. (Accounting for debtors, collecting the payments, sending reminders etc.)
- 6) Debtors are collected on time.
- 7) In case debtors are not collected in time, sending reminders and taking legal actions if required.
- 8) Balances are regularly reviewed.
- 9) A proper system of follow up exists and if necessary, adequate provision for bad debt should be made by preparing adequate ageing schedule of the debtors.

**Question 50:****(Model Test Paper-2) / (MTP-II Apr.24)**

**Auditor of Sunshine Ltd. is of the view that due to greater management intervention to specify accounting treatment, the risk of material misstatement is greater for non-routine transactions. Is view of the auditor correct? Specify the other matters due to which the risk of material misstatement is greater for significant non-routine transactions.**

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

Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.

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

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

Keeping in view above, view of Auditor of Sunshine Ltd is correct.

#### Question 51:

(Model Test Paper-3) / (Sept.24)

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

#### Answer:

##### **Inquiries of Management and Others within the Entity:**

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

- (i) Design of the accounting and internal control system
- (ii) Operation of the internal control throughout the period

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

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

- (i) Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- (ii) Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.

- (iii) Testing of internal control operating on specific computerized applications or over the overall information technology function, for example, access or program change controls.

**Question 52:****(Model Test Paper-3) / (Sept.24)**

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

- (i) Whether controls in LMN Ltd. are operating as intended and they are modified as appropriate for change in conditions.
- (ii) Whether there exists proper segregation of duties in the company and the person responsible for recording a transaction is different from the person authorizing it.

**Answer:**

- (i) In this case, CA. Amit is trying to understand that whether controls in the LMN Ltd. are operating as intended and they are modified as appropriate for change in conditions:

He is gaining the understanding of the Monitoring of controls component of internal control. Monitoring of controls is a process to assess the effectiveness of internal control performance over time.

It helps in assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. It includes considering whether controls are operating as intended and that they are modified as appropriate for change in conditions.

- (ii) In the given situation, CA Amit is trying to understand that whether there exists a proper system of segregation of duties in the company and the person responsible for recording a transaction is different from the person authorising it. He is gaining an understanding of internal control of the company.

In particular, he is understanding "control activities". When a person recording a transaction is different from one authorizing it, he gains confidence that there exists a system for preventing misstatements. It helps him in gaining insight into the internal control system of the company.

**Question 53:****(Model Test Paper-3) / (Sept.24)**

Z and Associates are the auditors of Realton Ltd., an export oriented unit, which specializes in manufacturing oil extraction plants. Since many complex processes are

involved, they are digitizing their operations. They are restructuring their business models which are driven by technology. Since most of the operations of the company are automated, Z and Associates are planning to do Digital Audit. Explain the use of digital technology in the conduct of an audit.

**Answer:**

**Use of Digital Technology in the conduct of an audit:** Entities are embracing digitization as part of their operations to keep pace with changing times. New technologies are helping companies revamp their operations and rethink the way business is conducted. Companies are restructuring their business models driven by technology. Automation is key to digitization. In such a business environment, use of digital technology is being made by auditors right from planning to expression of final opinion.

- a) Auditors are making use of artificial intelligence, data analytics and other latest technologies to help understand business processes in a better way.
- b) By using such tools, auditors can conduct audits in a better way and devote more attention to areas requiring greater focus.
- c) Digital audit is helping auditors to better identify risks making use of technology.

**Question 54:**

(Model Test Paper-6) / (MTP-I Nov.24)

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:**

- 1) 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.

- 2) 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.
- 3) 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.
- 4) 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.

**Question 55:****(Model Test Paper-8) / (May 24)**

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

**Answer:**

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

- Where judgment and discretion are required.
- Large, unusual or non-recurring transactions.

- c) Circumstances where errors are difficult to define, anticipate or predict.
- d) In changing circumstances that require a control response outside the scope of an existing automated control.
- e) In monitoring the effectiveness of automated controls.

**Question 56:****(Model Test Paper-8)**

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

**Answer:**

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

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

**Questions from ICAI RTP, MTP and Past Exam****Question 57:****(Jan.25)**

Spare Parts Limited received an input from internal auditors that internal controls implemented by the company appears to be reasonable but not so strong that any fraudulent activity can be prevented or timely detected by such controls. Accordingly a qualified person should head the internal controls department. CA Raj has been appointed as an Internal Control Head of the company. His scope of work includes development of internal controls in various departments/areas of the company. On his joining, he studied the various verticals and after identifying the important areas (prone to fraud) implemented strong controls in those areas. In his meeting with senior management and statutory auditors, he assured that satisfactory control environment exists and fraud cannot happen. Whether existence of a satisfactory control environment can be considered as an absolute deterrent to fraud?

**Answer:**

- 1) Existence of a satisfactory control environment is not an absolute deterrent to fraud. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement.
- 2) However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud.
- 3) Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorised transactions to be processed.
- 4) The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls.
- 5) For example, the monitoring of controls and the operation of specific control activities and thereby, the auditor's assessment of the risks of material misstatement.

**Question 58:****(Jan.25)**

In an automated environment, there are generally four types of audit tests available. As a senior auditor, it's crucial to guide your team in selecting the appropriate audit tests based on the situation. Explain the types of audit tests commonly used in an automated setting and provide insights on how to determine when and which tests to apply, emphasizing the role of professional judgment in making these decisions.

**Answer:**

- 1) There are basically **four types of audit tests** that should be used are inquiry, observation, inspection and reperformance.
- 2) Inquiry is the most efficient audit test, but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.
- 3) Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.
- 4) Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors including risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed etc.
- 5) The auditor should document the nature of test (or combination of tests) applied along with the judgements in the audit file.

**Question 59:****(RTP May 24)**

IT related risks can have an impact on audit. In what different ways, such risks can have an impact on audit of financial statements?

**Answer:**

IT related risks can have an impact on audit in different ways discussed as under:

**a) Impact on substantive checking**

Inability to address IT risks may lead to non-reliance of data obtained from systems. In such a case, all information, data, and reports would have to be tested thoroughly for their completeness and accuracy. It could lead to increased substantive checking i.e. detailed checking.



**b) Impact on controls**

It can lead to non-reliance on automated controls, system calculations and accounting procedures built into applications. It may result in additional audit work.

**c) Impact on reporting**

Due to regulatory requirements in respect of internal financial controls in case of companies, it may lead to modification of auditor's report in some instances.

**Question 60:****(RTP Sept. 24)**

Companies are increasingly using data analytics for managing their operations. Auditors can also obtain good results by using data analytics. What are the tools and techniques used by auditors in applying the principles of Data Analytics and in which areas data analytics can be used by auditors?

**Answer:**

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

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

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

**Question 61:****(RTP Jan.25)**

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

- (i) Management has created and maintained a culture of honesty and ethical behaviour; and
- (ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

**What is included in control environment? Also explain the elements of control environment.**

**Answer:**

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

- (i) Management has created and maintained a culture of honesty and ethical behaviour and
- (ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

**The control environment includes:**

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

**Question 62:**

**(RTP May 25)**

**In an automated environment, General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. It includes access security as well as program change. What are the objectives and activities included in access security and program change?**

**Answer:**

**Access Security in Automated Environment:**

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

**Activities:**

- a) Security Organization & Management
- b) Security Policies & Procedures
- c) Application Security
- d) Data Security
- e) Operating System Security
- f) Network Security
- g) Physical Security

**Program Change in Automated Environment:**

The objective of program change controls is to ensure that modified systems continue to meet financial reporting objectives.

It includes activities such as change in management process, recording, managing and tracking change requests, making and testing changes etc.

**Question 63:****(RTP Sept.25)**

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

**Answer:**

When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Matters the auditor may consider in determining the extent of test of controls include the following:

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

**Question 64:****(MTP-I Mar.25)**

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

In context of significant risk, explain the factors to be considered by the auditor in exercising judgment as to which risks are significant risks.

**Answer:**

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- (i) Whether the risk is a risk of fraud;
- (ii) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
- (iii) The complexity of transactions;
- (iv) Whether the risk involves significant transactions with related parties;
- (v) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
- (vi) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

**Question 65:****(MTP-II Apr. 25)**

While it is true that companies can benefit immensely from the use of data analysis in terms of increased profitability, better customer service, etc. Analyse various functions that an auditor can perform using Data Analytics tools and techniques to obtain good results.

**Answer:**

- 1) In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics. While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results.
- 2) The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

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

**Question 66:**

**(May 25)**

**Mention the types of control in an automated environment.**

**Identify the type of control in the following table in Column B against Column A which contains areas where controls are to be implemented in an automated environment.**

<b>Column A</b>	<b>Column B</b>
Access security	s?
Sequence number checks	?
Data centre and network operations	?
Mandatory data fields	?

**Answer:**

**Types of Controls in an automated environment:**

Controls in an automated environment can be categorised as under: -

- a) General IT controls
- b) Application controls
- c) IT-dependent controls

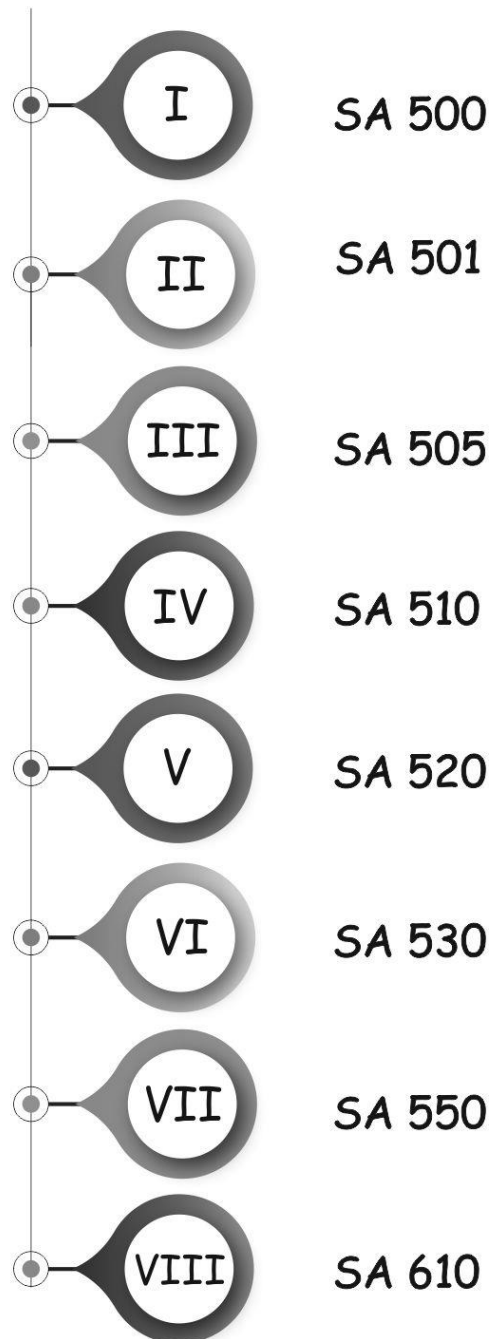
<b>Column A - Areas where Controls to be implemented</b>	<b>Column B - Type of Controls</b>
Access security	General IT controls
Sequence number checks	Application controls
Data centre and network operations	General IT controls
Mandatory data fields	Application controls



[illegible]

# Audit Evidence

## CHAPTER OVERVIEW:



## Case Study 1

CA Drishti Khandelwal is conducting audit of a company engaged in manufacturing of towels and bedspreads. The company is having its own manufacturing set-up. However, it also gets some manufacturing processes outsourced from third parties.

The company has three locations having substantial quantities of inventories in the same city. Besides, due to outsourcing of some processes, inventories are also held in premises of third parties in the same city. As part of audit procedures, she is performing many audit procedures required by different Standards on Auditing.

In particular, she is attending physical inventory count process of the company at year end in accordance with requirements of SA 501. The inventory of the company includes raw materials consisting mainly of natural and dyed yarns, work in process in different stages of manufacturing and finished stocks of towels and bedspreads.

She is also planning sending confirmations to parties to whom the company has sold goods. On reviewing trade receivables list, she finds that the list also contains large number of parties having small balances. She further finds that these receivables have arisen due to sale of bedspreads to small time retailers and possibility of difference in balances as per company's records and as per records of these small-time retailers is low. Risk of misstatements in relation to trade receivables has been assessed as low. Besides, there is nothing to suggest that small-time retailers would disregard such requests.

While conducting audit, she is testing controls operating in the company. She is also conducting tests of various items of income and expenditure as well as balances appearing in balance sheet. She intends to rely upon sampling extensively.

Based upon above, answer the following questions:

- 1) Which of the following statements is most appropriate regarding inventory count by auditor in accordance with SA 501?
  - a) She should inspect the inventory to ascertain its existence and condition at all locations, observe how company personnel are carrying out count procedures and perform test counting.
  - b) She should inspect the inventory to ascertain its existence at all locations, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.



- c) She should inspect the inventory to ascertain its existence at selected location, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.
  - d) She should inspect the inventory to ascertain its existence and condition at all locations and perform counting of each and every item.
- 2) **As regards inventories lying with third parties, which of following statements meets requirements of SA 501?**
- a) She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company as well as request third parties to allow her to inspect inventories held by them. Both requirements are necessary to be complied with.
  - b) She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these or both is required for purposes of SA 501.
  - c) There is no obligation cast upon an auditor in respect of inventories lying with third parties.
  - d) She should request confirmation from third parties regarding quantity, condition and value of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these is sufficient for purposes of SA 501.
- 3) **Keeping in view description regarding trade receivables, identify the most appropriate statement in context of SA 505?**
- a) She should not plan and design confirmation requests for large number of parties having small balances.
  - b) She should plan and design positive confirmation requests for large number of parties having small balances.
  - c) She should plan and design positive confirmation requests for large number of parties having small balances and meticulously analyse exception rate
  - d) She should plan and design negative confirmation requests for large number of parties having small balances.

- 4) As regards sampling, which of the following statements is most appropriate in terms of requirements of SA 530?
- a) Sampling is used in tests of transactions as well as tests of controls.
  - b) Sampling is used in tests of balances as well as tests of controls.
  - c) Sampling is used in tests of details.
  - d) Sampling is used in tests of details as well as tests of controls.
- 5) Since she intends to rely upon sampling extensively, which of the following statements is true about sampling risk?
- a) Sampling risk can be eliminated.
  - b) Increase in sampling risk would lead to decrease in detection risk.
  - c) Decrease in sampling risk would lead to increase in detection risk.
  - d) Sampling risk will always be in existence.

#### Answers to Case Study 1

- 1) a)
- 2) b)
- 3) d)
- 4) d)
- 5) d)

## Case Study 2

Financial statements of a firm have been put up for audit before CA Manushi. On going through financial statements, she wants to verify assertions contained in financial statements and has planned certain procedures for carrying out detailed checking.

- A. She plans to verify some major bills debited in "Machinery repair" account. The purpose of it is to ensure that bills are entered correctly and their classification is proper.
- B. She plans to verify that all balances appearing under trade payables are genuine and not fake.
- C. She plans to compare amount of wages paid in current year and last year. It is also planned to verify relationship between the number of employees and wages paid in both years.

- D. She is of the view that it is necessary to examine title deeds of "land" appearing in financial statements of the firm.
- E. The firm is engaged in export of goods to Europe. The sales invoices raised in Euros are converted into Indian rupees as per applicable norms.

Based on above, answer the following questions: -

- 1) As regards description given regarding verification of bills debited in "Machinery repair" account, identify what she intends to perform?
  - a) Tests of Controls
  - b) Tests of transactions
  - c) Tests of balances
  - d) Risk assessment procedures.
- 2) Identify which type of assertion she intends to focus when she wants to ensure genuineness of trade payables.
  - a) Occurrence
  - b) Cut-off
  - c) Existence
  - d) Accuracy
- 3) As regards comparison of wages of current year and last year and comparison of relationship between the number of employees and wages paid in both years, identify what she is trying to do?
  - a) She is intending to perform tests of details.
  - b) She is intending to perform tests of transactions.
  - c) She is intending to perform tests of balances.
  - d) She is intending to perform substantive analytical procedures.
- 4) In case of examination of title deeds of "land", which of the following fits into most appropriate description of such an audit procedure?
  - a) Observation
  - b) Inspection
  - c) External confirmation
  - d) Enquiry

- 5) She wants to verify whether conversion of foreign currency into Indian rupees is proper or not. Identify what she is trying to do?
- a) Reperformance
  - b) Recalculation
  - c) Observation
  - d) Inspection

### Answers to Case Study 2

- 1) b)
- 2) c)
- 3) d)
- 4) b)
- 5) b)

## Independent MCQ's

- 1) Which of the following is not one of functions of internal auditor of an organization?
  - a) Performing assurance activities
  - b) Performing consulting activities to improve governance of organization
  - c) Performing risk management activities
  - d) Expressing independent opinion on financial statements of organization
- 2) An auditor finds during course of an audit that the entity has entered into many related party transactions. Which of the following statements is true?
  - a) The risk that management may override controls in respect of related party transactions is lower.
  - b) The risk that management may override controls in respect of related party transactions is higher.
  - c) There is no effect on the risk that management may override controls in respect of related party transactions.
  - d) Risk of overriding of controls by management has no relationship at all with related party transactions.
- 3) Which of the following is not an objective of a company's policies for ensuring "internal financial controls"?
  - a) Efficient conduct of business
  - b) Safeguarding of assets

- c) Prevention and detection of frauds and errors
  - d) Assessing audit risk
- 4) Which of the following is not an advantage of statistical sampling?
- a) Sample size does not increase in proportion to size of area tested.
  - b) Sample selection is more objective.
  - c) It provides a means of deriving a calculated risk and corresponding precision.
  - d) In case of verifying compliance with specific legal requirements, it is suitable.
- 5) A company auditor receives external confirmation from an entity to whom company has sold goods. The said amount is properly classified in financial statements of company. Which of the following statements is not true in this regard?
- a) It shows that said trade receivable exists.
  - b) It shows that said trade receivable is properly valued.
  - c) It shows that company has a right to said trade receivable.
  - d) It shows that amount of said trade receivable has been recorded in proper account.

**Answers to the MCQs based Questions:**

- 1) d)
- 2) b)
- 3) d)
- 4) d)
- 5) b)

## SA 500 – Audit Evidence

### Illustrations & Questions from ICAI Study Material

**Question 1:**

(ICAI SM)

On perusal of financial statements of a company, auditor of company finds that notes to accounts contain aging of trade payables in accordance with requirements of Schedule III of Companies Act, 2013. The accountant of company is responsible for ensuring proper aging of trade payables included in notes to accounts. The auditor wants to verify

whether aging of trade payables made in financial statements is proper or not. Identify what he is trying to do.

**Answer:**

The auditor is verifying aging of trade payables. He is "reperforming" the control which was mandated by the management.

**Question 2:**

**(ICAI SM)**

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.

**Question 3:**

**(ICAI SM)**

A company has stipulated a control that reconciliations of its records showing quantitative details of its property, plant and equipment are carried out at regular intervals with physical verification of such items. The auditor has found that such reconciliations are being carried out as stipulated. Discuss, whether above factor, increases reliability of other internally generated evidence within the company relating to existence of such items.

**Answer:**

The management is carrying out reconciliations of items contained in Property, Plant and Equipment records with physical verification of such items at regular intervals. It means that controls in this regard have operated effectively.

The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

**Question 4:****(ICAI SM)**

The auditor of JPJ Limited explained to the audit team members about the relationship between Audit Evidence and Opinion of Auditor. Explain what relationship exists between Audit Evidence and Opinion of Auditor.

**Answer:**

There exists a very important relationship between Audit Evidence and opinion of the Auditor. While conducting an audit of a company, the auditor obtains audit evidence and with the help of that audit evidence obtained, the auditor forms an audit opinion on the financial statements of that company.

**Question 5:****(ICAI SM)**

An audit team member of the auditors of Genuine Limited was of the view that audit evidence obtained internally from within the company under audit are more appropriate from the reliability point of view as compared to audit evidence obtained externally as evidence obtained internally are obtained from the company whose audit is being conducted. Give your views as auditor of Genuine Limited.

**Answer:**

Audit evidence obtained externally is more appropriate from reliability point of view as compared to those which are obtained internally. The reason that audit evidence obtained externally is more appropriate from the point of view of reliability is that there is a very low risk that they can be altered or changed.

**Question 6:****(ICAI SM)**

There was a Partnership Firm of Chartered Accountants VM and Associates. Mr. M, one of the partners of VM and Associates, while explaining to his audit team members about importance of audit evidence informed them about sufficiency and appropriateness of audit evidence. Mr. A, one of the members of audit team of VM and Associates was of the view that sufficiency of audit evidence means simplicity of audit evidence and appropriateness of audit evidence means ease of obtaining audit evidence. Explain whether sufficiency and appropriateness of audit evidence mean simplicity and ease of obtaining audit evidence.

**Answer:**

**Sufficiency and Appropriateness** of audit evidence does not mean simplicity and ease of obtaining audit evidence rather sufficiency of audit evidence is related to the quantity of audit evidence and appropriateness of audit evidence is related to quality of audit evidence.

**Question 7:****(ICAI SM)**

While auditing the books of accounts of AB Limited for the financial year 2022-23, the auditor of the company used an audit procedure according to which complete documents and records of the company were checked in detail in order to obtain audit evidence. Explain the audit procedure used by the auditor of Extremely Distinct Limited.

**Answer:**

The audit procedure used by auditor of AB Limited is known as Inspection because inspection is an audit procedure in which complete documents and records of a company are checked in detail for the purpose of obtaining audit evidence.

**Question 8:****(ICAI SM)**

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.**

- 1) 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.
- 2) 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.
- 3) Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.
- 4) 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.
- 5) 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, reperformance and analytical procedures, often in some combination, in addition to inquiry.
- 6) 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.



- 7) As explained in SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. The sufficiency and appropriateness of audit evidence are interrelated.

**Question 9:****(ICAI SM)**

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

**Answer:**

- 1) **Sufficiency is the measure of the quantity of audit evidence.** The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.
- 2) **Following are the factors affecting the auditor's judgement as to the sufficiency of audit evidence:**
  - a) **Materiality:** It may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand, if assertions are more material to the users of the financial statements, more evidence would be required.
  - b) **Risk of material misstatement:** It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level:
    - (i) **Inherent risk:** The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.
    - (ii) **Control risk:** The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control.

Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand, if assertions have a higher risk of material misstatement, more evidence would be required.

- c) **Size of a population:** It refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

## Questions from ICAI Model Test Paper

**Question 10:**

**(Model Test Paper-1) / (MTP-I Mar.24)**

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:**

- 1) 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.
- 2) 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.
- 3) 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.

**Question: 11****(Model Test Paper-3) / (Sept.24)**

The management of D. Ltd. have engaged an actuary-expert to ascertain actuarial valuation of gratuity for provision to be made in the accounts. As an auditor of D. Ltd., you plan to use the report of the said expert as audit evidence for ascertaining appropriate valuation of provisions. As an auditor, what will you do to evaluate the competence, capabilities, objectivity and an understanding of the work of the actuary-expert who has carried out actuarial valuation of gratuity?

**Answer:**

- 1) As per SA 500, "Audit Evidence", issued by ICAI, when using the work of a management's expert as audit evidence the auditor should evaluate the competence, capabilities and objectivity of that expert that:
  - a) Whether the expert is employed by the entity or is an outside party.
  - b) Whether the expert is independent in respect of the entity.
  - c) Auditor's previous experience of the work of the expert.
  - d) Knowledge of the expert, his qualification, membership of a professional body or industry association, etc.
- 2) The auditor should also obtain an understanding of the work of that expert that:
  - a) Whether the auditor has expertise to evaluate the work of the expert.
  - b) Evaluating the assumptions and methods used by the management.
  - c) Evaluating the nature of internal or external data used by the expert.

**Question: 12****(Model Test Paper-4) / (MTP-I July 24)**

Expert Industries Limited is engaged in petrochemical business. Due to nature of its business, the company has hired PQR Associates, a reputed firm of chartered engineers, to determine the quantity and valuation of inventories for preparation of financial statements. The auditor of Expert Industries Limited want to use the same as audit evidence. Before using the work of PQR Associates, management's expert, what aspects should be taken care by auditor?

**Answer:**

- 1) As per SA 500, "Audit Evidence", if the entity has employed or engaged experts, the auditor may rely on the works of experts, provided he is satisfied that sufficient and appropriate audit evidence is obtained with reasonable assurance to form an opinion on the financial statements.

- 2) 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.

### **Conclusion:**

Before using the work of PQR Associates, management's expert, auditor should ensure that the criteria mentioned above are fulfilled.

### **Question: 13**

**(Model Test Paper-6) / (MTP-I Nov.24)**

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

### **Answer:**

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

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

## Questions from ICAI RTP, MTP and Past Exam

**Question 14:**

**(RTP May 24)**

CA Kanika audited books of accounts of Engineering Ltd. for the financial year 2022-2023. The auditor used an audit procedure according to which all the documents and records maintained by the company were checked in detail to obtain audit evidence. Explain the audit procedure used by the auditor. Comment on reliability of audit evidence obtained by performing such an audit procedure in some situations.

**Answer:**

**Audit Procedure:**

- 1) Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. In view of above, it can be concluded that CA Kanika used Inspection as an audit procedure.
- 2) Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.
- 3) Example of inspection used as a test of controls is inspection of records for evidence of authorisation.
- 4) Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a inventory or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value.
- 5) In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.
- 6) Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

**Question: 15**

**(MTP-I Mar.25)**

While conducting the audit of Pummy Limited, the statutory auditors collected written representations from the Management. The audit was finalised in addition to other audit procedures but, without making any inquiries, as the statutory auditors were short of time. In the light of this information, elaborate "inquiry" as one of the methods of collecting Audit Evidence.

**Answer:**

**Inquiry, as a method of obtaining audit evidence, is explained in accordance with SA 500, "Audit Evidence," as follows:**

- 1) Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures.
- 2) Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.
- 3) Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.
- 4) Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

**Question: 16****(Jan.25)**

**FRP & Associates are the statutory auditors of Paint Private Limited. Company is into the business of trading and has operations across India. CA M, partner in charge of the audit, is carrying out the audit procedures with his audit team. He entrusted CA Ravi, one of the team members, the task of obtaining various audit evidences connected with the audit and submit the same to the engagement partner for finalizing the audit report. How can CA M ensure that the evidences collected by CA Ravi during the audit will be sufficient for the purpose of audit or not?**

**Answer:**

The auditor has to obtain sufficient appropriate audit evidence to draw reasonable conclusions on financial statements. Sufficiency is the measure of the quantity of audit evidence.

CA M will ensure that the evidence collected by CA Ravi will be sufficient for the purpose of audit by considering following factors:

- (i) **Materiality:** It may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand, if assertions are more material to the users of the financial statements, more evidence would be required.
- (ii) **Risk of material misstatement:** It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components, namely, inherent risk and control risk at the assertion level. Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand, if assertions have a higher risk of material misstatement, more evidence would be required.
- (iii) **Size of a population:** It refers to the number of items included in the population. Less evidence would be required in the case of smaller, more homogeneous populations but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

**Question: 17****(MTP-II Apr.25)**

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

- (i) While auditing the books of accounts of ANT Limited for the financial year 2023-24, the auditor checked the complete documents and records of the company in detail to obtain audit evidence.
- (ii) Mr. M, auditor of company, looks at the process of inventory counting by the entity's personnel and of the performance of control activities.
- (iii) XYZ Ltd. is engaged in export of goods to Europe. The sales invoices raised in Euros are converted into Indian rupees as per applicable norms. The auditor wants to verify whether conversion of foreign currency into Indian rupees is proper or not.
- (iv) CA Isha is appointed as auditor of TUV Ltd., during the initial stage of audit, she reviewed the Gross Profit Ratio of the company. She also compared GP ratio of TUV Ltd. with the other companies operating in similar industry.

**Answer:**

- (i) The audit procedure used by auditor of ANT Limited is known as Inspection because inspection is an audit procedure in which complete documents and records of a company are checked in detail for the purpose of obtaining audit evidence.
- (ii) Mr. M is using Observation as audit procedure as Observation consists of looking at a process or procedure being performed by others.

- (iii) The audit procedure used by auditor is Recalculation. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.
- (iv) CA Isha is using Analytical Procedure to obtain audit evidence. Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.
- (v) Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

**Question 18:****(RTP Sept.25)**

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

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

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

**Answer:**

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

- (i) **Inspection:** Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.



- (ii) **External Confirmation:** An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.
- (iii) **Inspection:** Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.
- (iv) **Reperformance:** Repformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.
- (v) **Recalculation:** Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

## SA 501 – Audit Evidence- Specific Considerations for selected items

### Illustrations & Questions from ICAI Study Material

#### Question 19:

(ICAI SM)

The audit procedures performed so far by auditor of a company indicate that there is a possibility that company has not disclosed all material litigation cases involving the company. Does such a situation warrant direct communication by auditor with external lawyer of the company?

#### Answer:

As per requirements of **SA 501**, if the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, seek direct communication with the entity's external legal counsel. The above situation warrants direct communication with company's standing external lawyer.

**Question 20:****(ICAI SM)**

JK Exports Ltd is a manufacturer exporter having its own production capacity and also gets the job work done through various job workers. The auditor of JK Exports Ltd. Considers that inventory held with job workers is material to the financial statements. Suggest the audit procedures in the given case.

**Answer:**

When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

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

**Question 21:****(ICAI SM)**

Parag India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements. Suggest the auditor with reference to SAs.

**Answer:**

- 1) The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:
  - a) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
  - b) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
  - c) Reviewing legal expense accounts.
- 2) If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

**Question 22:****(ICAI SM)**

An auditor is appointed for the first time for audit of accounts of an entity. The accounts of previous year were unaudited. He is unable to obtain sufficient appropriate audit evidence regarding the opening balances. What is his responsibility in this regard?

**Answer:****Reporting by the auditor with regard to opening balances**

- 1) If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with **SA 705**.
- 2) If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with **SA 705**.

**Question 23:****(ICAI SM)**

Explain clearly the examples of matters relevant in planning attendance at physical inventory counting.

**Answer:**

**Matters relevant in planning attendance at physical inventory counting include, for example:**

- a) Nature of inventory.
- b) Stages of completion of work in progress.
- c) The risks of material misstatement related to inventory.
- d) The nature of the internal control related to inventory.
- e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- f) The timing of physical inventory counting.
- g) Whether the entity maintains a perpetual inventory system
- h) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate
- i) Whether the assistance of an auditor's expert is needed.

## Questions from ICAI Model Test Paper

**Question: 24**

**(Model Test Paper-1) / (MTP-I Mar.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:

- 1) 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.
- 2) It is important for the auditor to know beforehand how the inventory count will be conducted so as to assess its effectiveness.
- 3) 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: 25****(Model Test Paper-7) / (MTP-II Dec.24)**

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

**Answer:**

- 1) If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry requesting the entity's external legal counsel to communicate directly with the auditor.
- 2) If law, regulation or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.
- 3) If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:
  - a) A list of litigation and claims;
  - b) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
  - c) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

**Question: 26****(Model Test Paper-8) / (May 24)**

CA Z, the auditor of MNO Ltd., during the course of audit, assesses a risk of material misstatements regarding the litigations and claims involving the company. CA Z is not convinced with the management's explanations regarding the status of the litigations or

claims. It is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general enquiry. The auditor sent a letter of specific enquiry requesting the entity's external legal counsel to communicate directly with the auditor. List out the inclusions in the letter of specific enquiry.

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

**Answer:**

**A letter of specific inquiry includes:**

- (i) A list of litigation and claims;
- (ii) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
- (iii) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims.

Further, if management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or is prohibited from responding, and the auditor is unable to obtain sufficient appropriate evidence by performing alternate audit procedures, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

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

## Questions from ICAI RTP, MTP and Past Exam

**Question 27:**

**(MTP-II Apr.25)**

Wire Limited, a company engaged in manufacturing of electric equipment, gets some part of its production processes outsourced from third parties. During the audit, the company had sent raw material to third parties for carrying out certain processes on these raw

materials and such inventories worth ` 1.50 crores (material to financial statements) were lying with different third parties as at year end. How can auditor obtain sufficient appropriate audit evidence in respect of existence and condition of inventories lying with third parties?

**Answer:**

When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following: -

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

**Other audit procedure may include -**

**For example,**

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

**Question 28:**

**(RTP May 24)**

SPR Ltd has been into the media business since 2001. During the F.Y 2022-2023, many notices were received by the company for hurting public sentiments and financial claims were filed against the company. As an auditor of the company, you requested the management for arranging the meeting with company's external legal counsel. Management is of the view that such meetings are necessary in certain circumstances only. Can you list down such circumstances?

**Answer:**

- 1) Circumstances when it becomes necessary to meet with company's external legal counsel:
- 2) In the given case of SPR Ltd., Auditor requested the management for meeting with SPR's external legal counsel.

- 3) In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims.
- 4) This may be the case, **for example**, where:
  - (i) The auditor determines that the matter is a significant risk.
  - (ii) The matter is complex.
  - (iii) There is disagreement between management and the entity's external legal counsel.
- 5) Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

**Question 29:****(RTP Sept.24)**

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

**Answer:**

- 1) In accordance with requirements of **SA 501, "Audit Evidence- Specific Considerations for Selected Items"**, when inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:
  - a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.
  - b) Perform inspection or other audit procedures appropriate in the circumstances.
- 2) **Other audit procedure may include -**
  - a) Inspecting documentation regarding inventory held by third parties.
  - b) Requesting confirmation from other parties when inventory has been pledged as collateral.
  - c) Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
  - d) Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.



**Question 30:****(RTP Sept.25)**

Bold Ltd. supplies navy uniforms across the country. The company has 5 warehouses at different locations throughout the India and 4 warehouses at the borders. The major stocks are generally supplied from the borders. Bold Ltd. appointed M/s KPM & Co. to conduct its audit for the financial year 2024-25. Mr. P, partner of M/s KPM & Co., attended all the physical inventory counting conducted throughout the India but could not attend the same at borders due to some unavoidable reason.

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

- a) How sufficient appropriate audit evidence regarding the existence and condition of inventory may be obtained?
- b) How is an auditor supposed to deal when attendance at physical inventory counting is impracticable?

**Answer:**

- a) As per **SA 501 "Audit Evidence- Specific Considerations for Selected Items"**, when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:
  - 1) Attendance at physical inventory counting, unless impracticable, to:
    - i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
    - ii) Observe the performance of management's count procedures;
    - iii) Inspect the inventory; and
    - iv) Perform test counts.
  - 2) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.
- b) **Attendance at Physical Inventory Counting Not Practicable:**
  - 1) In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory. For example - where inventory is held in a location that may pose threats to the safety of the auditor.
  - 2) The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in **SA 200**, the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

- 3) In some cases where attendance is impracticable, alternative audit procedures, for example inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.
- 4) In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, **SA 705** requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

**Question 31:****(Jan.25)**

**Fashion Garments Limited (FOL) is a company engaged in the manufacturing and sale of ready-made garments. The products manufactured by FGL cater to clothing requirements of men, women and kids section. Pearl & Associates, Chartered Accountants, is the statutory auditor of FGL. Partner CA Pearl asked her audit assistant to go through the segment information disclosed and presented in the financial statements. Assistant is new to the audit engagements and seeks her guidance on what is the key responsibility of the auditor in relation to segment information.**

**What should CA Pearl guide the assistant on the said matter?**

**What audit procedures should CA Pearl perform to ensure that methods used by the management to present segment information are in accordance with the applicable financial reporting framework?**

**Answer:**

- 1) As per **SA 501, "Audit Evidence-Specific Considerations for Selected Items"**, the auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:
  - a) Obtaining an understanding of the methods used by management in determining segment information, and
  - b) Performing analytical procedures or other audit procedures appropriate in the circumstances.
- 2) The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a standalone basis.

- 3) Further, audit procedure performed by CA Pearl to ensure methods used by the management to present segment information are in accordance with the applicable financial reporting framework should include:
- a) Sales, transfers and charges between segments, & elimination of intersegment amounts.
  - b) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
  - c) The allocation of assets and costs among segments.
  - d) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

**Question 32:****(May 25)**

T Ltd. has appointed NFO & Co., Chartered Accountants, as statutory auditors. Since inventory is a material component of the financial statements, CA F plans to attend the physical inventory counting.

Provide any five matters that CA F should consider when planning their attendance at the physical inventory counting.

**Answer:**

**Matters that CA F should consider when planning attendance at physical inventory counting are:**

- a) Nature of inventory.
- b) Stages of completion of work in progress.
- c) The risks of material misstatement related to inventory.
- d) The nature of the internal control related to inventory.
- e) Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- f) The timing of physical inventory counting.
- g) Whether the entity maintains a perpetual inventory system.
- h) The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate
- i) Whether the assistance of an auditor's expert is needed to obtain sufficient appropriate audit evidence.

## SA 505 – External Confirmation

### Illustrations & Questions from ICAI Study Material

**Question 33:**

**(ICAI SM)/ (RTP May 24)**

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:

- a) Determining the information to be confirmed or requested;
- b) Selecting the appropriate confirming party;
- c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
- d) Sending the requests, including follow-up requests when applicable, to the confirming party.

In the given case, it appears that external auditor has delegated entire work of sending out external confirmation requests to internal audit department over which he has no control. Further, responses to external confirmation requests are received on mail id of internal audit department. **All these acts are not in line with requirements under SA 505.**

**Question 34:**

**(ICAI SM)**

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.

**Question 35:**

**(ICAI SM)**

During the financial year 2022-23, the auditor of Healthy and Wealthy Limited asked a Trade Receivable to respond directly to the auditor whether or not the amount they were required to pay to Healthy and Wealthy Limited was Rs. 1,23,000. That trade receivable confirmed to the auditor of Healthy and Wealthy Limited, that they were required to pay an amount of Rs. 1,23,000 to Healthy and Wealthy Limited. State and explain the type of Confirmation Request as required by the auditor.

**Answer:**

The above-mentioned situation is an **example of Positive Confirmation Request** because in Positive Confirmation Request the party confirms the auditor of a company whether such party agrees or whether such party disagrees with the information for which the confirmation is required by auditor of that company.

**Question 36:**

**(ICAI SM)**

While conducting the audit of AB Ltd, the auditor K of KLM and Associates, Chartered Accountants observes that there are large number of Trade payables and receivables standing in the books of accounts as on 31st March. The auditor wanted to send

confirmation request to few trade receivables, but the management refused the auditor to send confirmation request. Required How would the auditor proceed?

**Answer:**

- 1) If management refuses to allow the auditor to send a confirmation request, the auditor shall:
  - a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
  - b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
  - c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.
- 2) 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**.
- 3) The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with **SA 705**.

**Question 37:**

**(ICAI SM)**

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests.

**Answer:**

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.

## Questions from ICAI Model Test Paper

**Question 38:**

**(Model Test Paper-3) / (Sept.24)**

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

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

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

**Answer:**

- 1) **Positive confirmation request:** A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request or providing the requested information.
- 2) **Exception:** A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party. The exception needs to be assessed to the entire population after analyzing the reason for difference.
- 3) In the given situation, the auditor has sent the positive confirmation request for the amount of 4,25,000 to a trade receivable which was outstanding for more than 6 months, however, due to difference between information requested to be confirmed, or contained in the entity's records (i.e. 4,25,000), and information provided by the confirming party (i.e. 4,20,000) is forming situation of exception confirmation.
- 4) The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330 in case a response is indicating an exception.
- 5) The company should be asked to investigate and reconcile the discrepancy indicated by the confirming party.

**Question 39:****(Model Test Paper-4) / (MTP-I July 24)**

CA X is contemplating the use of negative confirmation requests as the sole substantive audit procedure to verify certain accounts payable balances reflected in financial statements of a company. Which conditions need to be met to use negative confirmation requests as stated above? Additionally, CA X is of the view that negative confirmations provide same level of persuasive audit evidence as in case of positive confirmations. Do you agree with his viewpoint? Provide reasons for your answer.

**Answer:**

- 1) In accordance with SA 505, "External Confirmations", the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:
  - a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion.
  - b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions.
  - c) A very low exception rate is expected and
  - d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.
- 2) The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request.
- 3) Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. **Therefore, view of CA X is not correct.**

**Question 40:****(Model Test Paper-7) / (MTP-II Dec.24)**

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



**Answer:**

- 1) As per **SA 505, "External Confirmation"**, If management refuses to allow the auditor to send a confirmation request, the auditor shall:
  - a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
  - b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
  - c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.
- 2) If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260 "Communication with Those Charged with Governance".
- 3) The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705 "Modifications to the Opinion in the Independent Auditor's Report".

**Questions from ICAI RTP, MTP and Past Exam****Question 41:****(MTP-I Mar.25)**

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

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

**Answer:**

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

Factors to be considered when designing confirmation requests include:

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

**Question 42:**

**(May 25)**

CA Pari is conducting the audit of Heavy Ltd., a company with large number of customers which are generally small retail shop owners. While verifying sundry debtors, CA Pari assesses the risk of material misstatement (ROMM) as low and internal control is operating effectively.

With reference to SA 505 (External Confirmations):

- (i) Which type of confirmation request is most likely to be used by CA Pari in this scenario?
- (ii) What are the conditions necessary for using such a confirmation request effectively?

**Answer:**

- (i) CA Pari is most likely to use Negative Confirmation Request since she has assessed the risk of material misstatement as low and internal control is operating effectively.
- (ii) The auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:
  - a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
  - b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
  - c) A very low exception rate is expected; and

- d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

## SA 510 – Initial Audit Engagements

### Illustrations & Questions from ICAI Study Material

**Question 43:****(ICAI SM)**

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

**Answer:**

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

- a) Opening balances contain misstatements that materially affect the current period's financial statements; and
- b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

**Question 44:****(ICAI SM)**

**M/s Pankaj & Associates, Chartered Accountants, have been appointed as an auditor of ABC Limited. CA Pankaj did not apply any audit procedures regarding opening balances. He argued that since financial statements were audited by the predecessor auditor therefore, he is not required to verify them. Is CA Pankaj correct in his approach?**

**Answer:**

- 1) Initial audit engagement is an engagement in which either:
  - a) The financial statements for the prior period were not audited; or
  - b) The financial statements for the prior period were audited by a predecessor auditor.
- 2) From the above, it is quite clear that CA Pankaj is not correct in his approach and therefore would be required to follow the initial audit engagement and also apply audit procedures regarding opening balances.

- 3) **Audit Procedures regarding Opening Balances:** The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.
- 4) The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:
- a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
  - b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
  - c) Performing one or more of the following:
    - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
    - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
    - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

**Question 45:****(ICAI SM)**

M/s PQR and associates are the statutory auditors of TUV Ltd. for the FY 2022-23-. They have been appointed as statutory auditors of TUV Ltd. for the first time. What is the objective of the engagement partner in terms of SA 510?

**Answer:**

As per SA 510, "Initial Engagement- Opening balances" the objective of the auditor with respect to the opening balances is to obtain sufficient and appropriate audit evidence about whether:

- a) Opening balances contain misstatements that materially affect the current period's financial statements; and
- b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

## Questions from ICAI Model Test Paper

**Question 46:**

**(Model Test Paper-2) / (MTP-II Apr.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:

- a) Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- b) Performing audit procedures on the valuation of the opening inventory items.
- c) Performing audit procedures on gross profit and cut-off.

**Question 47:**

**(RTP May 24)**

The newly appointed auditor of BTN Limited wants to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. What audit procedures should he perform for this purpose?

**Answer:**

**Audit Procedure Regarding Opening Balances:** The newly appointed auditor of BTN Ltd shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor of BTN Ltd shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- 1) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss.

- 2) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- 3) Performing one or more of the following:
  - i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements.
  - ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
  - iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

## SA 520 – Analytical Procedures

### Illustrations & Questions from ICAI Study Material

#### Question 48:

(ICAI SM)

An auditor of a company intends to apply analytical procedures for verifying revenue. Discuss any two analytical procedures which may be performed by auditor relating to revenues

#### Answer:

Analytical procedures in relation to revenue can include:

- a) Comparing revenue of current year with previous year and investigating significant fluctuations
- b) Comparing revenue of current year with budgeted targets and investigating significant fluctuations.

#### Question 49:

(ICAI SM)

CA Aarav wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2022-23. The rent amounts to Rs. 50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of Rs. 10,000/- per month for a similar location. How will applying the analytical procedures impact the verification process of such rental payments by XYZ Ltd.?

**Answer:**

- 1) If CA Aarav checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e. XYZ Ltd. paid Rs. 50,000/- per month as rent and the same is getting reflected in the rent agreement.
- 2) Here, CA Aarav may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location.
- 3) If CA Aarav applies analytical procedure i.e. compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.
- 4) However, if CA Aarav does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.

**Question 50:****(ICAI SM)**

Analytical procedure involves analysis of relationship among financial and nonfinancial data. Explain with the help of an example as to how, the statutory auditor of ABC Ltd. will analyse such relationship with respect to the total wages paid by ABC Ltd. during the FY 2022-23.

**Answer:**

- 1) As per **SA 520, Analytical Procedures** means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.
- 2) The following example explains the analysis of relationship between financial and non-financial data while applying analytical procedures.
- 3) The statutory auditor of ABC Ltd. has to verify the total wages paid by the company having factories in various states.
- 4) He can verify the same by analyzing the relationship between wages per worker and total number of workers across all the factories. i.e. **Total wages = Wages per worker × Total number of workers**. Here wages per worker is financial data i.e. in Rs. and total number of workers is a number which is a non-financial data.
- 5) Thus, the statutory auditor of ABC Ltd. is evaluating financial information i.e. total wages paid (in Rs.) by analyzing the relationship between wages per worker (in Rs.) which is financial data and number of workers which is a non-financial data.
- 6) Analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.

**Question 51:****(ICAI SM)**

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

**Answer:**

- 1) Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition, these are also required during the completion phase.
- 2) Analytical Procedures in Planning the Audit In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures.
- 3) Analytical procedures in planning the audit use both financial data and nonfinancial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.
- 4) **For example**, analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

**Question 52:****(ICAI SM)**

**While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence?**

**Answer:**

While applying the Substantive Analytical Procedures the statutory auditor of a company may use the following techniques to obtain sufficient and appropriate audit evidence

- 1) **Trend analysis:**
  - a) Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances.
  - b) We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.
- 2) **Ratio analysis:**

Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables



balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

**3) Reasonableness tests:**

- a) Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense).
- b) These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

**4) Structural modelling:**

- a) A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).
- b) The statutory auditor may use any of the above-mentioned techniques while applying substantive analytical procedures depending upon the availability of data and requirements of the case.

**Question 53:**

**(ICAI SM)**

The statutory auditor of MNO Ltd., CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non-financial data of MNO Ltd. What should CA Kishore do in this case with reference to SA 520 on "Analytical Procedures"?

**Answer:**

As per SA 520- "Analytical Procedures" If while applying analytical procedures in accordance with SA 520, the statutory auditor identifies fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- a) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.
- b) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

In the present case, CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non-financial data of MNO Ltd. CA Kishore should inquire the management of MNO Ltd. and obtain sufficient and appropriate audit evidence relevant to management response.

Further, CA Kishore should also perform other audit procedures if required in the circumstances of the case to obtain further sufficient and appropriate audit evidence.

**Question 54:****(ICAI SM)**

What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures".

**Answer:**

- 1) The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained.
- 2) Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:
  - a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;
  - b) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
  - c) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
  - d) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.
- 3) The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks.
- 4) When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls.

**Question 55:****(ICAI SM)****Define Analytical Procedures****Answer:****Meaning of Analytical Procedures:**

- 1) As per the **SA 520 "Analytical Procedures"** 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.
- 2) Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. Thus, analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.

### **Questions from ICAI Model Test Paper**

**Question 56:****(Model Test Paper-5) / (MTP-II Aug.24)**

**CA M, auditor of a company, has planned to use substantive analytical procedures during course of audit. In this regard, he has decided to use such procedures in following areas:**

- (i) For testing relationship between sales and cost of sales**
- (ii) For testing rights over certain assets forming part of account balances**

**Comment upon his approach along with reasons.**

**Answer:**

- (i)** Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable. A predictable relationship is one that may reasonably be expected to exist and continue over time.  
In the given case CA M, auditor of a company, has planned to use substantive analytical procedures for testing relationship between sales and cost of sales. Hence, auditor's approach is appropriate in this case.
- (ii)** Using substantive analytical procedures is also affected by nature of assertion. Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations).

In the given case, CA M has planned to use substantive analytical procedures for testing rights over certain assets forming part of account balances. Such procedures are likely to be less effective in this case.

**Question 57:****(Model Test Paper-6) / (MTP-I Nov.24)**

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

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

**Answer:**

In the given case, CA Srishti is performing analytical procedures as risk assessment procedures.

- 1) Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information.
- 2) Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
- 3) Risk assessment procedures are a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

Thus, it can be concluded that auditor's opinion cannot be solely based upon such procedures.

**Question 58:****(Model Test Paper-5) / (MTP-II Aug.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 ₹ 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:

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:**

- 1) 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.
- 2) 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.
- 3) 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.
- 4) 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.

## Questions from ICAI RTP, MTP and Past Exam

**Question 59:**

**(RTP May 25)**

Grape Limited presented its financial statements for the F.Y. 2023-24 to its auditor for expressing an opinion thereon. The auditor while carrying out the audit started comparing various items of profit and loss account of the year under audit with previous financial years. What is auditor trying to achieve by carrying out those comparisons?

**Answer:**

**Purpose of Applying Analytical Procedure:** Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

The auditor of Grape Ltd. would achieve the following by carrying out the comparison stated in the question:

- a) If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years.
- b) By setting up certain expenses' ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.
- c) If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.
- d) It may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications.

## SA 530 - Audit Sampling

### Illustrations & Questions from ICAI Study Material

**Question 60:**

**(ICAI SM)**

An auditor, while conducting audit of an entity, has selected samples based upon his personal experience and knowledge. Later on, it turns out that selected samples were

not representative and it has led to faulty selection of samples. The auditor contends that samples were selected based upon his personal experience and knowledge. Can auditor escape from his responsibility in this regard?

**Answer:**

In the provided situation, the auditor has selected samples based upon his personal experience and knowledge. It, is a case of non-statistical sampling approach adopted by the auditor. Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The auditor cannot escape his responsibility in this regard.

**Question 61:**

**(ICAI SM)**

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

**Answer:**

**Meaning of Audit Sampling:**

- 1) "Audit Sampling" means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.
- 2) The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.
- 3) Sample should be selected in such a manner that it is representative of the population from which the sample is being selected. It will necessitate that each item in the population has an equal chance of being included in the sample.

**Methods of Sampling**

- 1) **Random Sampling:** Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below-
  - a) **Simple Random Sampling:**
    - (i) Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection.

- (ii) Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum).
- (iii) Today random numbers are also generated using various applications on the cellphones like the random number generator. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e it is suitable for a homogeneous population having a similar range.

**b) Stratified Sampling:**

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

**2) Interval Sampling or Systematic Sampling:**

- a) Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.
- b) Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables.
- c) When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

**3) Monetary Unit Sampling:**

It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

**4) Haphazard sampling:**

- a) Haphazard selection, in which the auditor selects the sample without following a structured technique.
- b) Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always



choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection.

c) Haphazard selection is not appropriate when using statistical sampling.

**5) Block Sampling:**

a) This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population.

b) Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

c) Usually, a range of continuous transaction shall have similar characteristics, therefore, selection of a group at one time will not give a reasonable basis for opinion on the overall population as different types of transactions and unusual transactions may not be covered in the group taken all at once.

**Question 62:**

**(ICAI SM)**

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

**Answer:**

**1) Audit Sampling:**

As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is - the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. The requirements relating to sample design, sample size and selection of items for testing are explained below

**2) Sample design:** When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

**3) Sample Size:** The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

**4) Selection of Items for Testing:** The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

**Question 63:****(ICAI SM)**

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

**Answer:****Risk Factors while applying Sampling Techniques:**

As per SA 530 "Audit Sampling", sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions-

- a) In the case of a test of controls, that controls are more effective than they actually are, or in the case of tests of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- b) In the case of test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

**Question 64:****(ICAI SM)**

Write short notes on the following:

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

**Answer:****a) Advantages of Statistical sampling in Auditing.**

In statistical sampling, the sample results are measurable as to the adequacy and reliability of the audit objectives whereas in non-statistical sampling the auditor's opinion determines the sample size but it cannot be measured how far the sample size would fulfill the audit objective. The advantages of statistical sampling may be summarized as follows -

- 1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- 2) The sample selection is more objective and thereby more defensible.
- 3) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.

- 4) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
- 5) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.
- 6) It is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

**b) Stratified Sampling:**

- 1) This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them.
- 2) Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum.
- 3) The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.
- 4) The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.
- 5) Stratification means dividing heterogeneous (Diversified) population into Homogeneous (having similar characteristics) sub population, where samples are drawn from each sub population.
- 6) Therefore, we can say that random selection method is applied through random number generators, for example, random number tables.

## Questions from ICAI Model Test Paper

**Question 65:**

(Model Test Paper-2) / (MTP-II Apr.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:**

- 1) 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.
- 2) 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."
- 3) **Specific items selected may include:**
  - a) **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.
  - b) **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.
  - c) **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.

**Conclusion:**

**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.

**Question 66:****(Model Test Paper-3) / (Sept.24)**

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

**Answer:****Statistical sampling:**

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

**Statistical Sampling is more scientific and appropriate as:**

- 1) Audit testing done through this approach is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances.
- 2) Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.
- 3) There is no personal bias of the auditor in case of statistical sampling. Since it is scientific, the results of samples can be evaluated and projected on the whole population in a more reliable manner.
- 4) In larger organisations, with huge transactions, statistical sampling is always recommended as it is unbiased, and the samples selected are not prejudged.

**Question 67:****(Model Test Paper-3) / (Sept.24)**

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

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

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

**Answer:**

**Sample Selections Methods:**

**(i) Stratified Sampling:**

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

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

**(ii) Block Sampling:**

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

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

**Question 68:**

**(Model Test Paper-5) / (MTP-II Aug.24)**

During the audit of a company, CA Z is using a software to select samples pertaining to sales records of the company. While performing this process, a window opens in software prompting the user to enter certain information. CA Z is in the process of entering information in this regard as given under:

Selection Interval	?
Number of records to select	100

Starting record number to select	1
Ending record number to select	1000
File name	Sales

Going through the above fields, which method of sampling is likely being used in the software? Discuss. Which foremost consideration should be kept in mind by auditor for selecting samples in such a manner?

Additionally, partner of CA Z suggested him to select the first 200 sales invoices from the sales book of the last month. Which method of sampling is being suggested by partner of CA Z?

**Answer:**

- 1) In the given case, method of sampling being used in software is known as interval sampling or systematic sampling. It is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval.  
Sampling interval = Sampling units in population / Sample size i.e.  $1000/100$   
Sampling interval = 10  
Records selected = 100  
Software would pick every 10th record from 1 to 1000 records.
- 2) When using this method, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.
- 3) Further, partner of CA Z suggested him to select the first 200 sales invoices from the sales book for the last month. He is suggesting him block sampling for sales, this method involves selection of a block(s) of contiguous items from within the population.

**Question 69:**

(Model Test Paper-6) / (MTP-I Nov.24)

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

**Answer:**

- 1) In the given case, while performing tests of details on a sample in respect of sales, misstatements have been found by CA Shubham in selected sample pertaining to the sales transactions of small values. This indicates observance of deviations and misstatements while performing tests of controls and tests of details respectively in selected samples.
- 2) As per **SA 530, "Audit Sampling"**, in analysing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time.
- 3) In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.
- 4) Therefore, the auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.
- 5) In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population.
- 6) The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

**Question 70:****(Model Test Paper-8) / (May 24)**

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

**Answer:**

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

- (i) The auditor's understanding of the entity,
- (ii) The assessed risks of material misstatement, and
- (iii) The characteristics of the population being tested.



Specific items selected may include:

- a) **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.
- b) **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.
- c) **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.

## SA 550 – Related Parties

### Illustrations & Questions from ICAI Study Material

Question 71:

(ICAI SM)

Many related party transactions are in the normal course of business. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Give few examples of such areas.

Answer:

- 1) Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties.
- 2) However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.
- 3) **For Example,**
  - a) Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
  - b) Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
  - c) Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

**Question 72:****(ICAI SM)**

The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Explain with the help of at least three examples.

**Answer:**

- 1) Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties.
- 2) However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.
- 3) **Example**
  - a) Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
  - b) Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
  - c) Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

## Questions from ICAI Model Test Paper

**Question 73:****(Model Test Paper-4) / (MTP-I July 24)**

While performing audit of financial statements of a listed company, statutory auditor needs to maintain an attitude of professional skepticism for related party information. State examples of the records or the documents that may provide information about related party relationships and transactions.

**Answer:**

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. Examples of the records or the documents that may provide information about related party relationships and transactions are:

- 1) Entity income tax returns.
- 2) Information supplied by the entity to regulatory authorities.

- 3) Shareholder registers to identify the entity's principal shareholders.
- 4) Statements of conflicts of interest from management and those charged with governance.
- 5) Records of the entity's investments and those of its pension plans.
- 6) Contracts and agreements with key management or those charged with governance.
- 7) Significant contracts and agreements not in the entity's ordinary course of business.
- 8) Specific invoices and correspondence from the entity's professional advisors.
- 9) Life insurance policies acquired by the entity.
- 10) Significant contracts re-negotiated by the entity during the period.
- 11) Internal auditor's reports.
- 12) Documents associated with the entity's filings with a securities regulator (e.g. prospectuses).

**Question 74:****(MTP-II Apr.25)**

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances.

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the records or documents that may provide information about related party relationships and transactions. Explain in detail with examples.

**Answer:**

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the following records or documents that may provide information about related party relationships and transactions, **for example:**

- 1) Entity income tax returns.
- 2) Information supplied by the entity to regulatory authorities.
- 3) Shareholder registers to identify the entity's principal shareholders.
- 4) Statements of conflicts of interest from management and those charged with governance.
- 5) Records of the entity's investments and those of its pension plans.
- 6) Contracts and agreements with key management or those charged with governance.
- 7) Significant contracts and agreements not in the entity's ordinary course of business.
- 8) Specific invoices and correspondence from the entity's professional advisors.
- 9) Life insurance policies acquired by the entity.

- 10) Significant contracts re-negotiated by the entity during the period.
- 11) Internal auditors' reports.
- 12) Documents associated with the entity's filings with a securities regulator e.g, prospectuses).

## SA 610 - Using the work of another Auditor

### Illustrations & Questions from ICAI Study Material

#### Question 75:

(ICAI SM)

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.

#### Question 76:

(ICAI SM)

CA Sukesh is external auditor of an entity. He comes to know that there is also an internal auditor in the entity. However, he finds that internal auditor is not reporting directly to higher echelons of the management. CA Sukesh has also assessed risk of material misstatement to be high. Discuss, whether it would be proper for CA Sukesh to rely upon work of internal auditor extensively in above situation.

**Answer:**

In the given case, the organizational status of internal audit function is not commensurate with his duties. He is not reporting directly to higher echelons of management. It shows that such a function is not given its due importance in entity. Since risk of material misstatements has also been assessed as high by CA Sukesh, both the above factors suggest that **he should not rely upon work of internal auditor extensively.**

**Question 77:****(ICAI SM)**

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

**Answer:**

The external auditor shall not use the work of the internal audit function if the external auditor determines that:

- a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
- b) The function lacks sufficient competence; or
- c) The function does not apply a systematic and disciplined approach, including quality control.

**Question 78:****(ICAI SM)**

**Discuss what is understood by "appropriateness" of audit evidence.**

**Answer:**

Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and nature, and is dependent on the individual circumstances under which it is obtained.

**Question 79:****(ICAI SM)**

**Maintaining accounts using accounting software having a feature of recording audit trail can be useful for an auditor. Discuss some of the advantages for such a feature in accounting software for auditors.**

**Answer:**

- 1) An audit trail is a documented flow of a transaction. It is used to investigate how a source document was translated into an account entry and from there it was inserted into financial

statement of an entity. It is used as audit evidence to establish authentication and integrity of a transaction.

- 2) Audit trails help in maintaining record of system and user activity. Like, in case of banks, there is an audit trail keeping track of log-on activity detailing record of log-on attempts and device used.
- 3) It is a step-by-step record by which accounting, trade details, or other financial data can be traced to their source. Audit trails are used to verify and track many types of transactions including accounting and financial transactions.
- 4) Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use.
- 5) Audit trails help to enhance internal controls and data security. Audit trails can help in fixing responsibility, rebuilding events and in thorough analysis of problem areas. For example, audit trails can track activities of users thus fixing responsibility for users. These can also be used to rebuild events upon occurring of some problem.
- 6) Audit trail analysis can specify reason of the problem. It can also help in ensuring operation of system as intended. In this way, audit trails can help entities in their regular system operations. However, audit trails involve costs.
- 7) The cost is not only in terms of system expenditure but also in terms of time involved in analysing data made available by audit trails. However, use of automated tools can be made to analyse large volume of data thrown up by audit trails. Systems which have a feature of audit trail inspires confidence in auditors.
- 8) It helps auditors in verifying whether controls devised by the management were operating effectively or not. It aids in verification whether a transaction was indeed performed by a person authorised to do it.
- 9) Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.

**Question 80:****(ICAI SM)**

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

**Answer:****Precautions to be taken while applying test check techniques are**

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

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

**Question 81:****(ICAI SM)**

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

**Answer:**

The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

- 1) Size of the organisation under audit.
- 2) State of the internal control.
- 3) Adequacy and reliability of books and records.
- 4) Tolerable error range.
- 5) Degree of the desired confidence.

## Questions from ICAI Model Test Paper

**Question 82:****(Model Test Paper-1) / (MTP-I Mar.24)**

**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:**

- 1) 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.
- 2) 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.
- 3) 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.

**Question 83:****(Model Test Paper-8) / (May 24)**

**Mr. L is a principal auditor of OP Ltd. There are several divisions of OP Ltd. that are audited by other auditors. State the procedures Mr. L should ordinarily perform to obtain sufficient and appropriate audit evidence that the work of other auditors is adequate for the principal auditor's purpose in the context of this assignment.**

**Answer:**

The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

- (i) Advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as are as requiring special consideration, procedures for the identification of inter -component transactions that may require disclosure and the time-table for completion of audit; and
- (ii) Advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.
- (iii) The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be



in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor.

**Question 84:****(Model Test Paper-8) / (May 24)**

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

**Answer:**

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

- (i) Discussions take place at appropriate intervals throughout the period.
- (ii) The external auditor informs the internal audit function of significant matters that may affect the function.
- (iii) The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

**Question 85:****(Jan.25)**

PQR & Co., Chartered Accountants, has been appointed as statutory auditor of MGM Ltd. The financial statements of the company have material amount outstanding as debtors. Ageing of debtors is being done by the internal auditors and is given by them in their monthly report. This issue was also discussed with the management. The engagement partner from PQR & Co. decided to give the age wise debtors as per the report of internal auditor due to shortage of time. After the audit report was released, the engagement partner realized that the disclosure of the debtors is misleading and the ageing was not done by the internal auditor on correct principles due to which the provision made against old debtors was wrong. The engagement partner held the internal auditor responsible for this. Is he correct in making statement that the internal auditor

is responsible for false provisioning? What considerations PQR & Co. should have undertaken before relying on the work of internal auditor?

**Answer:**

- 1) In the given situation, the engagement partner has taken the age wise debtor report from the reports of the internal auditor due to shortage of time and provided the same in the audit report. However, after the issuance of audit report, engagement partner felt that disclosure of debtors is misleading and ageing was not done on the basis of correct principles due to which wrong provisions are made.
- 2) Contention of the engagement partner for holding internal auditor responsible for the same is not correct as the external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement.
- 3) Before relying on the work of internal auditor, PQR & Co. should consider the following:
  - a) To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent; and having made that determination;
  - b) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit; and
  - c) If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work;
  - d) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors;
  - e) The level of competence of the internal audit function; and
  - f) Whether the internal audit function applies a systematic and disciplined approach, including quality control.

**Question 86:**

**(RTP Sept.25)**

CA Mukul is the external auditor of Beige Ltd., a large company, engaged in the manufacturing of fast-moving consumer (FMCG) goods. After assessing the internal audit function of the company, CA Mukul decided to use the internal auditor of the company to provide direct assistance. In this context, what is meant by direct assistance under relevant Standard on Auditing? Also comment whether prior to using internal auditor for direct assistance for the purpose of audit, CA Mukul is required to obtain any written

agreements or not. Give examples of procedures in which CA Mukul shall not use an internal auditor to provide direct assistance.

**Answer:**

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

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

- a) Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor and
- b) Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

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

- a) Procedures which involve making significant judgments in the audit;
- b) Procedures relating to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited.
- c) Procedures relating to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or
- d) Procedures relating to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.



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## CHAPTER

## 5

**Audit of items of Financial Statements****Case Study**

Sunsteel Ltd. is a company engaged in the manufacture of variety of stainless steel household items ranging from hot pot, pressure cooker, cutlery set, bottles, to serving trays. The company has its corporate office in Delhi and its plant in Raigarh, a city in the state of Chhattisgarh. The company is planning to expand its manufacturing activities by setting up two new plants in the Raipur district of the state. For this purpose, the company also raised funds by making a follow-on public offer during the financial year 2022-23. R K Maheshwari & Associates are the statutory auditors of the company since the year 2020-21. The engagement team consisted of 5 members, with CA Raman as the engagement partner, CA Madhu as the senior associate and three articled trainees namely, Aman, Chetanya and Depesh.

The company raised fresh capital of ₹ 5 Cr during the FY 2022-23. The shares with the nominal value of ₹ 10 per share were issued at a premium of ₹ 5 per share.

The company has the Reserves and Surplus totaling to ₹ 2 Cr, comprising of securities premium and general reserve.

CA Raman directed CA Madhu to verify the issue of the share capital in detail giving special consideration to the utilization of the securities premium amount.

The audit engagement team discussed with the management about the performance of the company during the year under consideration. To this, the management told the engagement team that the company is performing very well and the company has doubled its revenue during the year as compared to the last year. The management of the company also told the auditors that during the year the company has made majority of its sales on credit basis to its customers.

CA Raman directed Mr. Aman to send balance confirmation requests to debtors having balance in excess of ₹ 1 lakh.

During the course of audit, CA Raman, Chetanya and Depesh also visited the power plants in Raigarh to get a detailed understanding of the manufacturing process. The team performed analytical procedures to obtain audit evidence with respect to the overall reasonableness of purchase quantity and price of inventory. More specifically, Chetanya

collected the reports from the management for composition of stock i.e. raw materials as a percentage of total stock and compared the same with the data of the previous year. CA Raman and Chetanya thereafter, discussed the reasons for the variations with the management.

Also, while considering the presentation and disclosure requirements as per Schedule III to the Companies Act, CA Madhu discussed with CA Raman the disclosure with respect to the following account balances:

- a) Current maturities to long term borrowings
- b) Long term maturities of finance lease obligations
- c) Interest accrued but not due on borrowings
- d) • Interest accrued and due on borrowings

Based upon above, answer the following questions:

- 1) Which of the following is not correct with respect to shares issued at premium and securities premium account in terms of Section 52 of the Companies Act, 2013?
  - a) Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a securities premium account.
  - b) The securities premium account can be applied by the company in paying up unissued equity shares of the company to be issued to members of the company as fully paid bonus shares.
  - c) The securities premium account cannot be applied by the company in writing off the expenses of or the commission paid or discount allowed on any issue of equity shares of the company.
  - d) The securities premium account can be applied by the company for the purchase of its own shares or securities under section 68.
- 2) Which of the following is not an example of capital reserve?
  - a) Revaluation reserve arising from revaluation of fixed assets
  - b) Securities Premium
  - c) Capital redemption reserve
  - d) General reserve

- 3) **Statement 1: Confirmations as well as undelivered letters should be given/ returned to the auditor and not to the client.**  
**Statement 2: When no reply is received, the auditor should perform alternate procedures regarding the balances.**
- a) Only statement 1 is correct
  - b) Only statement 2 is correct
  - c) Both statements 1 & 2 are correct
  - d) Both statements 1 & 2 are incorrect
- 4) **Mr. Chetanya performed which of the following analytical procedures to obtain the audit evidence with respect to the overall reasonableness of purchase quantity and price of raw material?**
- a) Consumption Analysis
  - b) Stock Composition Analysis
  - c) Reasonableness test
  - d) Ratio analysis
- 5) **Which of the following is not correct with respect to the disclosure requirements of Schedule III to the Companies Act 2013?**
- a) Current maturities of long term borrowings is to be disclosed under the head long term borrowings
  - b) Long term maturities of finance lease obligations is to be disclosed under the head long term borrowings
  - c) Interest accrued but not due on borrowings is to be disclosed under the head Other Current Liabilities
  - d) Interest accrued and due on borrowings is to be disclosed under the head Other Current Liabilities

### **Answers to Case Study 1**

- 1) c)
- 2) d)
- 3) c)
- 4) b)
- 5) a)

## Independent MCQ's

- 1) An auditor is verifying purchases to ensure their genuineness. Consequently, he is also trying to verify that no fake "trade payables" are present in financial statements. Which assertions concerning purchase transactions and trade payables respectively are being verified by auditor?
  - a) Occurrence; Existence
  - b) Occurrence; Completeness
  - c) Existence; Occurrence
  - d) Completeness; Occurrence
- 2) Which of the following statement is most appropriate as regards to disclosure of goods in transit in financial statements of a company?
  - a) No separate disclosure of goods in transit is required.
  - b) Disclosure of total goods in transit under head of inventories is required.
  - c) Disclosure of goods in transit under each sub-head of inventories is required.
  - d) Disclosure of goods in transit for raw material and finished goods is required.
- 3) Sweat Equity shares are issued by a company at a discount or for consideration other than cash to its:
  - a) Directors only
  - b) Clients only
  - c) Directors or employees
  - d) Auditors only
- 4) Which of the following is not an element of cost of an item of machinery included under head "Property, Plant and Equipment"?
  - a) Installation costs
  - b) Freight cost of bringing the item to its location
  - c) Inaugural costs
  - d) Employee benefit cost for making such an item suitable for production



- 5) Which of the classification is not required by a company in respect of its "Cash and cash equivalents?"
- a) Balance with Banks
  - b) Balance with scheduled banks
  - c) Cash on hand
  - d) Cheques on hand

**Answers to the MCQs based Questions:**

- 1) a)
- 2) c)
- 3) c)
- 4) c)
- 5) b)

## Descriptive Questions

### Questions from ICAI Study Material

**Question 1:**

(ICAI SM)

A company is engaged in manufacturing of fabrics from yarn purchased from different suppliers. Occasionally, it also manufactures fabrics tailor made in accordance with requirements of certain mills from yarn received from these mills. The company raises bill of its labour charges only on mills for converting yarn into fabrics. The auditor of company tries to ensure that stocks of the company as at year end do not include stocks pertaining to these mills. Which assertion auditor tries to verify in above situation? How he can ensure that?

**Answer:**

The auditor is trying to verify assertion relating to "Rights and Obligations". He is verifying that the company owns or controls the inventory recorded in the financial statements. Any inventory held by the company on behalf of another entity has not been recognized as part of inventory of the company. This can be achieved by verifying stock records pertaining to goods received from mills and sent back to mills after carrying out necessary operations. Besides, agreements with such mills may also be verified.

**Question 2:****(ICAI SM)**

A company has availed cash credit facility of ₹ 2 crore (O/s balance ₹ 2 crore as at year end) from a bank for meeting its working capital requirements against security of stocks and debtors and guaranteed by directors of the company. Discuss, how the above cash credit facility, would be classified and disclosed in financial statements of company.

**Answer:**

It shall be shown under the head "**Borrowings**" and classified as Short-term secured borrowings specifying nature of security. The above said outstanding amount shall be further sub-classified under heading "**Loans repayable on Demand**" from Banks.

As per requirements of Schedule III of Companies Act, 2013, where loans have been guaranteed by directors or others, aggregate amount of such loans under each head shall be disclosed.

**Question 3:****(ICAI SM)**

Various ratios of current year and preceding year are disclosed in financial statements of a company in accordance with requirements of Schedule III of Companies Act, 2013. Discuss requirements of law in this regard (Do not list out names of ratios)

**Answer:**

A company has to disclose various ratios in its financial statements in accordance with requirements of Schedule III of Companies Act, 2013. The company shall also explain the terms included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

**Question 4:****(ICAI SM)**

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.

**Question 5:****(ICAI SM)**

While verifying depreciation charged to statement of profit and loss account of a company, it is noticed by auditor that one new machinery was purchased and installed in month of April. The necessary trials were carried out and machinery was ready for use in April itself. However, owing to lack of orders in the market, the said machinery was put into actual operation from 1st October. The company has, accordingly, provided depreciation in its books on this machinery w.e.f. 1st October. Is above recording of depreciation by company proper in its books?

**Answer:**

Depreciation of an asset begins when it is available for use i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management. Depreciation on asset is charged on asset from the date when it is ready for use and not from date of actual usage. Hence, recording of depreciation by company w.e.f. 1st October is not proper.

**Question 6:****(Old Syllabus Questions, still included in ICAI Study Material)**

How will you vouch and/or verify the following:

- a) Goods sent out on Sale or Return Basis.
- b) Borrowing from Banks.

**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.

**b) Borrowing from Banks:**

Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows-

- (i) Reconcile the balances in the overdrafts or loan accounts with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
- (ii) Obtain independent balance confirmation from the bank showing balances, particulars of securities deposited with the bank as security for the loans or of the charge created on an asset and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
- (iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.
- (iv) Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened. Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

**Question 7: (Old Syllabus Questions, still included in ICAI Study Material)**

How will you vouch/verify the following?

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

**Answer:**

**a) Goods Sent on Consignment:**

- (i) Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.

- (ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.
- (iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.
- (iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.
- (v) See that goods in hand with the consignee have been shown separately under the head inventories.

**b) Foreign Travel Expenses:**

- (i) Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.
- (ii) Verify that the tour programme was properly authorised by the competent authority.
- (iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.
- (iv) See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.
- (v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".

**c) Receipt of Capital Subsidy:**

- (i) Check the application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.

- (ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.
- (iii) Ensure that the conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.
- (iv) Check relevant entries for receipt of subsidy.
- (v) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

**d) Provision for Income Tax:**

- (i) Obtain the computation of income and income tax prepared by the entity and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.
- (ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.
- (iii) Examine relevant records and documents pertaining to advance tax, self-assessment tax and other demands.
- (iv) Compute tax payable as per the latest applicable rates in the Finance Act.
- (v) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc.
- (vi) Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under audit.

**Question 8: (Old Syllabus Questions, still included in ICAI Study Material)**

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

**Answer:**

**Vouching of Payment of Taxes:**

- 1) 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.
- 2) Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.
- 3) 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.

- 4) 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.
- 5) 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.
- 6) 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 9: (Old Syllabus Questions, still included in ICAI Study Material)**

How would you vouch/verify the following:

- a) Advertisement Expenses.
- b) Sale of Scrap.

**Answer:**

**a) Advertisement Expenses:**

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

**b) Sale of Scrap:**

- (i) Review the internal control as regards generation, storage and disposal of scrap.
- (ii) Check whether the organization is maintaining reasonable record for generation of scrap.
- (iii) Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.
- (iv) Check the rates at which scrap has been sold and compare the rate with previous year.
- (v) Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.

- (vi) Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.
- (vii) Make an overall assessment of the value of realization from scrap as to its reasonableness.

**Question 10:****(ICAI SM)**

ABC Ltd. has issued shares for cash at a premium. Section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account. Advise the means in which the amount in the account can be applied.

**Answer:****Shares Issued at Premium:**

- 1) In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the means in which the amount in the account can be applied.
- 2) As per the section, where a company issue shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account" and the provisions of this Act relating to reduction of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.
- 3) **Application of securities premium account:**  
The securities premium account may be applied by the Company:
  - a) Towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
  - b) In writing off the preliminary expenses of the Company;
  - c) In writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
  - d) In providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
  - e) For the purchase of its own shares or other securities under section 68.
- 4) The auditor needs to verify whether the premium received on shares, if any, has been transferred to a "securities premium account" and whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above



**Question 11:****(ICAI SM)**

The auditor A of ABC & Co. - firm of auditors is conducting the audit of XYZ Ltd and while performing testing of additions wanted to verify that all PPE (Property Plant and Equipment) purchase invoices are in the name of the entity he is auditing. For all additions to land, building in particular, the auditor desires to have concrete evidence about ownership. The auditor is worried about whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Advise the auditor.

**Answer:**

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

**Question 12:****(ICAI SM)**

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

**Answer:**

**For Verification of Existence of Trade Receivables, the auditor should check the following:**

- 1) Check whether there are controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice. Ask for a period-end accounts receivable ageing report and trace the balance as per the report to the general ledger.

- 2) Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoice-wise and on FIFO basis i.e. previous bill is adjusted first.
- 3) If any large balance is due for a long time, auditor should ask for reasons and justification for the same.
- 4) A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed.
- 5) The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.
- 6) Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample.
- 7) Where no reply is received, the auditor should perform alternate procedures regarding the balances.
- 8) Agreeing the balance to cash received subsequently;
- 9) Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (examination in depth for those balances)
- 10) If there are any related party receivables, review them for collectability as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.
- 11) Check that receivables for other than sales or services are not included in the list.
- 12) Review a trend line of sales and accounts receivable, or a comparison of the two over time, to check if there are any unusual trends i.e. perform Analytical procedures. Make inquiries about reasons for changes in trends with the management and document the same in audit work papers.

**Question 13:****(ICAI SM)**

**MNO & Associates are the statutory auditor of Venus Ltd. for the FY 2021-22. During the course of audit, one of the audit team members, Mr. Viaan noticed that the company has made loans totaling to ₹ 50 lakhs to the promoters of the company, namely, Mr. Raj and Mr. Rajeev without specifying the period of repayment. Mr. Viaan discussed with Mr. Manik, the engagement partner, about the disclosure requirements with respect**

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

**Answer:**

Mr. Manik should advise Mr. Viaan to consider whether the following disclosures as required by Schedule III to the Companies Act, 2013, has been made in respect of the loans granted to promoters, namely, Mr. Raj and Mr. Rajeev, either severally or jointly with any other person, that are:

- a) Repayable on demand or
- b) Without specifying any terms or period of repayment

Type of Borrower	Amount of loan or advance in the nature of loan outstanding	Percentage to the total Loans and Advances in the nature of loans
Promoters		
Directors		
KMPs		
Related Parties		

**Question 14:**

(ICAI SM)

What are the disclosures requirements as per Part I of Schedule III to the Companies Act with respect to the cash & cash equivalents held by a company?

**Answer:**

**Disclosure of Cash & Cash Equivalent in the Financial Statements:**

The following are the disclosure requirements as per Schedule III to the Companies Act, 2013, with respect to the cash & cash equivalents held by the company:

- (i) Cash and cash equivalents shall be classified as:
  - a) Balances with banks;
  - b) Cheques, drafts on hand;
  - c) Cash on hand;
  - d) Others (specify nature)
- (ii) Earmarked balances with banks (for eg., for unpaid dividend) shall be separately stated.
- (iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
- (iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
- (v) Bank deposits with more than 12 months' maturity shall be disclosed separately.

**Question 15:****(ICAI SM)**

Mercury Ltd. is a company engaged in the manufacture of floor mats. The company sells its goods on credit. The debtors balance as on 31.03.2022 amounted to ₹ 20 cr. What is the disclosure requirement as per Schedule III to the Companies Act 2013, with respect to the ageing schedule of debtors of the company?

**Answer:**

The following are the disclosure requirement as per Schedule III to the Companies Act 2013, with respect to the ageing schedule of debtors of the company:

**Trade Receivable ageing schedule (Table 1)**

Particulars	Outstanding for following periods from due date of payments					
	Less than 6 Months	6 Months - 1 Year old	1-2 Years	2-3 Years	More than 3 Years	Total
(i) Undisputed TR - Considered Good.						
(ii) Undisputed TR - Considered Doubtful.						
(iii) Disputed TR - Considered Good.						
(iv) Disputed TR - Considered Doubtful						

**Question 16:****(ICAI SM)**

You are the statutory auditor of Jupiter Ltd. for the FY 2022-23. During the course of audit, you noticed that the company has PPE under construction i.e. Capital Work in Progress. What disclosures should the company give with respect to the ageing schedule of such capital work in progress as required by Schedule III to the Companies Act, 2013?

**Answer:****Capital-Work-in Progress**

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

CWIP ageing schedule

CWIP	Amount in CWIP for a period of				Total
	Less than 1 Year	1-2 Years	2-3 Years	More than 3 Years	
Projects in Progress					
Projects temporarily suspended					

\*Total shall tally with CWIP amount in the balance sheet.

b) For capital-work-in progress, whose completion is overdue or has exceeded its cost compared to its original plan, following CWIP completion schedule shall be given\*\*:

CWIP	To be completed in			
	Less than 1 Year	1-2 Years	2-3 Years	More than 3 Years
Project 1				
Project 2				

\*\*Details of projects where activity has been suspended shall be given separately.

#### Question 17:

(ICAI SM)

The auditor of Saturn Ltd. wants to verify whether the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2023. What audit procedures should the statutory auditor of the company perform?

#### Answer:

The statutory auditor of Saturn Ltd. should perform the following audit procedures to verify if the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2023.

The auditor should:

- Vouch recorded purchases to underlying documentation (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file).
- Evaluate the consigned goods.
- Examine client correspondence, sales and receivables records, purchase documents.
- Determine existence of collateral agreements.
- Review consignment agreements.
- Review material purchase commitment agreements.

- g) Examine invoices for evidence of ownership i.e. the invoices shall be in the name of the client.
- h) Obtain confirmation for significant items of inventory.

For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.

## Questions from ICAI Model Test Paper

### Question 18:

(Model Test Paper-1) / (MTP-I Mar.24)

Prudent Enterprises Private Limited has incurred and fully spent for the first time Corporate Social Responsibility (CSR) expenditure amounting to ₹ 14.50 lacs in pursuance to provisions of section 135 of Companies Act, 2013. The expenditure was spent for women empowerment programmes through an implementing agency (not a related party). As per law provisions, it was required to spend ₹ 14.00 lacs during the year. Discuss how such information is required to be disclosed in accordance with requirements of Schedule III to the Companies Act, 2013 in financial statements of the company.

### Answer:

In the given situation, following information is required to be disclosed in accordance with requirements to Schedule III to the Companies Act, 2013:

(i) Amount required to be spent by the company during the year	₹ 14.00 lacs
(ii) Amount of expenditure incurred	₹ 14.50 lacs
(iii) Shortfall at the end of the year	NIL
(iv) Total of previous years shortfall	NA
(v) Reason for shortfall	NA
(vi) Nature of CSR activities - Women empowerment activities through implementing agency	
(vii) Details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard	NIL
(viii) Where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately	NIL

**Question 19:****(Model Test Paper-1) / (MTP-I Mar.24)**

You are part of engagement team conducting audit of an entity engaged in manufacturing business. State few audit procedures you would undertake to perform to verify that recorded sales in financial statements represent goods actually sold during the period and recorded sales are not overstated.

**Answer:**

Following audit procedures can be performed to perform to verify that recorded sales in financial statements represent goods actually sold during the period and recorded sales are not overstated.

- a) Check whether a single sales invoice is recorded twice or a cancelled sales invoice has been recorded.
- b) Test check few invoices with their relevant entries in sales journal.
- c) Obtain confirmation from few customers to ensure genuineness of sales transaction
- d) Check whether any fictitious customers and sales have been recorded.
- e) Verify whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure
- f) Whether unearned revenue recorded as earned.
- g) Whether any substantial uncertainty exists about collectability
- h) Whether customer obligations are contingent on other (financing, resale, etc.).
- i) Review sequence of sales invoices
- j) Review journal entries for unusual transactions
- k) Calculate the ratio of sales return to sales and compare it with previous year and enquire for the reasons for unusual variation.

**Question 20:****(Model Test Paper-1) / (MTP-I Mar.24)**

WTE Private Limited is engaged in business of manufacturing a product liable to GST @ 5%. The input raw materials for manufacturing this product are liable to GST @ 12% and 18%. As a result, at the end of financial year, ITC on inputs amounting to ₹ 60 lacs is accumulated in Electronic Credit ledger and refundable to company under provisions of GST law. How would above amount of ₹ 60 lacs be reflected and classified in balance sheet of company? State few audit procedures to be performed by you for verification of above said balance.

**Answer:**

In the given situation, ₹ 60 lacs is accumulated in Electronic credit ledger of WTE Private Limited as finished product is liable to lower GST rate whereas input raw materials for

manufacturing carry higher GST rate. It is refundable to company by virtue of provisions of GST law. The above balance would be reflected and classified under current assets. Within current assets, it would be classified into "Other current assets".

Few audit procedures to be performed for verification of above balance are:

- In relation to balances with statutory authorities like GST input credit, prepare a reasonability analysis with respect to purchases by applying the applicable rate to the purchases and in case of any variance with the asset recorded by the entity, reasons for variance should be requested from the entity.
- Obtain copies of statutory GST returns filed on GST portal.
- In case refundable amount as on balance sheet date is still outstanding, verify whether the amount recorded as per books of account tallies with the claim made with the authorities subsequently by going to GST portal.
- In case refundable amount as on balance sheet date is received subsequently, verify it from Bank statement.

#### Question 21:

(Model Test Paper-2) / (MTP-II Apr.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 ₹ lacs)
1	Trade Receivables	240.00

Trade receivables ageing schedule.

Outstanding's for following periods from due date of payment (in ₹ 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:
  - a) Undisputed trade receivables considered good
  - b) Undisputed trade receivables considered doubtful
  - c) Disputed trade receivables considered good
  - d) 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
  - a) For less than 6 months
  - b) 6 months-1 year
  - c) 1- 2 years
  - d) 2-3 years
  - e) 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
  - a) Directors or other officers of the company or any of them either severally or jointly with any other person or
  - b) Firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

**Question 22:****(Model Test Paper-2) / (MTP-II Apr.24)**

Being statutory auditor of JAL Limited, a company engaged in manufacturing of chemicals, CA Gopika has understood that company is expected to have material work-

in-progress as on 31st March, 2024. State few audit procedures to verify existence and valuation assertions for work-in-progress.

**Answer:**

**Audit procedures to verify existence and valuation assertions for work-in-progress are as under: -**

- 1) Attend inventory count in accordance with SA 501 and understand how work in progress is arrived at.
- 2) Evaluate work of management expert, if any, in this regard.
- 3) Ascertain how the various stages of production/ value additions are measured and in case estimates are made, understand the basis for such estimates.
- 4) Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity.
- 5) Ensure that material costs exclude any abnormal wastage factors.

**Question 23:**

**(Model Test Paper-3) / (Sept.24)**

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

**Answer:**

- 1) Disclosure of Ratios as a part of Additional Regulatory Information as per Schedule III of the Companies Act 2013 and its Rules relating to disclosure are:
  - a) Current Ratio,
  - b) Debt-Equity Ratio,
  - c) Debt Service Coverage Ratio,
  - d) Return on Equity Ratio,
  - e) Inventory turnover ratio,
  - f) Trade Receivables turnover ratio,
  - g) Trade payables turnover ratio,
  - h) Net capital turnover ratio,
  - i) Net profit ratio,
  - j) Return on Capital employed,
  - k) Return on investment.

- 2) Rules relating to disclosures of Ratios: The Company shall explain the items included in the numerator and denominator for computing the above ratios.
- 3) Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

**Question 24:****(Model Test Paper-3) / (Sept.24)**

JB Limited has invested huge sums of money on establishment of new Property, Plant and Equipment during the year under audit. They have incurred an amount of ₹ 5,70,000/- on dismantling of an old plant, which had become obsolete, so that a new plant can be set up at the existing location. The Auditor is in the process of verifying the cost incurred towards addition to Property, Plant and Equipment. What should be the accounting treatment of the amount spent on dismantling of old plant in the financial statements? Which elements of cost should be considered for valuing Property, Plant and Equipment?

**Answer:**

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

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

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

**Question 25:****(Model Test Paper-4) / (MTP-I July 24)**

**BOTS is a manufacturing entity having material Property, Plant and Equipment (PPE) items in its financial statements. The auditor of the entity wants to verify that PPE items have been valued appropriately as per generally accepted accounting policies and practices. Comment on significance of such verification. Suggest a few audit procedures in this regard.**

**Answer:**

- 1) It is a common understanding that the value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period.
- 2) Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of PPE would be shown at higher amounts. Therefore, such verification is significant.
- 3) Audit procedures that the auditor should follow to verify that the PPE items have been valued appropriately as per generally accepted accounting policies and practices are: -
  - a) Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non- depreciable like freehold land
  - b) Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
  - c) The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 Impairment of Assets.

**Question 26:****(Model Test Paper-4) / (MTP-I July 24)**

**Zed Limited is engaged in the manufacturing and export of shoes. The statutory auditor of the company wants to reasonably ensure that only the inventories recorded in the financial statements are exclusively owned by the company and do not include any inventories that belong to third parties but includes inventories owned by the company but lying with third party. Advise the auditor on the audit procedures to be performed to achieve this assurance.**

**Answer:**

Audit procedures to be followed by the statutory auditor of Zed Limited to ensure that only the inventories held by entity have been recorded in the financial statements and do not include

any inventories that belong to third parties but does include inventories owned by the entity and lying with a third party are as under:

- a) Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).
  - (i) Compute inventory turnover ratio (COGS/ average inventory)
  - (ii) Perform vertical analysis (inventory/ total assets)
  - (iii) Compare budgetary expectations vis-à-vis actuals
- b) Examine non-financial information related to inventory, such as weights and other measurements.
- c) Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end.
- d) With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions.
- e) Verify the clerical and arithmetical accuracy of inventory listings.
- f) Reconcile physical inventory amounts with perpetual records.
- g) Reconcile physical counts with ledger control totals.
- h) Reconcile inventories which belong to client but are held with third parties like transporters, warehouses, port authorities etc.
- i) Goods received on a consignment basis have been properly segregated from other items of inventory.

**Question 27:****(Model Test Paper-5) / (MTP-II Aug.24)**

CA J is appointed as statutory auditor of Sigma and Beta Limited for the year 2023-24. During the audit he observed trade receivables amounting to ₹ 50 crores are reflected in the financial statements of the company. He wants to obtain sufficient appropriate evidence to conclude that trade receivables have been valued appropriately. Suggest few audit procedures in this regard.

**Answer:**

Few audit procedures to obtain sufficient appropriate audit evidence to conclude that trade receivables have been valued appropriately are as under: -

- 1) Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a

determination of whether the method is appropriate for the underlying business environment.

- 2) Obtain the ageing report receivable (both Dr/Cr balance).
- 3) Also, obtain the list of debtors under litigation and compare with previous year.
- 4) Scrutinize the analysis and identify those debtors which appear doubtful; discuss with management about reasons as to why these debtors are not included in the provision for bad debts. Perform further testing where any disputes exist.
- 5) He should check if provisions are made at appropriate rates considering recoverability of amounts due.
- 6) Prepare schedule of movements of bad debts - Provision accounts and debts written off and compare the proportion of bad debt expense to sales for the current year in comparison to prior years to see if the current expense appears reasonable.
- 7) Check that write-offs of the receivable balances have been authority appropriate approved by an appropriate authority i.e. the Board of Directors in case of a company.

#### Question 28:

(Model Test Paper-5) / (MTP-II Aug.24)

**M/s Veer and Associates is appointed as auditor of KMP limited. During the audit, auditor wants to verify that trade payables and liability balances that were supposed to be recorded have been recognized in the financial statements. Which assertion auditor wants to ensure and what audit procedures should be followed by him in this regard?**

#### Answer:

Auditor wants to ensure Completeness and the audit procedures to be followed by him to verify that trade payables and liability balances that were supposed to be recorded have been recognized in the financial statements are as follows:

- 1) The auditor needs to perform the following cut off procedures:
  - a) For the last 5 invoices received/ recorded at the end of the reporting date (cutoff date) and which have been included in the trade payables; the goods should have been received/ risk and rewards of ownership in goods should have been transferred in favour of the entity;
  - b) All goods received prior to the period/ year- end should have been booked in the form of purchases and included in trade creditors.
- 2) Test purchases/ expenses on a sample basis selecting the same from the accounts payable ledgers and checking their supporting documents to ensure that the purchases were recorded at the correct amounts and correct dates.

- 3) Match purchase invoice dates to the gate entry (inward) dates to check whether the purchases are being recorded in the correct accounting period. This can include an examination of purchase/expense invoices received subsequent to the period being audited, to see if they should have been included in the period under audit.
- 4) Review subsequent expense vouchers. Review all material expense vouchers recorded post the balance sheet date to see if they relate to transactions from within the audit period.
- 5) For advance received from customers/ revenue received in advance, obtain the customer wise listing along with its ageing and the nature. Enquire from the entity's management if there has been any dispute with the customer and if there is any additional liability to be recorded. For all such advances, the auditor should verify the underlying documentation based on which the entity had received the advance.
- 6) In relation to statutory dues liability like withholding tax (TDS) payable, GST payable, luxury tax payable, professional tax payable, PF and ESI payable etc., prepare a reasonability with respect to sales/ purchases/ employee benefit expenses. Example-GST liability for last month may be calculated by applying the applicable rate to the sales made and in case of any variance with the GST liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.
- 7) Similarly, Provident Fund liability for last month may be calculated by applying the applicable rate to the employee benefit expense and in case of any variance with the liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.
- 8) Further, the auditor should obtain and verify the challans for deposits made subsequent to the period-end for all statutory liabilities as at the balance sheet date and also analyse the reasons, if any, in consultation with the management for any variance between the amounts deposited subsequently vis-à-vis the liability recorded in books of account.
- 9) He shall prepare a complete list of all statutory dues and consider his reporting requirements under CARO, 2020.

**Question 29:****(Model Test Paper-5) / (MTP-II Aug.24)**

**Mr. Vaayu is appointed as the auditor of PRISM Limited for the year 2023-24. He wants to ensure that the PPE has been valued appropriately and as per generally accepted**



accounting policies and practices and also that PRISM Limited has valid legal ownership rights over the PPE claimed to be held by the company and recorded in the financial statements. Explain how the auditor will verify the same.

**Answer:**

PPE have been valued appropriately and as per generally accepted accounting policies and practices:

It is a common understanding that the value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of PPE would be shown at higher amounts. Mr. Vaayu, the auditor should:

- a) Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non- depreciable like freehold land;
- b) Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- c) The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 - Impairment of Assets.

**The entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements (Rights and Obligation)**

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



- e) In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

**Question 30:****(Model Test Paper-6) / (MTP-I Nov.24)**

**CA Karan wants to test the "completeness" assertion relating to intangible assets reflected in the financial statements of Data Solutions Private Limited. State audit procedures to be performed by CA Karan in this regard.**

**Answer:**

The audit procedures to be performed by CA Karan to test completeness assertion relating to intangible assets are as under: -

- 1) Verify the movement in the intangible assets schedule compiled by the management i.e. Opening balances + Additions - Deletions = Closing balances. Tally the closing balances to the entity's books of account.
- 2) Check the arithmetical accuracy of the movement in intangible assets schedule.
- 3) For additions during the period under audit, obtain a listing of all additions from the management and undertake the following procedures: -
  - a) For all material additions, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26.
  - b) Ensure that no intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred. Check the certificate or report or other similar documentation maintained by the entity to verify the date of use of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit.
  - c) Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel.
  - d) Verify whether proper internal processes and procedures like inviting competitive quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis.
  - e) In relation to deletions of intangible assets, understand from the management the reason and rationale for deletion and the manner of disposal. Obtain the management approval and disposal note authoring disposal of the asset from its active use. Verify the process followed for sale of discarded asset, for example inviting competitive quotes,

tenders and the basis of calculation of sales proceeds. Verify that the management has accurately recorded the deletion of intangible asset (original cost and accumulated amortization up to the date of disposal) and the resultant gain/ loss on disposal in the entity's books of account.

**Question 31:****(Model Test Paper-6) / (MTP-I Nov.24)**

Kyte Private Limited acquired an immovable property of substantial value during the financial year 2023-24, which is recorded in the financial statements as an addition in the Schedule of PPE. The auditor also observed that this immovable property has been mortgaged to a bank for availing credit facilities. How should the auditor verify the rights and obligations assertion for this property to ensure the entity's legal ownership and identify any charges against it?

**Answer:**

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

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

**Question 32:****(Model Test Paper-6) / (MTP-I Nov.24)**

As the statutory auditor of Ginni Ltd., you need to verify if the company has valid legal ownership rights over the inventories recorded in the balance sheet as on March 31,

**2024. What audit procedures should you perform to verify the company's ownership of the inventories, including items stored at third-party locations?**

**Answer:**

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

- 1) Vouch recorded purchases to underlying documentation (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file).
- 2) Evaluate the consigned goods.
- 3) Examine client correspondence, sales and receivables records, purchase documents.
- 4) Determine existence of collateral agreements.
- 5) Review consignment agreements.
- 6) Review material purchase commitment agreements.
- 7) Examine invoices for evidence of ownership i.e. the invoices shall be in the name of the client.
- 8) Obtain confirmation for significant items of inventory.
- 9) For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.

**Question 33:**

**(Model Test Paper-7) / (MTP-II Dec.24)**

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

**Answer:**

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

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

- (i) Whether the expenditure pertained to current period under audit;
- (ii) Whether the expenditure qualified as a revenue and not capital expenditure;
- (iii) Whether the expenditure had a valid supporting document like travel tickets, insurance policy, third party invoice etc.;
- (iv) Whether the expenditure has been classified under the correct expense head;
- (v) Whether the expenditure was authorised as per the delegation of authority matrix;
- (vi) Whether the expenditure was in relation to the entity's business and not a personal expenditure.

**Question 34:****(Model Test Paper-7) / (MTP-II Dec.24)**

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.

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

**Question 35:****(Model Test Paper-8) / (May 24)**

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

The cost of inventory includes the following:

- (1) Material purchase cost - ₹ 25,05,000/-
- (2) Allocated transport cost - ₹ 18,000/-
- (3) Abnormal wastage - ₹ 2,000/-

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

**Answer:****Value of Inventory:**

- 1) Inventory to be recognized at the lower of cost and net realizable value in accordance with AS 2 - Inventories. Further, any costs that could not be reasonably allocated to the cost of production (e.g. general and administrative costs) and any abnormal wastage have been excluded from the cost of inventory. An acceptable valuation basis (e.g. FIFO, Weighted average etc.) has been used to value inventory as at the period-end.
- 2) In the given situation, ABC & Co. is using FIFO method for valuation of its inventories. Further, cost of inventory as on 31.03.2024 is rupees 25,25,000 which includes material purchase cost of rupees 25,05,000, allocated cost of transport of rupees 18,000 and abnormal wastage of rupees 2,000. Net realizable value of said inventory is ₹ 25,24,000. In view of provisions of AS 2, cost allocated to transport for inventory is relating to bringing the inventory to the location, thus it will be added in cost of material. However, abnormal wastage of rupees 2000 should be excluded from cost of inventory.
- 3) Thus, cost of inventory will be ₹ 25,25,000 - ₹ 2,000 = 25,23,000 rupees and Net realizable value of inventory is ₹ 25,24,000.
- 4) For valuation in accordance with AS 2, "Inventory", lower of cost and net realizable value will be considered. Accordingly, ₹ 25,23,000 to be considered as value of inventory in the given situation.

## Question 36:

(Model Test Paper-8) / (May 24)

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

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

**Answer:**

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

- Repayable on demand or
- Without specifying any terms or period of repayment.

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

**Question 37:****(Model Test Paper-8) / (May 24)**

PQ & Co. want to diversify its business and for that purpose they want to raise money by issuing shares to the general public. The face value of the shares is ₹ 100 but the directors of the company propose to issue the shares at a discounted rate of ₹ 95/- so as to receive more response. The statutory auditor, however, objects to the same as it is not allowed as per the Companies Act, 2013. State the provisions of Section 53 of the Companies Act, 2013 with reference to shares issued at a discount and the consequences where the company fails to comply with the provisions of this section.

**Answer:**

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

- 1) A company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54 of the Companies Act, 2013.
- 2) Any share issued by a company at a discounted price shall be void.
- 3) Notwithstanding anything contained in above sub-sections (1) and (2), a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.
- 4) Where any company fails to comply with the provisions of this section, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of twelve per cent. per annum from the date of issue of such shares to the persons to whom such shares have been issued.

**Question 38:****(Model Test Paper-8) / (May 24)**

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

**Answer:**

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

- (i) Costs of opening a new facility or business, such as, inauguration costs;

- (ii) Costs of introducing a new product or service (including costs of advertising and promotional activities);
- (iii) Costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
- (iv) Administration and other general overhead costs.

**Question 39:****(Model Test Paper-8) / (May 24)**

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

**Answer:**

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

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

- a) **Status of Ownership:** Ownership transfer option at the end of the lease period is with the lessee. Title may or may not be eventually transferred.
- b) **Accounting treatment:** Finance lease is treated like loan arrangement. Hence, the asset ownership is considered of that of the lessee and thus appears on the balance sheet of the lessee.
- c) **Tax benefit:** Lessee can claim both interest and depreciation expense as financial lease is treated like a loan.

**Question 40:****(RTP May 24)**

Proceedings have been initiated against False Limited for holding benami property under law relating to prohibition of benami transactions and the rules made thereunder but



such property is not recorded in books of accounts. As a consultant to the company, what will you advise the company as far as disclosure requirements are concerned in financial statements in relation to said proceedings?

**Answer:**

**Disclosure in case of Benami Properties held by the Company:** Where any proceedings have been initiated or pending against the company for holding any benami property under the relevant law relating to prohibition of such transactions, the company shall disclose the following:

- a) Details of such property, including year of acquisition
- b) Amount thereof
- c) Details of Beneficiaries
- d) If property is not in the books, then the fact shall be stated with reasons
- e) Where there are proceedings against the company under this law as an abettor of the transaction or as the transferor, then the details shall be provided
- f) Nature of proceedings, status of same and company's view on same.

**Question 41:**

**(RTP May 24)**

Droma Shoes Private Limited was established in year 2022-23 for manufacturing of footwear. As funds were needed to carry on its business activities - including for purchase of different raw materials, incurring of regular expenses like power and fuel and payment of wages etc., it had got sanctioned a credit facility amounting to ₹ 2 crores repayable on demand from a bank against primary security of its current assets and collateral security of residential house of one of its directors. Duly signed guarantee documents by directors in favour of bank also form part of bank's loan documentation. Account statement of above facility downloaded from bank's website shows debit balance of ₹ 1.85 crores as on 31st March, 2023. The operations in above credit facility are satisfactory. In this regard:

- i) Identify nomenclature of such credit facility given by banks. How would above amount of ₹ 1.85 crores be reflected and classified in financial statements of company as on 31.3.23?
- ii) Also state specific disclosure requirements of Schedule III of Companies Act, 2013 in relation to above.

**Answer:**

- i) The type of credit facilities referred to in above situation given by banks to meet working capital requirements of business which are repayable on demand are known as "cash credit facilities/overdraft" facilities. The amount of ₹ 1.85 crores outstanding as on 31st March, 2023 reflects borrowings of the company and it would be classified as "short-term borrowings" as loans repayable on demand from banks under current liabilities in balance sheet of the company. Borrowings shall further be subclassified as secured.
- ii) Specific disclosure requirements of short-term borrowings under Schedule III to Companies Act, 2013 in given situation are as under:
- Nature of security i.e. primary security of current assets and collateral security of residential house belonging to a director shall be specified.
  - As loans have been guaranteed by directors, the aggregate amount of such loans shall be disclosed.

**To be disclosed as Additional Regulatory Information**

Since the Company has borrowings from bank on the basis of security of current assets, it shall also disclose the following:

- Whether quarterly returns or statements of current assets filed by the Company with banks or financial institutions are in agreement with the books of accounts.
- If not, summary of reconciliation and reasons of material discrepancies, if any to be adequately disclosed.

**Question 42:****(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:**

- 1) The disclosure given in the question does not meet requirements of Schedule III to Companies Act, 2013.
- 2) 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.
- 3) 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	31.3.2023	31.3.2022	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%

- 4) 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 43:****(RTP Sept. 24)**

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

**Answer:**

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

- a) Review board minutes for approval of new lending agreements. During review, ensure that new loan agreements or bond issuances were authorized. Ensure that significant debt commitments are approved by the board of directors.

- b) Check the details of loans recorded (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits, if any, imposed by the agreements are not exceeded.
- c) Roll out and obtain independent balance confirmations (SA 505) in respect of all the borrowings from the lender (banks/ financial institutions etc.).
- d) Verify the details of leases and hire purchase creditors recorded to underlying contracts/agreements.
- e) In case of Debentures, examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- f) When debt is retired, ensure that a discharge is received on assets securing the debt.
- g) Obtain Written Representation that all the liabilities which have been recorded represent a valid claim by the lenders.

**Question 44:****(Jan.25)**

ABC & Co., a Chartered Accountant firm, has been appointed as the statutory auditors of Pen Private Limited for the F.Y. 2023-24. During audit, one of the team members, Mr. R noticed that Pen Private Limited has purchased software amounting to ₹ 2.00 crore and the said software is not an integral part of the related hardware. Mr. R further observed that Pen Private Limited has conducted some research of an internal project work amounting to ₹ 1.00 crore. Pen Private Limited, following Indian GAAP, has presented the aforesaid details in the Balance Sheet as on 31st March, 2024 as follows:

Property, Plant, and Equipment	₹
- Software	2.00 crore
- Research	1.00 crore

Mr. R approached the engagement partner with above details and enquired about the correctness of the presentation made by Pen Private Limited in terms of Schedule III to the Companies Act, 2013. Mr. R further wanted to ensure that all additions to Intangible assets during the year 2023-24 have been recorded appropriately in the financial statements of Pen Private Limited. Guide Mr. R.

**Answer:**

- 1) Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset. Thus, purchase of software, which is not an integral part of

related hardware, amounting to ₹ 2 crore by Pen Private Limited should be presented in the Balance Sheet under the head intangible asset not under the head Fixed Asset.

- 2) Further, Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred. Therefore, presentation of research amounting to ₹ 1 crore of an integral project work by Pen Private Limited under the head Property, Plant and Equipment as Research is not correct as it should be recognised as an expense.
- 3) Audit Procedure for ensuring all additions to Intangible assets during the year have been recorded appropriately in the financial statements of Pen Private Limited:
- a) For all material additions, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26.
  - b) Ensure that no intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.
  - c) Check the certificate or report or other similar documentation maintained by the entity to verify the date of use of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit.
  - d) Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel.
  - e) Verify whether proper internal processes and procedures like inviting competitive quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis

**Question 45:****(Jan.25)**

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

- (i) Employee benefit expenses do not include the cost of any unauthorised personnel.**
- (ii) All the items of inventory pertaining to the relevant year shall be included regardless of the location.**
- (iii) Sales are recorded correctly in the books based on the invoices. Discounts have been properly adjusted or accounted for.**

- (iv) The entity owns or controls the inventory recorded in the financial statements. i.e. the purchase invoices have been made in the name of the client.
- (v) Inventory has been recognised at the lower of cost and net realizable value in accordance with AS 2 - Inventories.

**Answer:**

- (i) For Employee benefit expenses do not include the cost of any unauthorised personnel: The auditor will check the occurrence assertion for the same to ensure that transactions recognised in the financial statements have occurred and relate to the entity.
- (ii) All the items of inventory pertaining to the relevant year shall be included regardless of the location: The auditor will check the cut-off assertion to ensure that all assets and liabilities are reported in the appropriate period.
- (iii) Sales are recorded correctly in the books based on the invoices. Discounts have been properly adjusted or accounted for: The auditor will check measurement assertion to ensure transactions have been recorded accurately at their appropriate amounts in the financial statements. There have been no errors while preparing documents or in posting transactions to ledger. The figures and explanations are not misstated.
- (iv) The entity owns or controls the inventory recorded in the financial statements. i.e., the purchase invoices have been made in the name of the client: The auditor will check rights & obligations assertion to ensure that the entity has the right to assets (i.e. whether the entity has ownership and legal title to assets), and the liabilities recognised in the financial statements represent all the entity's obligations to repayment as at a given date.
- (v) Inventory has been recognised at the lower of cost and net realizable value in accordance with AS 2 - Inventories: The auditor will check valuation assertion to ensure assets, liabilities and equity balances have been valued appropriately i.e. the amounts at which they are recorded are appropriate. There has been no overstatement or understatement.

**Question 46:****(MTP-I Mar.25)**

**CA T is the statutory auditor of QRS Ltd. While performing testing of additions during the year, he wanted to verify that:**

- (i) All PPE (property, plant and equipment) are in the name of the entity he is auditing.
- (ii) For all additions to land and building in particular, the auditor desires to have concrete about the ownership.

(iii) CA T also wants to know whether the entity has valid legal ownership rights over the PPE, where it is kept as security for any borrowings.

Advise the auditor CA T on the audit procedure to be undertaken by him to establish the Rights and Obligations of the entity over the PPE.

**Answer:**

CA T should undertake the following audit procedure to establish Rights and Obligations of the entity over PPE:

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

**Question 47:**

**(MTP-I Mar.25)**

WEQ Ltd. has issued shares for cash at a premium. In accordance with section 52 of the Companies Act, 2013, the company is required to transfer the premium received from the issuance of shares to the securities premium account. What are the specific applications allowed for the funds in the securities premium account, as per the provisions of the Companies Act, 2013?

**Answer:**

**Application of Securities Premium Account:** The securities premium account may be applied by the Company:

- a) Towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
- b) In writing off the preliminary expenses of the Company;

- c) In writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
- d) In providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
- e) For the purchase of its own shares or other securities under section 68.

The auditor needs to verify whether the premium received on shares, if any, has been transferred to a "securities premium account" and whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above.

#### Question 48:

(MTP-I Mar.25)

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

#### Answer:

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

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

- a) Check that in respect of invoices raised in last few days nearing the cut-off date, goods have been actually dispatched and not lying with the company.
- b) Test invoices listed in receivable report. Select few invoices from the accounts receivable ageing report and compare them to supporting documentation to see if they were billed with the correct amounts, to the correct customers, and on the correct dates.
- c) Match invoices to shipping/ dispatch log. Match invoice dates to the shipment dates for those items in the shipping/ dispatch log, to see if sales are being recorded in the correct accounting period. This can include an examination of invoices issued subsequent to the period being audited, to see if they should have been included in the period under audit.
- d) Assess bill and hold sales. If there is a situation where the Company is billing customers for sales despite still retaining the goods on-site (known as "bill and hold"), examine supporting documentation to determine whether a sale has actually taken place or not.



- e) Review the receiving log to see if the Company has recorded an inordinately large amount of customer returns after the audit period, which would suggest that the Company may have shipped more goods near the end of the audit period than what the customers had authorized to inflate the profits of the company.
- f) Review the process of giving discounts/ incentives and check whether the same were given as per the Company's policy/ general industry trends.

**Question 49:****(MTP-II Apr.25)**

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

- (i) Inventory recognised in the balance sheet actually existed as at the period end.**
- (ii) All the items of inventory pertaining to the relevant year shall be included regardless of the location.**
- (iii) All goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis.**
- (iv) Examine client correspondence, sales and receivables records, purchase documents.**
- (v) Verifying that the entity has charged depreciation on all items of PPE unless any item of PPE is non-depreciable like freehold land.**

**Answer:**

- (i) The auditor will check the Existence Assertion to ensure Assets, liabilities and equity balances exist as at the period end.
- (ii) The auditor will check the Cut-off assertion to ensure that all assets and liabilities are reported in the appropriate period.
- (iii) The auditor will check Completeness Assertion to ensure all Trade receivable balances that were supposed to be recorded have been recognized in the financial statements.
- (iv) The auditor will check Rights & Obligations assertion to ensure that the entity has valid legal ownership rights over the inventories claimed to be held by the entity and recorded in the financial statements.
- (v) The auditor will check Valuation assertion to ensure PPE have been valued appropriately and as per generally accepted accounting policies and practices.

**Question 50:****(MTP-II Apr.25)**

During the audit of Grace Pvt. Ltd., CA Tanu notices that significant amount of depreciation and amortisation charges are reflected in financial statements of the company. Which attributes need to be considered by him while verifying such depreciation and amortisation charges?

**Answer:**

Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses: -

- 1) Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- 2) Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act/ applicable accounting standards.
- 3) The accounting policy has been applied consistently year on year. Any change in the accounting policy has been adequately disclosed.
- 4) Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- 5) Whether depreciation and amortisation charges are valid.
- 6) Whether depreciation and amortisation charges are accurately calculated and recorded.
- 7) Whether all depreciation and amortisation charges are recorded in the appropriate period.
- 8) Whether each part of an item of PPE with a cost that is significant in relation to the total cost of the item have been depreciated separately.
- 9) Example: It may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease.
- 10) Whether the most appropriate depreciation method for each separately depreciable component has been used.

**Question 51:****(RTP Sept.25)**

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

- (i) Employee benefit expenses recognised during the period relates to the current accounting period only.
- (ii) Employee benefit expenses in respect of all personnel have been fully accounted for.

- (iii) Any inventory held by the entity on behalf of another entity has not been recognised as part of inventory of the entity.
- (iv) Recorded sales represent goods which were ordered by valid customers and were despatched and invoiced in the period.

**Answer:**

- (i) The auditor will check the **cut-off** assertion to ensure that whether all income and expenses are reported in the-correct accounting period. Cut-off is a separate assertion because the substantive procedures to verify it are typically different from those applied to the other components of completeness.
- (ii) The auditor will check the completeness assertion for the same to ensure that all transactions that were supposed to be recorded have been recognised in the financial statements. Transactions have not been omitted.
- (iii) The auditor will check rights & obligations assertion to ensure that the entity has the right to assets i.e. (whether the entity has ownership and legal title to assets) and the liabilities recognised in the financial statements represent all the entity's obligations to repayment as at a given date.
- (iv) The auditor will check the occurrence assertion for the same to ensure that transactions recognised in the financial statements have occurred and relate to the entity.

**Question 52:**

(RTP May 25)

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

**Answer:**

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

- a) Review the process followed by the Company to identify if any old creditor balance needs to be written back. This will include a consistency comparison with the method used in the

last year, and a determination of whether the method is appropriate for the underlying business environment.

- b) Obtain the ageing of payable balances, and the list of vendors with whom the Company has disputes and any claims from customers, under litigation and compare with previous year.
- c) Check that write backs in the trade payable balances assessed as no longer payable have been approved by an appropriate and authorised member of senior management, for example, CEO/MD.
- d) Check that the restatement of foreign currency trade payables has been done properly in accordance with AS 11.
- e) Understand management's process to identify the principal amount and the interest due thereon (if any) remaining unpaid to any Micro, Small and Medium Sized Enterprises suppliers at the end of accounting year. Test check the management process to assess if the auditor could rely on the management process.

#### Question 53:

(MTP-II Apr.25)

**CAR Ltd., an automotive parts manufacturer, appointed Amit & Associates as auditors for F.Y. 2023-24. During the audit, CA Amit noticed a significant rise in raw material consumption (steel and aluminium) despite a decrease in production. This discrepancy led to detailed reviews of vendors supplying these raw materials. While verifying the existence of vendors and the actual receipt of goods or raw materials by the company, which assertion is being verified by CA Amit. Explain the procedure for the same.**

#### Answer:

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

The audit procedures generally required to be undertaken while verifying Occurrence Assertion:

**Ensure purchases are not understated/ overstated by performing following audit procedures:**

- a) Whether any fictitious vendors have been booked or purchases have been recorded by reviewing the vendor selection process followed by the entity and also performing procedures to ensure existence of the vendors.
- b) Whether the goods were received at the factory gate and whether there exists an entry in the security gate inward register.
- c) Whether quality inspection of goods was done.

- d) Whether a goods receipt note was prepared and signed by an appropriate client personnel.
- e) Whether the purchase invoice was approved as per delegation of authority and whether a 3 or 2-way match was done.
- f) Whether stock record has been updated by the stores personnel.

**Special considerations during audit of purchases:**

- a) The purchase invoice received should be the "Original" copy (and not photocopy/ carbon copy) against which the entity has recorded the purchase in its books of account.
- b) Purchase invoice should have been booked only once risk and reward incidental to ownership has been transferred to the entity. Specific consideration for cases where the terms of delivery as agreed with vendor are F.O.B., C.I.F. etc.
- c) Purchase invoice should be in the name of entity. However, in case of different branches, it should be addressed to the appropriate branch.
- d) Input tax component should have been booked in the input tax ledger. The auditor should obtain tax returns filed with the authorities and tally the input tax as reflected in the books to the amount disclosed in the returns.
- e) In case of purchases made from related parties or allied and associated concerns, the auditor needs to verify if requisite approval from Board of Directors (appropriate authority) has been obtained and should verify the selected samples and perform analytical procedures in relation to price of goods to confirm that the price charged is at arm's length.
- f) The auditor should review whether purchases should be capitalized or expensed off in Statement of Profit and loss according to his professional judgement.
- g) Review journal entries for unusual transactions.

**Question 54:**

(RTP Jan 25)

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

**Answer:**

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

**For Raw materials and consumables:**

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

**For Work in Progress:**

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

**Question 55:****(May 25)**

**LMN Ltd., a mid-sized manufacturing company, generates revenue primarily through the sale of consumer electronics in domestic and international market. The company reported sales of ₹ 2 crores in the Financial Year 2024-25. The company generates revenue through sale of standard electronics devices, customized product orders with specific delivery terms and extended warranties and after-sales services.**

**The auditor has to verify that all sales are accurately measured as per applicable accounting standards and correctly journalized, summarized and posted in the financial statements,**

**Explain the audit procedures to ensure the same.**

**Answer:**

**The auditor will apply the following audit procedures to verify that all sales are accurately measured as per applicable accounting standards and correctly journalised, summarised, and posted in the financial statements are:**

- a) Trace a few transactions from inception to completion. (Examination in depth)

- b) **Eg:** Take few sales transaction, and check from the receipt of sales order to the payment of receivable balance, every underlying document to ensure if it is properly recorded at every stage and measured accurately taking into consideration all the incentives, discounts, if any. The recognition shall be according to the revenue recognition policy of the entity.
- c) If the client is engaged in export sales, then compliance with AS 11 shall be ensured.
- d) Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.
- e) Compare the rate of sales affected with related parties and review them for collectability, as well as whether they were properly authorised and the value of such transactions were reasonable and at arm's length.

**Question 56:****(May 25)**

While auditing the accounts of PQR Ltd., a member of the audit team wants to carry out test of controls for checking the effectiveness of internal control over sales as a part of debtor's audit procedure. State any four points that need to be considered in respect of trade receivables.

**Answer:**

To carry out test of controls for checking the effectiveness of internal control over sales as a part of the debtors' audit procedure, following points need to be considered in respect of trade receivables by audit team of PQR Ltd:

- a) Only bona fide sales lead to trade receivables.
- b) All such sales are made to approved customers.
- c) All such sales are properly recorded in the books of accounts.
- d) Once recorded, the debtors can be settled only by receipt of cash or on the authority of a responsible official.
- e) Segregation of duties at every point in sales transaction. (accounting for debtors, collecting the payments, sending reminders etc.)
- f) Debtors are collected on time.
- g) In case debtors are not collected in time, sending reminders and taking legal actions if required.
- h) Balances are regularly reviewed.
- i) A proper system of follow up exists and if necessary, adequate provision for bad debt should be made by preparing adequate ageing schedule of the debtors.

**Question 57:****(May 25)**

As an auditor of Star Ltd., a company covered under Section 135 of the Companies Act, 2013, what matters should auditor verify to ensure that proper disclosures regarding Corporate Social Responsibility (CSR) activities is made in Additional Information to notes to account.

Mention any four such matters.

**Answer:**

As an auditor of Star Ltd., a company covered under Section 135 of the Companies Act, 2013, the auditor should verify the following matters to ensure that proper disclosures regarding Corporate Social Responsibility (CSR) activities is made in "Additional Information" to notes to account are:

- a) Amount required to be spent by the company during the year.
- b) Amount of expenditure incurred.
- c) Shortfall at the end of the year.
- d) Total of previous years shortfall.
- e) Reason for shortfall.
- f) Nature of CSR activities.
- g) Details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard.
- h) Where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately.





## CHAPTER

## 6

# Audit Documentation

## Case Study

CA Rajan Pillai is heading the engagement team conducting audit of a company. While audit is in progress, consider following issues regarding audit documentation:

- A) Audit programme was prepared assigning responsibilities for different types of works to be performed to team members. The engagement team consists of 4 members Mohit (CA final student), Rohit (CA final student), Shobhit (Paid CA) and CA Rajan Pillai (partner of audit firm).
- B) The team has determined materiality for financial statements as a whole.
- C) The team has assessed risks of material misstatements to be low.
- D) CA Shobhit is responsible for attending inventory count process and putting down its documentation part.
- E) During the course of audit, many related party transactions have come to notice.

On the basis of above, answer the following questions:

- 1) Work relating to verification of revenue was assigned to Mohit in audit programme. However, it is being performed by Rohit actually. Verification of trade receivables was planned to be carried out by Rohit in audit programme. However, it being performed by CA Rajan Pillai due to last minute practical issues. Which of the following statements is most appropriate in this regard relating to audit documentation?
  - a) Audit programme contains names of persons and work to be performed. It is immaterial whether work assigned to one person is performed by another person.
  - b) Audit programme was already prepared. Only persons assigned specific responsibilities can perform those duties.
  - c) It is necessary that audit programme be suitably updated or notes are given in working papers to this effect so that planned duties are in accordance with actual work performance.
  - d) Changes in audit programme or notes clarifying the matter are required only when a person not forming part of engagement team is deputed to perform a duty. Otherwise, this issue of inter-shuffling of team members is frivolous.

- 2) As regards materiality, which of the following statements is most appropriate in context of audit documentation?
- a) Materiality has already been determined. There is no need to put it into working papers.
  - b) Materiality depends upon professional judgment of auditor. Whatever amount has been determined can be documented in working papers.
  - c) Materiality arrived on basis of professional judgment along with factors considered in the determination has to be documented.
  - d) Materiality has been arrived upon professional judgment. It also depends upon professional judgment of auditor whether he wants to document it or not.
- 3) As regards team's assessment that risk of material misstatements is low, which of the following statements is odd one relating to documentation of risk?
- a) Discussion amongst engagement team members and detail of significant decisions reached has to be documented.
  - b) Details of risk assessment procedures have to be documented.
  - c) Details about how understanding of each component of internal control was obtained has to be documented.
  - d) Precise calculation of risk of material misstatements has to be documented.
- 4) CA Shobhit is responsible for attending physical inventory count of the company. Which of the following is not true in this regard relating to audit documentation?
- a) Dates on which physical inventory count process was attended by him should be documented. It may also include photographs of that date showing his attendance of inventory counting process at a particular location.
  - b) Detail of test counting undertaken should form part of audit documentation.
  - c) Detail of obsolete goods found should form part of audit documentation.
  - d) Reports showing that stocks conform to quality control standards in accordance with law are essential part of audit documentation.

- 5) As regards related party transactions, which of the following should not be part of audit documentation?
- a) Management representation letter in this regard
  - b) Related party transaction policy of the company
  - c) Documentation to show that such transactions are at arm's length basis
  - d) Documentation to show that such transactions are at close length basis.

**Answers to Case Study:**

- 1) c)
- 2) c)
- 3) d)
- 4) d)
- 5) d)

## Independent MCQ's

- 1) Which of the following statement is appropriately suited to preparation of audit documentation?
- a) Audit documentation has to be prepared simultaneously as audit progresses.
  - b) Audit documentation has to be prepared 60 days after date of audit report.
  - c) Audit documentation has to be prepared when information is required by regulator.
  - d) Audit documentation has to be prepared 60 days after completion of audit work.
- 2) Audit documentation is owned by:
- a) Client
  - b) Auditor
  - c) Team member responsible for documentation
  - d) Regulator
- 3) Which of the following is least likely to be included in audit documentation of a company engaged in manufacturing and export of goods?
- a) Previous years audited financial statements
  - b) Projected cash flow statement for next twelve months provided by management in support of going concern assumption

- c) Statements showing dispatch of overseas consignments in accordance with delivery schedules of overseas buyers
  - d) Statement showing verification of ageing of trade receivables as on date of balance sheet.
- 4) Which of the following is false in relation to audit documentation when an external auditor relies upon work of internal auditor?
- a) Evaluation of objectivity and competence of internal auditor has to be documented.
  - b) Nature of work used and reason for relying upon work used forms part of documentation.
  - c) Documentation on whether quality control is exercised in internal audit work forms part of audit documentation.
  - d) Documentation on what specific recommendations were given by internal auditor for risk assessment to external auditor forms part of audit documentation.

**Answers to the MCQs based Questions:**

- 1) a)
- 2) b)
- 3) c)
- 4) d)

## Descriptive Questions

### Illustrations & Questions from ICAI Study Material

**Question 1:**

(ICAI SM)

A new team member of the auditors of Extremely Vibrant Limited was of the view that Audit Documentation does not help in planning the audit of any company. Explain whether Audit Documentation has any relation with regard to planning the audit of a company.

**Answer:**

Audit Documentation helps in planning the audit of a company in a proper manner and also helps in conducting the audit of that company in a more effective way.

**Question 2:****(ICAI SM)**

While auditing the books of accounts of Very Careful Limited for the financial year 2020-21, a team member of the auditors of Very Careful Limited was of the view that with regard to audit of the company, no relation exists between Audit File and Audit Documentation. Explain the relationship between Audit File and Audit Documentation.

**Answer:**

- 1) Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
- 2) The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

**Question 3:****(ICAI SM)**

A director of Very Different Limited was of the view that Audit Documentation of a company is the property of that company. Comment on the contention of the director regarding the audit documentation of the company.

**Answer:**

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

**Question 4:****(ICAI SM)**

During the course of audit of a company, an issue arose relating to treatment of interest costs of company on its restructured loans taken from a bank. This important matter was discussed with CFO of the company and was properly resolved. Is it necessary for the auditor to include in its working papers?

**Answer:**

The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

In the instant case, an important matter regarding treatment of interest costs of company on its restructured loans taken from a bank directly impacting profits of the company was discussed. Although issue was resolved, it is necessary to document the same by including detail of the person with whom discussions took place along with date.

**Question 5:****(ICAI SM)**

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:**

- 1) 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.
- 2) 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.
- 3) 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.
- 4) 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.

**Question 6:****(ICAI SM)**

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

**Answer:**

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

- 1) The size and complexity of the entity.
- 2) The nature of the audit procedures to be performed.
- 3) The identified risks of material misstatement.
- 4) The significance of the audit evidence obtained.

- 5) The nature and extent of exceptions identified.
- 6) The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- 7) The audit methodology and tools used.

**Question 7:****(ICAI SM)**

**Discuss any two purposes of audit documentation.**

**Answer:**

**The following are the purpose of Audit documentation:**

- 1) Assisting the engagement team to plan and perform the audit.
- 2) Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
- 3) Enabling the engagement team to be accountable for its work.
- 4) Retaining a record of matters of continuing significance to future audits.
- 5) Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
- 6) Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

**Question 8:****(ICAI SM)**

**Define audit documentation. Also give some examples.**

**Answer:**

- 1) Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (Terms such as "working papers" or "work papers" are also sometimes used.)
- 2) **Audit Documentation include:**
  - a) Audit programmes.
  - b) Analyses.
  - c) Issues memoranda.
  - d) Summaries of significant matters.
  - e) Letters of confirmation and representation.
  - f) Checklists.
  - g) Correspondence (including e-mail) concerning significant matters.

**Question 9:****(ICAI SM)**

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

**Answer:**

- 1) The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes:
  - a) The significant matters identified during the audit and
  - b) How they were addressed.
- 2) Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits.
- 3) Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

### **Questions from ICAI Model Test Paper**

**Question 10:****(Model Test Paper 1) / (MTP-I Mar.24)**

**What is meant by audit documentation? What are objectives of an independent auditor in accordance with SA 230?**

**Answer:**

Audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. The objective of the auditor in accordance with SA 230 is to prepare documentation that provides: -

- a) A sufficient and appropriate record of the basis for the auditor's report and
- b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

**Question 11:****(Model Test Paper 2) / (MTP-II Apr.24)**

**One of the factors affecting the form, content and extent of audit documentation relates to size and complexity of the entity. State six other factors in this respect.**



**Answer:**

One of the factors affecting the form, content and extent of audit documentation relates to size and complexity of audit. Other factors are:

- 1) The nature of the audit procedures to be performed.
- 2) The identified risks of material misstatement.
- 3) The significance of the audit evidence obtained.
- 4) The nature and extent of exceptions identified.
- 5) The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- 6) The audit methodology and tools used.

**Question 12:****(Model Test Paper 3) / (Sept 24)**

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

**Answer:**

- 1) In the given case, the audit assistant has kept a large chunk of draft inventory sheets and the final inventory sheet in the audit file which is not correct as the auditor is not required to document draft inventory sheets.
- 2) Auditor should ensure that only final inventory sheets will form part of the audit documentation. Thus, approach of the audit assistant of filing draft and final inventory sheet is not correct.
- 3) As per **SA 230, "Audit documentation"**, audit documentation may be recorded on paper or on electronic or other media.
- 4) **The auditor need not include in audit documentation:**
  - a) Superseded drafts of working papers and financial statements,
  - b) Notes that reflect incomplete or preliminary thinking,
  - c) Previous copies of documents corrected for typographical or other errors, and
  - d) Duplicates of documents.

**Question 13:****(Model Test Paper 5) / (MTP-II Aug.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:**

- a) Deleting or discarding superseded documentation.
- b) Sorting, collating and cross-referencing working papers.
- c) Signing off on completion checklists relating to the file assembly process.
- d) 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.

**Question 14:****(Model Test Paper 7) / (MTP-II Dec.24)**

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

**Answer:**

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

- a) An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.

- b) Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.
- c) After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

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

**Question 15:****(Model Test Paper 8) / (May 24)**

CA B, an auditor, after the completion of busy audit season, was occupied in assembling of final audit files of one of his client. First of all, he started preparing various documents of that client and then kept those documents in various folders. He was preparing documents as well as audit file in paper form because he believed that it is mandatory. He could complete documentation as well as assembling of final audit file of that client after three months from the date of audit report. Generally, he retains audit file of the clients for 4 years from the date of audit report. Check the validity of the action of CA B.

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

- 1) Audit documentation may be recorded on paper or on electronic or other media. Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.
- 2) Hence the views of CA B that audit documentation should be maintained mandatorily in paper form is not correct.
- 3) The auditor shall prepare audit documentation on timely basis. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized.

- 4) Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed. Completing the audit Documentation by CA B not on timely basis is not proper.
- 5) 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.
- 6) In the given situation, CA. B, after completion of audit season, is completing the audit file as well as assembling of final audit files of his client after three months of the date of audit report which is not valid as per SQC 1.
- 7) SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and Related Services", requires firms to establish policies and procedures for the retention of engagement documentation.
- 8) The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report. He retains audit file of the client for 4 years from the date of audit report is also non-compliance of SQC 1.

### Questions from ICAI RTP, MTP and Past Exam

#### Question 16:

(RTP May 24)

Rajni, a CA student, has understood that SA 230 requires auditor to prepare audit documentation on a timely basis. While reading about SQC 1, she notices that time limit for completion of final audit file is ordinarily not more than 60 days after the date of auditor's report. She finds it to be puzzling. Unable to comprehend, she seeks your guidance. Guide her.

#### Answer:

- 1) **SA 230** requires that the auditor shall prepare audit documentation on a timely basis. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized.
- 2) **SQC 1**, however, requires auditor to complete assembly of final audit file in ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is only an administrative

process that does not involve the performance of new audit procedures or the drawing of new conclusions.

- 3) Therefore, auditor shall prepare documentation on a timely basis. However, for completion of assembly of final audit file which is an administrative process, time period of 60 days after the date of auditor's report has been required in SQC 1.

**Question 17:****(RTP May 24)**

**Discussing meaning of completion memorandum, elaborate upon its importance.**

**Answer:**

- 1) Completion memorandum is a summary that describes the significant matters identified during the audit and how they were addressed.
- 2) Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits.
- 3) Further, the preparation of such a summary may assist auditor's consideration of the significant matters.
- 4) It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

**Question 18:****(RTP Sept.24)**

**An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Explain stating clearly the examples of significant matters.**

**Answer:**

- 1) As per SA 230, "Audit documentation" judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:
  - a) Matters that give rise to significant risks.
  - b) Results of audit procedures indicating
    - (i) That the financial statements could be materially misstated, or
    - (ii) A need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.

- c) Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
  - d) Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report.
- 2) An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgement exercised in performing the work and evaluating the results.
  - 3) Documentation of the professional judgements made, where significant, explains the auditor's conclusions and reinforces the quality of the judgement.
  - 4) Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (**for example**, when performing a retrospective review of accounting estimates).

**Question 19:****(MTP-I Mar.25)**

During an audit of MNT Ltd., CA Shubh, the auditor discovers an issue with stock valuation. To ensure the accuracy and reliability of his observations, CA Shubh needs to document the audit procedures, evidence collected, and his observations thoroughly.

**Answer:**

During the audit of MNT Ltd., CA Shubh identifies an issue with stock valuation. To ensure the accuracy and reliability of his observations, it is crucial for him to document the audit procedures performed, the evidence obtained, and his findings in a structured manner.

Audit documentation plays a vital role in supporting CA Shubh's findings in accordance with the Standards on Auditing. Its key purposes include:

- 1) Assisting the engagement team to plan and perform the audit.
- 2) Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
- 3) Enabling the engagement team to be accountable for its work.
- 4) Retaining a record of matters of continuing significance to future audits.
- 5) Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
- 6) Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

**Question 20:****(RTP May 25)**

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

**Answer:**

- 1) In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
  - a) The identifying characteristics of the specific items or matters tested.
  - b) Who performed the audit work and the date such work was completed; and
  - c) Who reviewed the audit work performed and the date and extent of such review.
- 2) The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:
  - a) The nature, timing and extent of the audit procedures performed.
  - b) The results of the audit procedures performed, and the audit evidence obtained; and
  - c) Significant matters arising during the audit and the conclusions reached thereon and significant professional judgements made in reaching those conclusions.
- 3) Thus, all above matters shall be recorded to meet requirements of SA 230. Documenting nature, time and extent of audit procedures performed alone does not meet the requirements of **SA 230**. Therefore, CA Piku's views are not valid.

**Question 21:****(RTP May 25)**

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

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

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

**Answer:**

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

- (i) The size and complexity of the entity.
- (ii) The nature of the audit procedures to be performed.
- (iii) The identified risks of material misstatement.
- (iv) The significance of the audit evidence obtained.
- (v) The nature and extent of exceptions identified.
- (vi) The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- (vii) The audit methodology and tools used.

**Question 22:****(RTP May 25)**

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

**Answer:**

- 1) The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.
- 2) SQC 1, "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files.
- 3) An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.



- 4) Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.
- 5) 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.
- 6) In the given case, even after passage of more than six months, CA Ripun has not assembled an audit file. Besides, he has put in some papers with the current date which is not permissible at all. It shows that part of the audit documentation has been prepared afterwards putting a question mark on the quality of audit.

**Question 23:****(May 25)**

M/s BPA & Associates, Chartered Accountants, was appointed as the auditors of Nissan Ltd., a company with PAN-India presence, for the financial year 2023-24. The audit report was issued on August 20, 2024. Following the issuance of audit report, CA P instructed junior team member Mr. Y to assemble the final audit file and prepare the Completion Memorandum.

- (i) Explain the meaning and significance of a Completion Memorandum.
- (ii) Team Member Y completed the assembly of the final audit file in March 2025 and handed it over to CA P. Was team member Y correct in his approach?

**Answer:**

- (i) **Meaning and Significance of Completion Memorandum:** The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-
  - a) The significant matters identified during the audit and
  - b) How they were addressed.

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

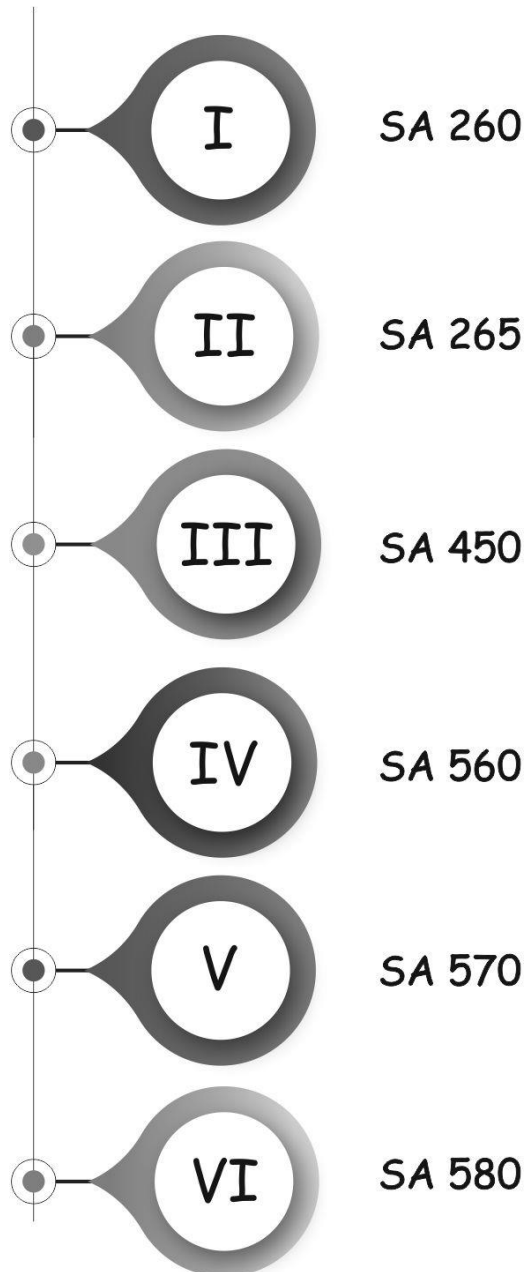
In the given case, the audit report was issued on August 20, 2024 and CA P instructed team member Mr. Y to assemble the final audit file and to prepare completion memorandum. However, Mr. Y completed the assembly of the final audit file in the month of March 2025, i.e. more than 60 days, is non-compliance of SQC 1. Thus, the approach of team member Y is not correct.



## This image shows a full page of white paper with horizontal dashed lines, typical of primary school writing paper. The lines are evenly spaced and run across the width of the page. There are no margins, text, or other markings on the paper.

# Completion and Review

## CHAPTER OVERVIEW:



## Case Study

CA. Gaurav Gogoi is about to conclude audit of a company. It has been noticed during the course of audit that there is shortage of important raw material supplies being imported from China due to prevailing geo-political situation. The company has shared with him its plan to deal with the situation. He is satisfied with assessment of the company for dealing with the matter.

The issue is disclosed in financial statements and considering management's assessment, it is felt that use of going concern assumption by company in preparation of financial statements is appropriate.

Besides, he also wants to be sure that all subsequent events till now have been considered and accounted for, where ever necessary, in financial statements.

Before concluding audit, he requests written representations from management regarding its responsibilities. However, it is noticed that such written representations provided by management use qualifying language.

He has also communicated significant findings from audit in writing with those charged with governance in the company and has retained copy of relevant mails. Besides, there are certain matters which were communicated by him orally from time to time during the course of audit to those charged with governance.

Based upon above, answer the following questions:

- 1) As regards description of matter above concerning issue of going concern, which of the following statements is most appropriate for auditor's report?
  - a) The auditor should express an unmodified opinion.
  - b) The auditor should express a qualified opinion as material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
  - c) Besides expressing an unmodified opinion, the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" drawing attention to the note in which such disclosure is made in financial statements along with related matters.
  - d) Such an issue does not affect auditor's opinion.

- 2) As regards going concern basis of accounting is concerned, which of the following statements is true?
- a) A company showing net loss in its financial statements is essentially not a going concern.
  - b) Following going concern assumption of accounting is primary duty of auditor.
  - c) In case, a company is not a going concern, its financial statements must be prepared on liquidation basis.
  - d) Audit procedure seeking confirmation from banker regarding outstanding balance relates to verification of going concern assumption.
- 3) Which of the following statements is true in respect of auditor's responsibilities in respect of subsequent events?
- a) There is no obligation for an auditor to perform audit procedures for events occurring between date of financial statements and date of auditor's report.
  - b) There is no obligation for an auditor to perform audit procedures after signing of auditor's report, even if he comes to know of an event, which if known to him earlier would have caused him to amend the audit report.
  - c) The auditor has only to rely upon written representation of management regarding subsequent events. He has no other means to know about such events.
  - d) The auditor should perform necessary audit procedures to know about events occurring between the date of financial statements and date of auditor's report.
- 4) As regards use of qualifying language in written representations, which of the following statement is most appropriate?
- a) It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.
  - b) Written representations should be unconditional. Such a wording is not acceptable.
  - c) Such a wording dilutes intent of written representations. However, it can be accepted by auditor only in exceptional circumstances.
  - d) Qualifying language in written representations is compulsory.

- 5) As regards auditor's responsibility regarding matters communicated orally with those charged with governance, which of following is most appropriate?
- a) Matters communicated orally have to be documented by the auditor stating when and to whom these were communicated.
  - b) Matters communicated orally need not be put into writing. It is sufficient for auditor to have communicated orally.
  - c) Matters communicated orally need not be put into writing. It is not practically feasible.
  - d) Matters communicated orally have to be documented by the auditor stating to whom these were communicated.

**Answers to Case Study:**

- 1) c)
- 2) c)
- 3) d)
- 4) a)
- 5) a)

## Independent MCQ's

- 1) An auditor of a company communicates significant findings from audit with those charged with governance in the company. Which of the statements is false in regard to communication made?
- a) Evaluation of adequacy of communication process is required on part of the auditor.
  - b) Planned scope and timing of audit has also to be communicated.
  - c) Communication of rationale behind audit procedures is necessary.
  - d) Significant difficulties encountered during audit, if any, have to be communicated.
- 2) Written representations are:
- a) Necessary audit evidence
  - b) Sufficient appropriate audit evidence
  - c) Not audit evidence
  - d) Audit evidence depending upon auditor's professional judgment

- 3) Which of the following is false regarding communication of misstatements identified during course of an audit?
- a) The auditor should request those charged with governance for correction of identified misstatements.
  - b) The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is material.
  - c) The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is immaterial.
  - d) The auditor should communicate effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.
- 4) Which of the following is not an example of subsequent event?
- a) Event occurring between date of financial statements and date of auditor's report.
  - b) Event occurring on date of financial statements.
  - c) Event occurring after filing audit report with tax authorities. Had such an event been known earlier, auditor would have amended report.
  - d) Event occurring during course of performing audit procedures after date of financial statements.
- 5) Which of the following is not an example of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern?
- a) Adverse key financial ratios
  - b) Inability to invest in modernisation of plant
  - c) Inability to pay creditors on time
  - d) Inability to pay salary of staff

**Answers to the MCQs based Questions:**

- 1) c)
- 2) a)
- 3) b)
- 4) b)
- 5) b)

## SA 260 – Communication with Those Charged With Governance and Management

### Questions from ICAI Study Material

**Question 1:**

**(ICAI SM)**

In what ways an effective two-way communication between auditor and those charged with governance is important?

**Answer:**

Communication from auditor is important with those charged with governance. An effective two-way communication is important in assisting:

- 1) The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity.
- 2) The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and
- 3) TCWG in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

### Questions from ICAI RTP, MTP and Past Exam

**Question 2:**

**(Jan.25)**

SRP Limited appointed M/s JK & Co. as its statutory auditors. Auditors while carrying out the audit observed that company has entered into a complex transaction having material effect on the financial statements. In order to have realistic information on the said transaction (relevant to the audit), audit team decided to take assistance from those charged with governance. Two of the team members were discussing as to who can be "Those charged with governance" but could not get a fair idea of the same. Can you guide them by explaining the same?



**Answer:****Who are “Those Charged with Governance”:**

- 1) The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process.
- 2) For some entities, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.
- 3) Governance structures vary by entities, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example, in some entities, a supervisory board exists that is separate from executive board.
- 4) In other entities, both supervisory and executive functions are performed by a single board. In some entities, those charged with governance hold positions that are an integral part of the entity's legal structure. For example, company directors. In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.
- 5) In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, trustees, or equivalent persons.
- 6) In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee.
- 7) Such diversity means that it is not possible to specify for all audits the persons with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate persons with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities and some not-for-profit organizations.
- 8) In such cases, the auditor may need to discuss and agree with the engaging party the relevant persons with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with SA 315 is relevant. The appropriate persons with whom to communicate may vary depending on the matter to be communicated.

## SA 265 - Communicating Deficiencies in Internal Control to those Charged with Governance and Management

### Questions from ICAI Study Material

**Question 3:**

**(ICAI SM)**

List out some matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency"

**Answer:**

Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency

- 1) The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- 2) The susceptibility to loss or fraud of the related asset or liability.
- 3) The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- 4) The financial statement amounts exposed to the deficiencies. • The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- 5) The importance of the controls to the financial reporting process, for example:
  - a) General monitoring controls (such as oversight of management).
  - b) Controls over the prevention and detection of fraud.
  - c) Controls over the selection and application of significant accounting policies.
  - d) Controls over significant transactions with related parties.
  - e) Controls over significant transactions outside the entity's normal course of business.
  - f) Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
- 6) The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- 7) The interaction of the deficiency with other deficiencies in internal control.

## Questions from ICAI Model Test Paper

**Question 4:**

**(ICAI SM) / (Model Test Paper-2) / (RTP May 25)**

On reviewing internal control over inventories as part of statutory audit of a company, auditor finds that physical verification is not being conducted at regular intervals as stipulated by the management. The auditor finds it to be significant deficiency in internal control over inventories.

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

"Physical verification of inventories is not being conducted at regular intervals as stipulated by management."

Is above communication by auditor proper? Ignore statutory reporting requirements, if any in this regard.

**Answer:**

- 1) 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.
- 2) Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of not carrying out physical verification of inventories at regular intervals as stipulated by management.
- 3) It should explain that such a significant deficiency can lead to misstatement of inventories impacting profits of the company.
- 4) 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 5:**

**(Model Test Paper-3) / (Sept.24)**

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

**"Controls over significant transactions with related parties are weak." In view of the above, please explain:**

- (i) What is meant by deficiency in internal control?**
- (ii) As per SA 265, whether the significant deficiency communicated by CA Vasu to TCWG is appropriate? Explain.**

**Answer:**

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

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

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

Therefore, the above communication is not proper. Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of transactions with firm in which the directors are interested.

It should explain that such a significant deficiency can lead to misstatement of transactions with related party. Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

**Question 6:**

**(Model Test Paper-4) / (MTP-I July 24)**

**CA Sumit has been appointed as statutory auditor of Core Limited. List out some matters that he may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency".**

**Answer:**

**Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency**

- 1) The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- 2) The susceptibility to loss or fraud of the related asset or liability.

- 3) The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- 4) The financial statement amounts exposed to the deficiencies.
- 5) The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- 6) The importance of the controls to the financial reporting process, for example:
  - a) General monitoring controls (such as oversight of management).
  - b) Controls over the prevention and detection of fraud.
  - c) Controls over the selection and application of significant accounting policies.
  - d) Controls over significant transactions with related parties.
  - e) Controls over significant transactions outside the entity's normal course of business.
  - f) Controls over the period-end financial reporting process (such as controls over non-recurring journal entries).
- 7) The cause & frequency of exceptions detected as a result of the deficiencies in the controls.
- 8) The interaction of the deficiency with other deficiencies in internal control.

## Questions from ICAI RTP, MTP and Past Exam

### Question 7:

(MTP-II Apr.25)

Auditors are required to obtain an understanding of internal control relevant to the audit when identifying and assessing its effectiveness and risk of material misstatement. PDC Ltd. appointed CA Nikhil as auditor for the F.Y. 2023-24. During the audit, he observed that significant deficiency exists in the internal control system and he wants to ascertain the same. Elucidate the various indicators of significant deficiencies which will help you in assessing the efficiency of internal control system of the organisation.

### Answer:

As per SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", Indicators of significant deficiencies in internal control include, for example:

- a) Evidence of ineffective aspects of the control environment, such as: -
  - (i) Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.

- (ii) Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
- (iii) Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- b) Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- c) Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- d) Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
- e) Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
- f) Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss.
- g) Evidence of management's inability to oversee the preparation of the financial statements.

**Question 8:****(MTP-I Mar.25)**

**A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. Give examples of indicators of significant deficiencies in internal control.**

**Answer:**

**Examples of indicators of significant deficiencies in internal control are as follows:**

- a) Evidence of ineffective aspects of the control environment, such as:
  - (i) Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
  - (ii) Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
  - (iii) Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- b) Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.

- c) Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- d) Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
- e) Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
- f) Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss.
- g) Evidence of management's inability to oversee the preparation of the financial statements.

## SA 450 – Evaluation of Misstatements Identified during the Audit

### Questions from ICAI Study Material

#### Question 9:

(ICAI SM)

You are nearing completion of audit of a company. On going through your working papers, it is noticed that finished goods inventory was overvalued by Rs. 2 crore. It has also been noticed that freight of Rs.10 lacs paid on import of machinery was charged to statement of profit and loss. Discuss, how you should, proceed and communicate in above situation before signing audit report.

#### Answer:

The instances highlighted in above situation are examples of misstatements identified during the audit.

- 1) Over valuation of inventory of finished goods by Rs. 2 crore and wrongly charging freight of Rs. 10 lacs paid on machinery to statement of profit and loss instead of capitalizing are examples of misstatements.
- 2) The auditor should communicate above identified misstatements to those charged with governance and request for correction of these misstatements.

- 3) In case, these are not corrected, understand the reasons for not making the corrections and reassess materiality. It should also be considered whether uncorrected statements are material individually or in aggregate.
- 4) Effect of uncorrected misstatements on the opinion in auditor's report should be communicated to those charged with governance.

**Question 10:****(ICAI SM)**

Discuss documentation requirements for an auditor regarding misstatements identified during audit under SA 450.

**Answer:**

The audit documentation shall include: -

- a) The amount below which misstatements would be regarded as clearly trivial;
- b) All misstatements accumulated during the audit and whether they have been corrected; and
- c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

## Questions from ICAI Model Test Paper

**Question 11:****(Model Test Paper-1) / (MTP-I Mar.24)**

Up and High Private Limited has started its export business during the year 2023-24. The company was catering to domestic market only in past years. CA H, statutory auditor of the company, is of the view that the company has understated its revenue by Rs.50.00 lacs in the year 2023-24 by not complying with requirements of AS 9 relating to revenue recognition.

- i) Discuss responsibilities of statutory auditor to communicate with management in the above situation in accordance with SA 450. Also explain the usefulness of such communication.
- ii) If management refuses to correct misstatement as communicated by the statutory auditor, how should he proceed?

**Answer:**

- 1) The above situation is an example of misstatement relating to non-compliance with requirements of AS 9 identified during audit.



- 2) In accordance with requirements of **SA 450**, the auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements.
- 3) Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees and take action as necessary.
- 4) The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.
- 5) If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

## SA 560 - Subsequent Events

### Questions from ICAI Study Material

#### Question 12:

(ICAI SM)

CA PK Jacob is conducting audit of a company for year 2021-22. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2022. However, it becomes known to the auditor that one of overseas buyers has made a legal claim against the company on 1st June 2022 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August, 2021. The management of company has decided to agree to an out of court settlement of Rs.5 crore to protect its reputation. The financial statements of the company are silent on this issue. Discuss, how, CA PK Jacob should proceed to deal with above issue.

**Answer:**

- 1) In the given case, the auditor has come to know of legal claim against the company before issue of audit report. It has also come to his knowledge that management of company has agreed to an out of court settlement of Rs.5 crore.
- 2) It is an example of subsequent event between the date of the financial statements and the date of the auditor's report. It provides evidence of conditions that existed at the date of the financial statements and requires adjustment in financial statements.
- 3) He should ask company management to make necessary adjustment to the financial statements. If adjustment is not made by management, he should consider impact on auditor's report.

**Question 13:****(ICAI SM)****Discuss meaning of "Date the financial statements are issued" under SA 560.****Answer:**

- 1) It reflects the date that the auditor's report and audited financial statements are made available to third parties.
- 2) The date the financial statements are issued generally depends on the regulatory environment of the entity.
- 3) In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority.
- 4) Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report, but must also be at or later than the date the auditor's report is provided to the entity.

## Questions from ICAI Model Test Paper

**Question 14:****(Model Test Paper-2) / (MTP-II Apr.24)**

CA J is working as internal auditor in JKL Limited, a non-listed company. The responsibilities of internal auditor include reviewing financial information and performing detailed tests on transactions and balances.

He is also responsible for compliance with laws, regulations and external requirements.

During the year 2022-23, services of an employee of company were terminated. The said employee had filed a suit against the company in respect of certain compensation dues amounting to ` 10 lakhs which were not paid to him. Based upon advice of legal counsel, the company had made a provision of ` 10 lacs in financial statements for year 2022-23. However, somewhere in June 2023, there is an out of court settlement between company and employee for ` 6 lakhs. The statutory audit of company is under progress and audit report has not yet been finalized. How internal auditor should have proceeded in situation?

**Answer:**

- 1) Subsequent events are events occurring between the date of financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report.
- 2) In the given case, the company had already made provision of ` 10 lakhs in financial statements for year 2022-23. However, there is an out of court settlement between the company and employee for ` 6 lakhs.
- 3) It is an example of event which provides evidence of conditions that existed at the date of financial statements i.e. 31st March, 2023. It provides evidence on adjustment in provision amount already made in financial statements. Therefore, internal auditor should ask management to revise provision downwards to ` 6 lakhs so that financial statements are in accordance with applicable accounting standards.

**Question 15:****(Model Test Paper-3) / (Sept.24)**

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

On 25/4/2024, the company received a communication from the Central Government that an incentive amount of ₹ 5 crores pertaining to financial year 2023-24 was approved.

It was paid to the company before the end of April 2024. The financial statements of the company were not yet issued to the shareholders.

The Board of Directors wished to include the incentive amount in the financial statements and requested the auditor to issue a fresh audit report for the year ended 31/03/2024. Analyze the issue involved and give an overview of the auditor's responsibility in such a situation.

**Answer:**

**Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued:**

- 1) As per SA 560, "Subsequent Events", the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report.
- 2) However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall
  - (i) Discuss the matter with management and, where appropriate, those charged with governance.
  - (ii) Determine whether the financial statements need amendment and, if so,
  - (iii) Inquire how management intends to address the matter in the financial statements.
- 3) If management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment. Further, the auditor shall extend the audit procedures and provide a new auditor's report on the amended financial statements. However, the new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.
- 4) In the instant case, ABC Ltd. received an amount of ` 5 crore on account of incentives pertaining to year 2023-24 in the month of April 2024 i.e. after finalisation of financial statements and signing of audit report but before the issuance of Financial Statements to stakeholders. The Board of Directors of ABC Ltd. wished to amend the financial statements and requested the CA. Rashmi (auditor) to consider this event and issue a fresh audit report on the financial statements for the year ended on 31.03.2024.
- 5) After applying the conditions given in SA 560, CA. Rashmi can issue new audit report subject to date of audit report which should not be earlier than the date of approval of the amended financial statements.

**Question 16:****(Model Test Paper-5) / (MTP-II Aug.24)**

As per SA 560, when after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that had it been known to the auditor at the date of the auditor's report, it may have caused the auditor to amend the auditor's report. In this context, what is meant by "Date the financial statements are issued"? Can it be later than the date of providing auditor's report to the entity?

**Answer:**

- 1) "Date the financial statements are issued" reflects the date on which the auditor's report and audited financial statements are made available to the third parties. The date the financial statements are issued generally depends on the regulatory environment of the entity.
- 2) In some circumstances, the date the financial statements are issued maybe the date that they are filed with a regulatory authority.
- 3) Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report but must also be at or later than the date the auditor's report is provided to the entity.
- 4) Therefore, "date the financial statements are issued" can be later than date of providing auditor's report to the entity.

**Questions from ICAI RTP, MTP and Past Exam****Question 17:****(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 ` 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:**

- 1) 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 ` 5 crores. The auditor has yet to sign audit report.
- 2) 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:
  - a) Inquiry of management whether any subsequent events have occurred
  - b) 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
  - c) Reading entity's latest subsequent interim financial statements
  - d) Obtaining Written representations from management in accordance with SA 580
- 3) 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.

**Question 18:****(RTP Sept.25)**

During the audit of Cryst Ltd. for the financial year ended 31st March 2025, the auditor, CA Z was in the process of finalising the audit report dated 30th May 2025. The engagement partner emphasised that CA Z shall perform audit procedure designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report, that requires adjustment of, or disclosure in, the financial statements have been identified. What audit procedures, in accordance with SA 560, should the auditor CA. Z perform based on risk assessment to identify events occurring between the date of the financial statements and the date of the auditor's report that require adjustment or disclosure?

**Answer:**

**Audit procedures relating to events occurring between the date of the financial statements and the date of the auditor's report:**

- 1) The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the

date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.

- 2) The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.
- 3) The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:
  - a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
  - b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
  - c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
  - d) Reading the entity's latest subsequent interim financial statements, if any.

**Question 19:****(MTP-II Apr.25)**

During the audit of Jimjam Ltd., CA Arjun, the auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report, that requires adjustment of, or disclosure in, the financial statements have been identified. With reference to Standards on Auditing, what specific audit procedures should CA Arjun include in his risk assessment to address subsequent events effectively?

**Answer:**

- 1) The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.
- 2) The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

- 3) The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto.
- 4) **The auditor shall take into account the auditor's risk assessment which shall include the following:**
  - a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
  - b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
  - c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
  - d) Reading the entity's latest subsequent interim financial statements, if any.

## SA 570 - Going Concern

### Questions from ICAI Study Material

#### Question 20:

(ICAI SM)

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:**

- 1) 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.
- 2) 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.
- 3) Such a cash flow forecast should address auditor's concerns regarding liquidity crisis being faced by the company.
- 4) 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.
- 5) The auditor should also consider whether any additional facts or information have become available since the date on which management made its assessment.

**Question 21:**

**(ICAI SM)**

**The auditor of a company is having concerns about following of going concern basis of accounting followed by management for preparation of financial statements. It asks the management to justify preparation of financial statements. However, management is not willing to make its assessment and share with auditor. What are implications for auditor's report in such a scenario?**

**Answer:**

**Implications for the auditor's report**

- 1) **If use of Going concern basis of accounting is inappropriate:**  
If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.
- 2) **If use of going concern basis of accounting is appropriate but a material uncertainty exists**

- a) Adequate Disclosure of a Material Uncertainty is made in the Financial Statements If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:
- (i) Draw attention to the note in the financial statements that discloses such matters.
  - (ii) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

- b) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:

- (ii) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705.
- (iii) 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.

**3) Management unwilling to make or extend its assessment:**

If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider the implications for the auditor's report. In such a situation, a qualified opinion or a disclaimer of opinion in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements.

## Questions from ICAI Model Test Paper

**Question 22:**

**(Model Test Paper-1) / (MTP-I Mar.24)**

**Mention any four financial events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as going concern.**

**Answer:**

**Financial events or conditions that may cast significant doubt on the entity's ability to continue as going concern:**

- a) Net liability or net current liability position.**
- b) Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short term borrowings to finance long term assets.**
- c) Indications of withdrawal of financial support by trade payables.**
- d) Negative operating cash flows indicated by historical or prospective financial statements.**
- e) Adverse key financial ratios.**
- f) Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.**
- g) Arrears or discontinuance of dividends.**
- h) Inability to pay trade payables on due dates.**
- i) Inability to comply with terms of loan agreements.**
- j) Change from credit to cash-on-delivery transactions with suppliers.**
- k) Inability to obtain financing for essential new product development or other essential investments.**

**Question 23:**

**(Model Test Paper-1) / (MTP-I Mar.24)**

**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:**

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

**Question 24:****(Model Test Paper-4) / (MTP-I July 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:**

- 1) 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.
- 2) 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.

- 3) 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.
- 4) 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.
- 5) 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.
- 6) 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.
- 7) 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.

**Question 25:****(Model Test Paper-6) / (MTP-I Nov.24)**

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

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

**Answer:**

- 1) 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.
- 2) 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.
- 3) 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.
- 4) The auditor should also consider whether any additional facts or information have become available since the date on which management made its assessment.

**Question 26:****(Model Test Paper-7) / (MTP-II Dec.24)**

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

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

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

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

**Answer:**

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

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern

through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:

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

### Questions from ICAI RTP, MTP and Past Exam

#### Question 27:

(RTP May 24)

Kundan, a CA student, is part of an engagement team conducting audit of an entity. The audit procedures are nearing completion. He notices that engagement partner has asked for a cash flow forecast from management for next twelve months from date of financial statements. Keeping in view above, answer the following:

- i) Discuss likely purpose of engagement partner in the above situation. Elaborate upon significance of such testing being performed by engagement partner.
- ii) State any two audit procedures in relation to cash flow forecast likely to be performed by engagement partner.

**Answer:**

- 1) In the given situation, the engagement partner has asked for a cash flow forecast from management for next twelve months from date of financial statements. The audit procedures are also nearing completion.
- 2) Therefore, purpose of engagement partner in requiring a cash flow forecast is to obtain sufficient appropriate audit evidence regarding and to conclude on appropriateness of management's use of going concern basis of accounting in preparation of its financial statements.
- 3) Further, his purpose is also to conclude on basis of audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast a significant doubt on ability to entity to continue as a going concern, and to report in accordance with SA 570.
- 4) The significance of testing going concern assumption is due to its effect on preparation of financial statements. When the use of going concern is considered as appropriate, assets and liabilities are recorded on the basis that entity will be able to realize its assets and discharge liabilities in normal course of business. In case it is not so viewed, financial statements are prepared on liquidation basis. Hence, testing such an assumption provides evidence to auditor whether use of such assumption is appropriate or not.
- 5) **Two audit procedures in relation to cash flow forecast likely to be performed**
  - a) Evaluate reliability of underlying data generated to prepare the forecast
  - b) Determine whether there is adequate support for assumptions underlying the forecast

**Question 28:****(RTP Sept.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 29:****(Jan.25)**

Projects India Limited (PIL) is engaged in manufacturing and trading of disposable glasses and plates used in social gatherings/functions. XYZ & Co., Chartered Accountants, is the statutory auditor of PIL for the F.Y. 2023-24. Analytical procedures carried out by the audit team, headed by CA Z, indicate that company's business is going downward and PIL could achieve only 50% of total revenue of F.Y. 2022-23. Management has not taken any steps to increase the revenue or add new products or customers to stabilize the revenue and profitability. Also the suppliers are demanding cash payment at the time of purchase of raw material. Before finalizing the audit report, audit in charge asked for a cash flow forecast from management for the next 12 months from the end date of financial statements. Keeping in view the above facts, answer the following:

- (i) What can be the likely purpose of CA Z in the above situation?
- (ii) State any two audit procedures in relation to the cash flow forecast likely to be performed by CA Z.

**Answer:**

- (i) In the given situation, CA Z indicated that the company's business is going downward and 50% of total revenue is also being achieved, further, no steps are being taken by the management to stabilize the revenue and profitability. Accordingly, auditor in-charge asked for a cash flow forecast from management for the next 12 months to analyse as it is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions. Thus, likely purpose of CA Z in the given situation are:
  - 1) To obtain sufficient appropriate audit evidence regarding and conclude on the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;

- 2) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
  - 3) To report in accordance with SA 570.
- (ii) Audit procedures in relation to the cash flow forecast, and analysis likely to be performed by CA Z are:
- 1) Evaluating the reliability of the underlying data generated to prepare the forecast; and
  - 2) Determining whether there is adequate support for the assumptions underlying the forecast.

**Question 30:****(Jan.25)**

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

**Answer:**

- 1) Loss of major markets, key customers and inability to obtain financing for new product development are examples of events or conditions that may cast a significant doubt on the entity's ability to continue as going concern.
- 2) If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors. These procedures shall include:
  - a) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
  - b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.

- c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions: -
  - (i) Evaluating the reliability of the underlying data generated to prepare the forecast; and
  - (ii) Determining whether there is adequate support for the assumptions underlying the forecast.
- d) Considering whether any additional facts or information have become available since the date on which management made its assessment.
- e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

**Question 31:****(May 25)**

**Give five examples of operating events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.**

**Answer:**

As per **SA 570, "Going Concern"**, the following are examples of operating events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

- a) Management intentions to liquidate the entity or to cease operations.
- b) Loss of key management without replacement.
- c) Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- d) Labour difficulties.
- e) Shortages of important supplies.
- f) Emergence of a highly successful competitor.

## SA 580 – Written Representations

### Questions from ICAI Study Material

**Question 32:****(ICAI SM)**

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:**

- 1) 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.
- 2) 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.
- 3) The rationale of obtaining written representations is that even after performing above said procedures, she may not come to know all subsequent events.
- 4) Therefore, it is necessary from an auditor's point of view to obtain acknowledgment from management in the form of Written representations that all such events for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

**Question 33:****(ICAI SM)**

CA R Gurumurthy is about to complete audit of a company. Before completion, he asks management to provide him a written representation confirming that management has fulfilled its responsibilities regarding preparation of financial statements. He also wants

management to confirm in writing about providing of all the necessary information and completeness of transactions to him. The management feels that auditor is seeking irrelevant documents near the completion of audit. Why view of management is not proper? What possible implications it may lead to?

**Answer:**

**The view of management is not proper.**

- 1) Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities.
- 2) This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities.
- 3) In case of refusal of management to provide such a confirmation, it may lead to disclaimer of opinion by the auditor.

## Questions from ICAI Model Test Paper

**Question 34:**

**(Model Test Paper-2) / (MTP-II Apr.24)**

**Written representation about management's responsibilities involves confirmation of fulfilment of management's responsibilities in the preparation of the financial statements providing the relevant information and also informing about completeness of transactions. Explain.**

**Answer:**

Written representation about management's responsibilities involves confirmation of fulfilment of management's responsibilities in following areas: -

**I) Preparation of the financial statements**

- a) The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as set out in the terms of the audit engagement.

- b) Due to its responsibility for the preparation and presentation of the financial statements and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.

## II) Information provided and completeness of transactions

The auditor shall request management to provide a written representation that: -

- a) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement and
- b) All transactions have been recorded and are reflected in the financial statements.

### Question 35:

(Model Test Paper-6) / (MTP-I Nov.24)

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

How should CA Jack proceed in this situation?

### Answer:

- 1) In the given situation, company's management has not provided complete information regarding instances of non-compliance with laws & regulations. If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations and audit evidence in general.
- 2) The above situation highlights that auditor has obtained audit evidence relating to non-compliance with laws which is inconsistent with written representations in this respect casting a doubt about reliability of written representations.
- 3) As per SA 580, "Written Representation", if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations and audit evidence in general.

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

**Question 36:** (Model Test Paper-7 & 8) / (May 24) / (MTP-II Dec.24)

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:**

- 1) 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.
- 2) 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.
- 3) 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.
- 4) 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.
- 5) 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.

- 6) 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.

## Questions from ICAI RTP, MTP and Past Exam

### Question 37:

(RTP Sept.24)

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

### Answer:

- 1) 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.
- 2) Since written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated before the date of the written representations.
- 3) Furthermore, because the auditor must consider events occurring up to the date of the auditor's report that might require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.
- 4) In the given situation, CA Manoj obtained written representations dated June 29, 2024, from the management of the company before signing the audit report on June 30, 2024.
- 5) From the above it can be concluded that written representations have been obtained appropriately.

### Question 38:

(MTP-I Mar.25)

CA Yash is conducting audit of a company for year 2023-24. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2024. However, it becomes known to the auditor that one of overseas buyers has made a legal claim against the company on 1st June 2024 for injury caused to a



customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August, 2023. The management of company has decided to agree to an out of court settlement of ₹ 5 crore to protect its reputation. The financial statements of the company are silent on this issue. Discuss, how, CA Yash should proceed to deal with above issue.

**Answer:**

In the given case, the auditor has come to know of legal claim against the company before issue of audit report. It has also come to his knowledge that management of the company has agreed to an out of court settlement of Rs.5 crore. It is an example of subsequent event between the date of the financial statements and the date of the auditor's report as per SA 560.

**Auditor's responsibilities regarding subsequent events between the date of the financial statements and the date of the auditor's report are as under:**

- a) Perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.
- b) If such subsequent events that require adjustment of, or disclosure in, the financial statements have been identified, it shall be determined whether each such event is appropriately reflected in those financial statements.
- c) Obtain a written representation from management or those charged with governance 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.

**Question 39:**

**(May 25)**

The Management of Sun Shine Ltd. has provided the auditor with a written representation regarding its responsibilities for the preparation of the financial statements. In addition to this, the auditor may request other written representations about the financial statements.

Mention such other representations which may supplement but do not form part of the written representation relating to management's responsibilities regarding preparation of financial statements.

**Answer:**

As per **SA 580, "Written Representations"**, in addition to the written representation about management's responsibilities regarding preparation of financial statements, the auditor may consider it necessary to request other written representations about the financial statements. Other representations which may supplement, but do not form part of the written representation relating to management's responsibilities regarding preparation of financial statements are the following:

- a) Whether the selection and application of accounting policies are appropriate; and
- b) Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed in accordance with that framework:
  - (i) Plans or intentions that may affect the carrying value or classification of assets and liabilities;
  - (ii) Liabilities, both actual and contingent;
  - (iii) Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
  - (iv) Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

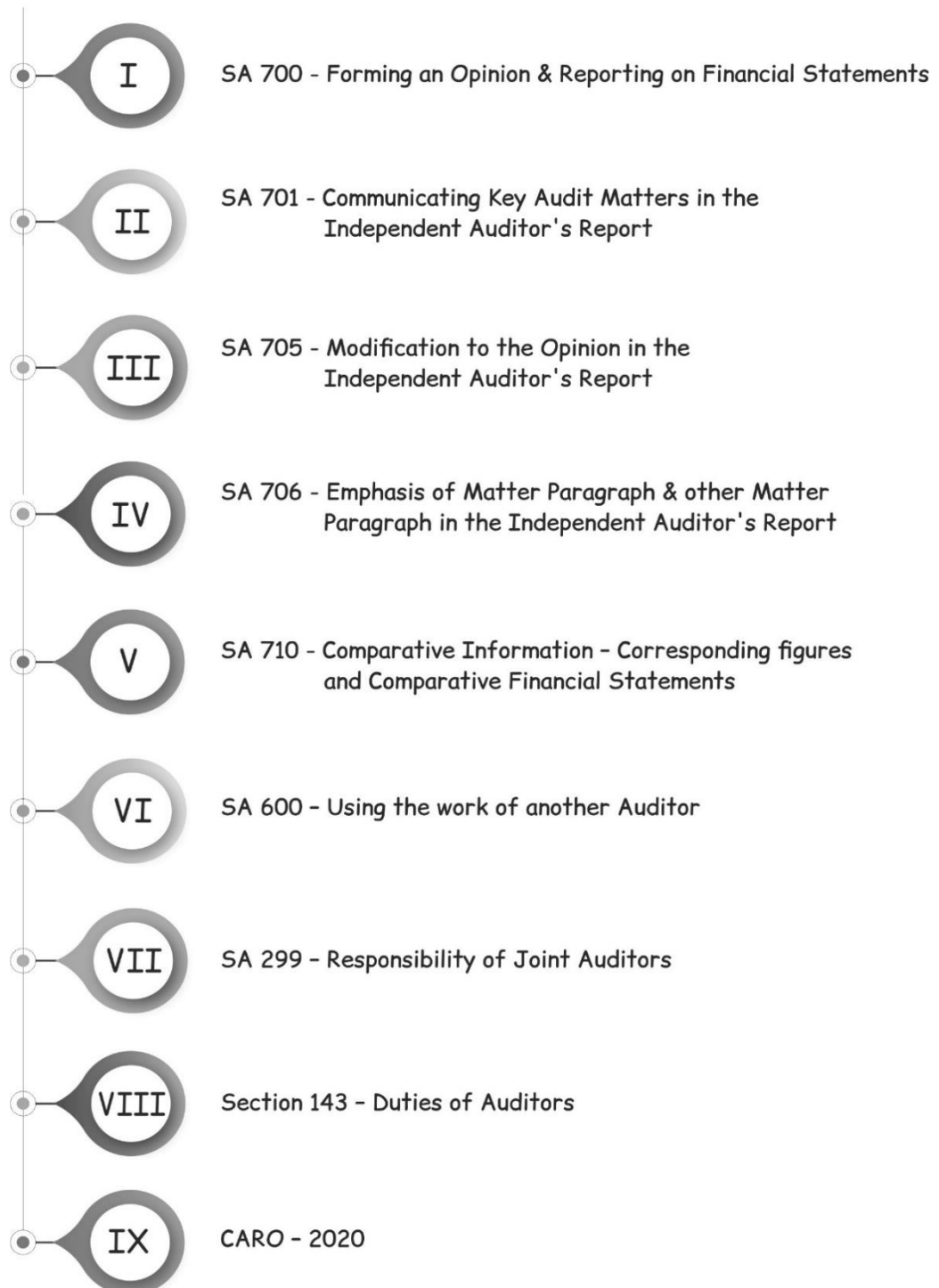


## CHAPTER

## 8

# Audit Report

## CHAPTER OVERVIEW:



## Case Study

M/s AB & Company is a firm of Chartered Accountants based in Mumbai. Mr. A and Mr. B are the Partners of the Firm. The Firm is engaged in various assignments including Audits. The partners are taking a summary of their work in order to prepare themselves to finalize the Audit and issue the audit report to various clients. You are requested to go through the following and answer the questions that follow:

- During the audit of M/s Persistent & Co, Mr. A found that the firm has changed the method of Depreciation from WDV to SLM but has not given the retrospective effect. Mr. A has calculated the difference of depreciation but M/s Persistent & Co. has stated that they don't want to change the financial statements and if auditor persists they may give the effect in the next financial year.
- During the audit of M/s Dubious Brothers, Mr B observed that the firm had a very large amount of cash sales and there were no details of the customers to whom the sales were made. Further, cash generated was not even deposited into bank regularly. When Mr. B asked the firm to give him an opportunity to count cash, the manager of the firm said that the cash is with the owner and it cannot be made available to the auditor for the checking purpose. The manager also declined to give an opportunity for stock verification to Mr. B.
- During the audit of M/s Honest & Associates, Mr. A came to know that the firm has changed its method of valuation of stock. This change has a material impact on the financial statement of the firm. The firm has made relevant disclosures in the financial statements and has given proper accounting treatment to this exercise.

Based upon above, answer the following questions:

- 1) In case of M/s Persistent & Company, what would be an ideal Audit Opinion?
  - a) Unmodified
  - b) Qualified
  - c) Mention the fact in Emphasis of Matter Paragraph
  - d) Disclaimer
- 2) In case of M/s Dubious Brothers, what Audit Opinion should the Auditor give?
  - a) Qualified
  - b) Adverse

- c) Disclaimer
  - d) Unmodified
- 3) According to you, what would be appropriate course to take in case of M/s Honest & Associates?
- a) Issue Qualified Opinion
  - b) Issue Adverse Opinion
  - c) Mention the fact of change in method in Emphasis of Matter Paragraph
  - d) Issue Disclaimer of Opinion
- 4) When the Auditor, after conclusion of an Audit exercise, is of the opinion that there are material misstatements in the Financial Statements, but they are not pervasive, then what should an Auditor do?
- a) Issue Unmodified Opinion
  - b) Issue Qualified Opinion
  - c) Issue Disclaimer of Opinion
  - d) Mention it in Emphasis of Matter Paragraph
- 5) When the Auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, Auditor shall give:
- a) Modified Opinion
  - b) Qualified Opinion
  - c) Disclaimer of Opinion
  - d) Unmodified Opinion

**Answers to Case Study:**

- 1) b)
- 2) c)
- 3) c)
- 4) b)
- 5) d)

## Independent MCQ's

- 1) While expressing an unmodified opinion on financial statements, the auditor shall not use which of the following phrases?
  - a) present fairly in all material respects
  - b) give a true and fair view
  - c) with the foregoing explanation
  - d) All of the above
  
- 2) ..... is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to the user's understanding of the financial statements.
  - a) Emphasis of Matter Paragraph
  - b) Other Matter Paragraph
  - c) Key Audit Matter
  - d) Management Responsibility Paragraph.
  
- 3) Statement 1: Communicating key audit matter in the auditor's report constitutes a substitute for disclosure in the financial statements. Statement 2: Instead of modifying an opinion in accordance with SA 705, the statutory auditor can use Key Audit Matter paragraph in the audit report with an unmodified opinion.
  - a) Only Statement 1 is correct
  - b) Only Statement 2 is correct
  - c) Both the statements are correct
  - d) None of the statement is correct
  
- 4) Which of the following is not correct?
  - a) SA 700 - Forming an Opinion and Reporting on the Financial Statements
  - b) SA 701- Key Audit Matters in the Independent Auditor's Report
  - c) SA 705- Comparative Information- Corresponding figures and Comparative Financial Statements
  - d) SA 706- Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

5) Responsibilities of Joint Auditors are governed by:

- a) SA 200
- b) SA 229
- c) SA 299
- d) SA 230

Answers to the MCQs based Questions:

- 1) c)
- 2) a)
- 3) d)
- 4) c)
- 5) c)

## SA 700 – Forming an Opinion & Reporting on Financial Statements

### Illustrations & Questions from ICAI Study Material

Question 1:

(ICAI SM)

M/s Amitabh & Associates are the statutory auditors of Ringston Ltd. which is a company engaged in the business of manufacture of pen drives. The auditor has started drafting the audit report for the FY 2021-22. CA Amitabh, the engagement partner is of the view that the financial statements of Ringston Ltd. represent a true and fair view. Give the draft of the opinion paragraph of the audit report

Answer:

**We have audited** the financial statements of Ringston Limited which comprise the Balance Sheet as at 31.03.2022 and the statement of Profit and Loss Account and the notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

**In our opinion and to the best of our information and according to the explanations given to us,** the aforesaid financial statements give the information required by the Act in the

manner so required and give a **true and fair view** in conformity with the accounting principles generally accepted in India, of the state of affairs of the company as at 31.03.2022 and the Profit & Loss for the year ending on that date.

**Question 2:****(ICAI SM)**

M/s Kite Rite & Associates are the statutory auditors of Prime Deluxe Limited, for the FY 2021-22. At the time of finalising the audit report, one of the engagement team members, Mr. Robin, asked the engagement partner, CA Kite as to what all should be included in the Basis of Opinion Paragraph. The engagement partner CA Kite, explained the team in detail and asked Mr. Robin to draft such section for the auditor's report of Prime Deluxe Limited. Help Mr. Robin to draft the Basis for opinion section.

**Answer:****Basis for Opinion:**

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under **section 143(10) of the Companies Act, 2013**. Our responsibilities under those Standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report.

We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

**Question 3:****(ICAI SM)**

Diamond Shine Ltd. is a company engaged in the manufacture of detergent. M/s Bright & Associates are the statutory auditors of the company. Explain how the paragraph related to the management's responsibility will come in the auditor's report.

**Answer:****Management's Responsibility for the Standalone Financial Statements**

- 1) The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity) and cash flows of the Company in accordance with the



accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act.

- 2) This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgements and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error.
- 3) In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so. Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

**Question 4:****(ICAI SM)**

M/s Ajay Vijay & Associates are the statutory auditors of Sarovar Ltd. for the FY 2021- 22. The company is engaged in the business of manufacture of water bottles. At the time of finalising the auditor's report, one of the audit team members asked CA Ajay, the engagement partner to advise as to how the auditor's responsibilities can be shown in an appendix to the auditor's report. Draft the auditor's responsibility paragraph so as to advise the audit team member.

**Answer:****Auditor's Responsibilities for the Audit of the Financial Statements**

- 1) Our objectives are to obtain **reasonable assurance** about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.
- 2) **Reasonable assurance is a high level of assurance, but is not a guarantee** that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

- 3) A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor's report. This description, which is located at [indicate page number or other specific reference to the location of the description], forms part of our auditor's report.

**Question 5:****(ICAI SM)**

M/s TUV & Associates are the statutory auditors of Venus Ltd. for the FY 2021-22. At the time of finalising the auditor's report, one of the audit team members asked the engagement partner, CA Tarun, to explain as to how the auditor's report will be signed. Help CA Tarun in explaining the same.

**Answer:**

The following is the correct way of signing an audit report.

M/s TUV & Associates

Chartered Accountants

(Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

(Membership No. XXXXX)

Place of Signature:

UDIN: 20037320AAAAAH1111

Date:

**Question 6:****(ICAI SM)**

Maithili Thakur, a CA student, was perusing audit report of a company. Her eyes fell on an 18-digit alpha numeric number stated at end of audit report below the signatures of auditor and membership number. Make her understand objective and significance of such a randomly generated number. Is it required to be stated in case of audit reports only?

**Answer:**

- 1) The 18-digit alpha numeric number noticed by her at end of audit report is **Unique Document Identification number (UDIN)**. It is a system generated unique number.

- 2) Its basic objective is to curb the malpractices of non-CAs impersonating themselves as CAs. It helps in securing reports and documents issued by practicing CAs.
- 3) It is required to be stated in case of audit reports and certificates.

**Question 7:****(ICAI SM)**

CA. Maya Memani has conducted audit of a company. She has asked Sana, a CA student undergoing training in her office, to prepare draft audit report. Sana was part of engagement team conducting the audit. She has been further told to prepare draft report expressing unmodified opinion. After drafting para comprising unmodified opinion, Sana feels no need to provide basis for opinion. Discuss why her thinking is not proper.

**Answer:**

**"Basis for Opinion"** is one of basic elements of an audit report in accordance with **SA 700**. Even in cases where unmodified opinion is expressed by auditor, "Basis for opinion" has to be provided by auditor. Basis for opinion section provides context about auditor's opinion. **Therefore, Sana's thinking is not proper.**

**Question 8:****(ICAI SM)**

**"The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements."** Discuss stating clearly qualitative aspects of the entity's accounting practices

**Answer:**

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

**Qualitative Aspects of the Entity's Accounting Practices**

- 1) Management makes a number of judgements about the amounts and disclosures in the financial statements.
- 2) **SA 260 (Revised)** contains a discussion of the qualitative aspects of accounting practices.
- 3) In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that

the cumulative effect of lack of neutrality, together with the effect of uncorrected misstatements, causes the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality include the following:

- a) The selective correction of misstatements brought to management's attention during the audit.
  - b) Possible management bias in the making of accounting estimates.
- 4) **SA 540** addresses possible management bias in making accounting estimates.

#### Question 9:

(ICAI SM)

**"The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework."**

**Explain**

#### Answer:

- 1) The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
- 2) In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.
- 3) **That conclusion shall take into account:**
  - a) Whether sufficient appropriate audit evidence has been obtained;
  - b) Whether uncorrected misstatements are material, individually or in aggregate;
  - c) The evaluations

#### Question 10:

(ICAI SM)

**In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required.**

#### Answer:

- 1) In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements.
- 2) The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:

- a) The selective correction of misstatements brought to management's attention during the audit.
- b) Example
  - (i) Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
  - (ii) The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgement and involvement of audit executives.
- c) Possible management bias in the making of accounting estimates.

**Question 11:****(ICAI SM)**

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section.

**Answer:**

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

**The Opinion section of the auditor's report shall also:**

- a) Identify the entity whose financial statements have been audited;
- b) State that the financial statements have been audited;
- c) Identify the title of each statement comprising the financial statements;
- d) Refer to the notes, including the summary of significant accounting policies; and
- e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

**Question 12:****(ICAI SM)**

"An auditor is required to make specific evaluations while forming an opinion in an audit report." State those evaluations.

**Answer:**

**Specific Evaluations by the auditor:**

**In particular, the auditor shall evaluate whether:**

- a) The financial statements adequately disclose the significant accounting policies selected and applied;
- b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- c) The accounting estimates made by management are reasonable;
- d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;
- e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
- f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

**Question 13:****(ICAI SM) / (MTP-I Mar.25)**

The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Explain

**Answer:****Responsibilities for the Financial Statements:**

- 1) The auditor's report shall include a section with a heading "**Responsibilities of Management for the Financial Statements.**"
- 2) SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements.
- 3) Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.
- 4) The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.
- 5) This section of the auditor's report shall describe management's responsibility for:
  - a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; [because of the possible effects of fraud

on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] and

- b) Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

**Question 14:****(ICAI SM)**

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section.

**Answer:****Basis for Opinion:**

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

- a) States that the audit was conducted in accordance with Standards on Auditing;
- b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
- c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.
- d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

**Questions from ICAI RTP, MTP and Past Exam****Question 15:****(Jan.25)**

Singh & Associates, while carrying out statutory audit of Rubber Industries Limited, observed that debtors are not making payments invoice wise. As the debtors constitute sixty percent of the total assets, so auditors requested management to provide external confirmations of all the debtors outstanding for an amount exceeding ` 1.00 Lac. However, management resisted and no external confirmations were made available.



Auditor firm has decided to disclaim an opinion on the financial statements and seek your guidance on amendments that should be made in the "Basis for Opinion" section and elements required by SA 700 (Revised) which need not to be included in the auditor's report. Guide them suitably.

**Answer:**

In the given situation, since the audit firm has decided to disclaim an 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" to "Basis for Disclaimer of Opinion; and within this section, include a description of the matter giving rise to the modification.

Further, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include the following elements required by SA 700 (Revised):

- (i) A reference to the section of the auditor's report where the auditor's responsibilities are described; and
- (ii) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

**Question 16:**

(RTP Jan.25)

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

**Answer:**

- 1) The 18-digit alpha numeric number noticed by her at the end of the audit report is Unique Document Identification number (UDIN). It is a system generated unique number.
- 2) It was noticed that financial documents/ certificates attested by third persons misrepresenting themselves as CA Members were misleading the Authorities and Stakeholders. ICAI also received number of complaints of signatures of CAs being forged by non CAs.
- 3) To curb the malpractices, ICAI implemented the concept of UDIN i.e. Unique Document Identification Number.
- 4) Chartered Accountants having full-time Certificate of Practice can register on UDIN Portal and generate UDIN by registering the certificates attested/certified by them.



- 5) An auditor is required to mention the UDIN with respect to each audit report being signed by him, along with his membership number while signing an audit report and Certificates.
- 6) It is required to be stated in case of audit reports and certificates.

## SA 701 - Communicating Key Audit Matters in the Independent Auditor's Report

### Questions from ICAI Study Material

**Question 17:**

**(ICAI SM)**

Communicating Key Audit Matter is not a substitute for disclosure in the Financial Statements rather Communicating key audit matters in the auditor's report is in the context of the Auditor having formed an opinion on the financial statements as a whole. Analyse.

**Answer:**

Communicating key audit matters in the auditor's report is not:

- a) A substitute for disclosures in the financial statements that the applicable Financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
- b) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);
- c) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
- d) A separate opinion on individual matters

### Questions from ICAI RTP, MTP and Past Exam

**Question 18:**

**(RTP May 25)**

As per SA 701, the objectives of the auditor are to determine key audit matters and having formed an opinion on the financial statements, communicate those matters by describing them in the auditor's report. Which factors are taken into account by auditor

while determining Key Audit Matters? How Key Audit Matters are communicated in audit report?

**Answer:**

The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit.

**In making this determination, the auditor shall take into account the following:**

- a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.
- b) Significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty.
- c) The effect on the audit of significant events or transactions that occurred during the period.
- d) The auditor shall determine which of the matters determined, as stated above, were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

**The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters". The introductory language in this section of the auditor's report shall state that:**

- a) Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements [of the current period]; and
- b) These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

**Question 19:**

**(MTP-II Apr.25)**

Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not considered as a substitute or alternative for a number of important items. What are those items in view of above?

**Answer:**

As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", communicating key audit matters in the auditor's report is in the context of the auditor having formed an

opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

- (i) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
- (ii) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report";
- (iii) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
- (iv) A separate opinion on individual matters.

**Question 20:****(May 25)**

**SA 701 "Communicating Key Audit Matters in the Auditor's Report" deals with the auditor's responsibility to communicate key audit matters in the auditor's report. Explain the definition of Key Audit Matter and how an auditor will determine the Key Audit Matters?**

**Answer:**

**Definition of Key Audit Matter:** Key Audit Matters are those matters that, in the auditor's professional judgement were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

**Determining Key Audit Matters:** The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

- a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.
- b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- c) The effect on the audit of significant events or transactions that occurred during the period.

## SA 705 - Modification to the Opinion in the Independent Auditor's Report

### Illustrations & Questions from ICAI Study Material

#### Question 21:

(ICAI SM)

Super Duper Ltd. is a company engaged in the manufacture of office furniture. M/s Young Old & Associates are the statutory auditors of the company for the FY 2021-22. During the year under audit, the engagement partner CA Young noticed that the company has not bifurcated its loans into long term and short term. CA Young understands that such misstatement is not pervasive though the same is material.

Explain the type of opinion that should be given by M/s Young Old & Associates in this case.

#### Answer:

M/s Young Old & Associates should give a qualified opinion as the effect of the misstatement on account of the non-bifurcation of loans into long term and short term loans, is material but not pervasive.

#### Question 22:

(ICAI SM)

M/s Taj Raj & Associates are the statutory auditors of Porex Ltd. engaged in the manufacture of premium watches, for the FY 2021-22. During the course of audit, CA Taj, the engagement partner found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Both the facts are not reflected in the financial statements for the year ending 31.03.2022. Accordingly, CA Taj is of the view that the impact of both the situations on the financial statements is material and pervasive and thus, the financial statements represent a distorted view of the state of affairs of the company. Explain the reporting requirements of CA Taj.

#### Answer:

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

- 2) In the case Porex Ltd., CA Taj found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Such situations are not reflected in the financial statements of the company despite having a material and pervasive impact on the financial statements. As such, CA Taj should give an adverse opinion.
- 3) Further, CA Taj should also consider the reporting responsibilities under CARO 2020 and section 143(12) of the Companies Act, 2013.

**Question 23:****(ICAI SM)**

Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2021-22 the company transferred its accounts to computerised system (SAP) from manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such the statutory auditors of the company were not able to extract correct data and reports from the system. Such data was not available manually also. Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. Explain the kind of audit report that the statutory auditor of the company should issue in this case.

**Answer:**

When the statutory auditor of the company is unable to obtain sufficient and appropriate audit evidence, the auditor should give disclaimer of opinion as per **SA 705**.

In the present case, the statutory auditor of the company is unable to extract correct data and reports from the SAP system for conduct of audit. Also, such data and reports are not available manually. **As such, the statutory auditor of Delightful Ltd. should give a disclaimer of opinion.**

**Question 24:****(ICAI SM)**

M/s Daisy & Associates are the statutory auditors of Zebra Ltd. for the FY 2021-22. CA Daisy, the engagement partner wants to verify the cash in hand as on 31.03.2022. The cash balance of the company as on 31.03.2022 is ₹ 1,00,000/- and the turnover of the company for the year is ₹ 6 crores. The management of the company informs CA Daisy that such cash verification is not possible as the cashier is on leave for his marriage and no other employee of the company is available as all are busy in year ending activities. Explain the relevant provisions to deal with such a situation.

**Answer:**

- 1) If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers is likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.
- 2) In the present case CA Daisy, the statutory auditor is unable to verify the cash in hand of Zebra Ltd. as on 31.03.2022. The same is due to a limitation imposed by the management of Zebra Ltd. which is due to the non-availability of the cashier.
- 3) In such situation, CA Daisy should perform alternate procedures to verify the cash on hand of the company. **Further, CA Daisy should consider the impact on the auditor's report and may consider issuing a qualified opinion in this case.**

**Question 25:****(ICAI SM)**

M/s Sun Moon & Associates are the statutory auditors of Venus Ltd. for the FY 2021-22. Owing to the pervasive nature of material misstatements in the financial statements of the company, CA Moon, the engagement partner decided to give an adverse opinion. Explain the responsibility of CA Moon with respect to communication with those charged with governance.

**Answer:**

CA Moon, being the statutory auditor of Venus Ltd. should communicate with those charged with governance about the circumstances that led to the expected modification i.e. an adverse opinion. Further the wording of such modification also needs to be discussed.

**Question 26:****(ICAI SM)**

CA. Sarasbhai Patel, while conducting audit of an entity, feels that there is an atmosphere of non-cooperation all around. He has not been provided with necessary support for attending inventory count process of entity as at year end. Besides, CFO is not providing him present addresses of customers as well as suppliers for sending external confirmations. Even mail ids have not been provided on the pretext of business confidentiality. He was not able to verify revenues of entity due to lack of complete details. For verifying expenses, he has been asking for bills on a sample basis, but staff has been making lame excuses. The matter was brought to knowledge of higher echelons of management, but of no avail. The auditor feels that there could be misstatements and their possible effects would be material and affecting many aspects of financial

statements. Assuming it is not possible to withdraw from engagement, what type of opinion should be expressed by auditor?

**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 has brought to knowledge of management but no result has been achieved. Besides, auditor opines that there could be misstatements and their possible effects could be both material and pervasive.

**In such circumstances, he should make disclaimer of opinion in accordance with SA 705.**

**Question 27:**

**(ICAI SM)**

Discuss the factors affecting the decision of the auditor regarding which type of modified opinion is appropriate.

**Answer:**

**The decision regarding which type of modified opinion is appropriate depends upon:**

- a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- b) The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements

**Question 28:**

**(ICAI SM)**

Discuss the objective of the auditor as per Standard on Auditing (SA) 705 "Modifications to The Opinion in The Independent Auditor's Report".

**Answer:**

As per SA 705 "Modifications to the Opinion in the Independent Auditor's Report", the objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when:

- a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or
- b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

**Question 29:**

**(ICAI SM)**

Distinguish between an adverse opinion and a qualified opinion. Also draft an opinion paragraph for both types of opinion.

**Answer:**

- 1) An auditor shall express an adverse opinion, when the auditor having obtained sufficient and appropriate audit evidence, concludes that misstatements, individually or in aggregate are both material and pervasive.
- 2) Whereas, when the auditor, having obtained sufficient and appropriate audit evidence, concludes that misstatements are material but not pervasive, shall express a qualified opinion.
- 3) **SA 705 - "Modifications to the Opinion in the Independent Auditor's Report"** deals with the form and content of both types of report. The following are the draft of the opinion paragraphs of the reports.

**a) Adverse Opinion**

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2021, the consolidated statement of profit and Loss, (consolidated statement of changes in equity) and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "consolidated financial statements").

**In our opinion and to the best of our information and according to the explanations** given to us, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements **do not give a true and fair view in conformity with the accounting principles generally accepted in India**, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 2021, of its consolidated profit/loss, (consolidated position of changes in equity) and the consolidated cash flows for the year then ended.

**b) Qualified Opinion**

**We have audited** the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 2021, and the statement of Profit and Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included



the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)) .

**In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2021 and profit/loss, (changes in equity) and its cash flows for the year ended on that date.**

## Questions from ICAI Model Test Paper

**Question 30:**

**(Model Test Paper-2) / (MTP-II Apr.24)**

M/s S R & Associates are the Statutory Auditors of Vanee Textile and Garments Ltd., a company engaged in the business of manufacturing of various textile products. The auditor has completed the audit and is in the process of forming an opinion on the financial statements for the F.Y. 2023-2024. CA S, the engagement partner, wants to conclude whether the financial statements as a whole are free from material misstatements, whether due to fraud or error. Guide him about the factors he should consider to reach that conclusion.

**Answer:**

**Factors to be considered to form an opinion:**

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

- 1) Whether sufficient appropriate audit evidence has been obtained
- 2) Whether uncorrected misstatements are material, individually or in aggregate.
- 3) The evaluations required
  - a) The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.
  - b) This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

**Question 31:****(Model Test Paper-2) / (MTP-II Apr.24)**

**Discuss the objective of the auditor as per Standard on Auditing (SA) 705 "Modifications to The Opinion in The Independent Auditor's Report".**

**Answer:**

As per Standard on Auditing (SA) 705 "Modifications to the Opinion In the Independent Auditor's Report", the objective of the auditor is **to express clearly an appropriately modified opinion** on the financial statements that is necessary when:

- a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or
- b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

**Question 32:****(Model Test Paper-3) / (Sept.24)**

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

**Answer:**

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

- (i) In our opinion, the accompanying financial statements **present fairly, in all material respects**, [...] in accordance with [the applicable financial reporting framework]; or
- (ii) In our opinion, the accompanying financial statements **give a true and fair view of** [...] in accordance with [the applicable financial reporting framework].

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

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

**Question 33:****(Model Test Paper-6) / (MTP-I Nov.24)**

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

- (i) Qualified Opinion.
- (ii) Adverse Opinion and
- (iii) Disclaimer of Opinion.

**Answer:**

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

**(i) Qualified Opinion**

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

**(ii) Adverse Opinion:**

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

**(iii) Disclaimer of Opinion:**

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

**Questions from ICAI RTP, MTP and Past Exam****Question 34:****(RTP Sept.25)**

Auditors do not always issue an unmodified opinion on financial statements. In cases where there are material misstatements or limitations in obtaining sufficient audit evidence, a modified opinion may be necessary.

Discuss the types of modified audit opinions an auditor can issue? Explain how these opinions differ based on the concepts of materiality and pervasiveness of the issue.

**Answer:**

There are three types of modified opinions, namely:

- (i) A qualified opinion.
- (ii) An adverse opinion.
- (iii) A disclaimer of opinion.

**(i) Qualified Opinion:**

The auditor shall express a qualified opinion when:

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

**(ii) Adverse Opinion:**

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

**(iii) Disclaimer of Opinion:**

- a) The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.
- b) The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

**Question 35:**

**(RTP May 24)**

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

- i) He has not been provided with necessary support for attending inventory count process of entity as at year end.
- ii) 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.
- iii) He was not able to verify revenues of entity due to lack of complete details.
- iv) 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:**

- 1) 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:
- 2) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
  - (i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or
  - (ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.
- 3) 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 Paragraph & Other Matter Paragraph in the Independent Auditor's Report

### Illustrations & Questions from ICAI Study Material

Question 36:

(ICAI SM)

Lomaxe Ltd. is a company engaged in the business of manufacture of candles. CA Kamalnath is the statutory auditor of the company for the FY 2021-22. During the year under audit, there was a fire in the company's factory as a result of which, some of the company's plant and machinery was destroyed. The same was disclosed by the company in the notes to accounts annexed to the financial statements for the year ending 31.03.2022. CA Kamalnath decided to communicate this matter in the auditor's report as he is of the view that the matter is of such importance that it is fundamental to the user's understanding of the financial statements. Help CA Kamalnath to deal with this situation in the auditor's report.

Answer:

In the present case there is a need to add Emphasis on Matter Paragraph in the Auditor's Report. The draft of the same is as under:

Emphasis of Matter - Effects of Fire in Company's Factory

We draw attention to Note Y of the financial statements, which describes the effects of a fire in the Company's factory. Our opinion is not modified in respect of this matter.

Question 37:

(ICAI SM)

Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?

Answer:

Emphasis of Matter paragraph:

A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgement, is of such importance that it is fundamental to users' understanding of the financial statements.

**When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:**

- a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
- b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
- c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

### Questions from ICAI Model Test Paper

**Question 38:**

**(Model Test Paper-5) / (MTP-II Aug.24)**

Pure Services Limited is into the litigation relating to some legal action initiated by the industry regulator. The matter has reached jurisdictional High Court. Keeping in view uncertainty related to future outcome of matter, statutory auditor of the company has decided to include Emphasis of Matter (EOM) Paragraph in auditor's report.

- (i) Briefly discuss the considerations to be taken care of by the statutory auditor when EOM paragraph is included in auditor's report.
- (ii) State any two examples of circumstances where the auditor may consider it necessary to include an EOM paragraph.

**Answer:**

- (i) When the auditor includes an Emphasis of Matter (EOM) paragraph in the auditor's report, the auditor shall:-
  - a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter"
  - b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements and
  - c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.
- (ii) Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter (EOM) paragraph are:

- a) An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- b) A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- c) Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- d) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

**Question 39:****(RTP May 24)**

Mention some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph.

**Answer:**

**Examples of circumstances to include Emphasis of Matter Paragraph:**

As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs in The Independent Auditor's Report", the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- a) An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- b) A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- c) Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- d) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

**Questions from ICAI RTP, MTP and Past Exam****Question 40:****(Jan.25)**

NHG & Co., Chartered Accountants, is statutory auditor of M/s Backlog Private Limited (BPL) for the F.Y. 2023-24. BPL is engaged in providing telecom services and received a notice from telecom regulator to deposit fee for violating norms. BPL went into litigation and filed an appeal with telecom appellate authority and the matter is pending



for decision as at the end of the financial year. However, the company has disclosed the same in financial statements. Audit team members have completed the audit procedures for the year 2023-24 and are in the process of drafting the audit report. Audit team leader knows that matter of norms violation and pending appeal need to be included in the audit report and seeks your guidance on how to report the matter in the auditor's report. Guide him suitably.

**Answer:**

- 1) As per **SA 501** if the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.
- 2) Further, as per **SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"**, the auditor shall report an uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- 3) In addition to above, the auditor's report shall also state whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement as per Section 143(3) of the Companies Act, 2013.
- 4) In the given case, M/s BPL received a notice to deposit fee for violating norms. It went into litigation and filed an appeal which is pending for decision as at the end of the financial year. The company has disclosed the same in the financial statements. The auditor should assess that pending appeal requires adjustment in financial statements. He should ask company management to make necessary adjustment to the financial statements. If adjustment is not made by management, he should consider the impact on auditor's report and report accordingly.

**Alternative Solution:**

- 1) As per **SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"**, the auditor shall report an uncertainty relating to the future outcome of exceptional litigation or regulatory action under Emphasis of Matter paragraph.
- 2) When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:
  - (i) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

- (ii) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
- (iii) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

## **SA 710 - Comparative Information - Corresponding figures and Comparative Financial Statements**

### **Questions from ICAI RTP, MTP and Past Exam**

**Question 41:**

**(Jan.25)**

Oval Enterprises Limited (OEL) is under legal obligation to represent its current year's financial statements along with the previous year's financial statements (comparative financial statements). Karan & Associates, Chartered Accountants, has been appointed as the statutory auditor for the year. CA Karan noticed that the last year's financial statements contain an adverse opinion for the financial statement as a whole due to a misstatement in the evaluation and disclosure of the debtors. Guide CA Karan for his duty regarding the treatment and addressing the issue while drafting his audit report. What disclosures he is required to make in this regard?

**Answer:**

- 1) In the given case, CA Karan noticed that the last year's financial statements contain an adverse opinion for the financial statement whole due to a misstatement in the evaluation and disclosure of the debtors.
- 2) If the auditor's report on the prior period, as previously issued, included an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements.
- 3) In the Basis for Modification paragraph in the auditor's report, the auditor shall either:
  - a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

- b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.
- 4) Further, when comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed. 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:
- a) That the financial statements of the prior period were audited by a predecessor auditor;
  - b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
  - c) The date of that report,

**Question 42:****(MTP-II Apr.25)**

The senior member of the firm Soni & Associates, Chartered Accountants, informed to its auditing staff that at the time of audit reporting regarding corresponding figures, when corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in specified circumstances. What are those exceptional circumstances?

**Answer:**

**When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:**

If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements.

In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

- a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
- b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

**Question 43:**

(RTP Jan.25)

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

Explain clearly the differences between the approaches stating the essential audit reporting. Also define comparative information and audit procedures regarding comparative information.

**Answer:**

- 1) The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework.
- 2) There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in terms of engagement.
- 3) The **essential audit reporting differences between the approaches are:**
  - a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
  - b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.
- 4) **Definition of Comparative Information** - The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.
- 5) **Audit Procedures regarding comparative information:**

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

  - a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
  - b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

## SA 600 – Using the work of another Auditor

### Questions from ICAI Study Material

**Question 44:**

**(ICAI SM)**

CA. Dicky Yadav is auditor of a company having four branches. The four branches are audited by another auditor CA. Yamini Jain. The reports in respect of accounts of branches examined by her have already been sent to company auditor. During the course of audit, CA Dicky Yadav asks the branch auditor to share with her summary of audit procedures and findings in respect of accounts of branches examined. CA. Yamini Jain feels it as encroachment of her domain. Discuss the issue.

**Answer:**

As per SA 600 - "Using the Work of Another Auditor", the principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. Such review of audit procedures and findings can be undertaken if principal auditor feels that it is necessary to apply such procedures to obtain sufficient appropriate audit evidence. **It is not an encroachment of another auditor's domain.**

## SA 299 – Responsibility of Joint Auditors

### Questions from ICAI Study Material

**Question 45:**

**(ICAI SM)**

Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard.

**Answer:**

Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan.

**In developing the joint audit plan, the joint auditors should:**

- a) Identify division of audit areas and common audit areas;
- b) Ascertain the reporting objectives of the engagement;
- c) Consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;
- d) Consider the results of preliminary engagement activities, or similar engagements performed earlier.
- e) Ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

**Question 46:****(ICAI SM)**

**The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Explain stating the advantages of the joint audit.**

**Answer:****Joint Audit:**

- 1) The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations.
- 2) Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually.
- 3) It essentially involves sharing of the total work. This is by itself a great advantage. In specific terms the advantages that flow may be the following:
  - a) Sharing of expertise.
  - b) Advantage of mutual consultation.
  - c) Lower workload.
  - d) Better quality of performance.
  - e) Improved service to the client.
  - f) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
  - g) Lower staff development costs.

- h) Lower costs to carry out the work.
- i) A sense of healthy competition towards a better performance

## Questions from ICAI Model Test Paper

**Question 47:**

**(Model Test Paper-4) / (MTP-I July 24)**

PQR & Associates and MNO & Co., both firms of Chartered Accountants, have been appointed as joint auditors of Gama and Beta Limited. Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard with reference to the Standards on Auditing.

**Answer:**

In accordance with SA 299, "Joint Audit of financial statements", before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, PQR & Associates and MNO & Co., the joint auditors should:

- a) Identify division of audit areas and common audit areas;
- b) Ascertain the reporting objectives of the engagement;
- c) Consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;
- d) Consider the results of preliminary engagement activities, or similar engagements performed earlier
- e) Ascertain the nature, timing and extent of resources necessary to accomplish the engagement

**Question 48:**

**(Model Test Paper-7) / (MTP-II Dec.24)**

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

**Answer:**

**Joint Audit of Financial Statements:**

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

- a) the audit work which is not divided among the joint auditors and is carried out by all joint auditors;
- b) Decisions taken by all the joint auditors under audit planning in respect of common audit areas;
- c) Matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;
- d) Examining that the financial statements of the entity comply with the requirements of the relevant statutes;
- e) Presentation and disclosure of the financial statements as required by the applicable financial reporting framework;
- f) Ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

**Question 49:**

**(May 25)**

As per SA 299 "Joint Audit of Financial Statements", joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. Explain by stating any five advantages of joint audit.

**Answer:**

As per SA 299, "Joint Audit of Financial Statements", the advantages of Joint Audit are:

- (i) Sharing of expertise.
- (ii) Advantage of mutual consultation.
- (iii) Lower workload.
- (iv) Better quality of performance.
- (v) Improved service to the client.
- (vi) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- (vii) Lower staff development costs.
- (viii) Lower costs to carry out the work.



## Section 143 – Duties of Auditors and CARO – 2020

### Questions from ICAI Study Material

**Question 50:** (ICAI SM) / (Model Test Paper-2) / (MTP-II Apr.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 ₹ 4 crores were released to the company by branch of a bank for meeting its working capital requirements. He finds that out of above funds, ₹ 1 crore have been used by company for installing effluent treatment plant to meet State pollution control Board requirements. Is there any reporting obligation upon him under CARO, 2020?

**Answer:**

**Clause (ix) (d) of CARO, 2020** whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated.

In the given situation, funds have been raised for meeting working capital requirements for ₹ 4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings. Out of above, ₹ 1 crore have been used by the company for investment in effluent treatment plant which is ostensibly for a long-term purpose.

Hence, the matter needs to be reported in accordance with requirements of **Clause (ix) (d) of CARO, 2020**.

**Question 51:** (ICAI SM)

ABC Ltd is a company incorporated in India. It has branches within and outside India. Explain who can be appointed as an auditor of these branches within and outside India. Also explain to whom branch auditor is required to report.

**Answer:**

- 1) Sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor.

- 2) Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:
- 3) It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.
- 4) Further as per rule 12 of the Companies (Audit and Auditors) Rules, 2014, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

**Question 52:****(ICAI SM)**

**Discuss the reporting requirements under CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.**

**Answer:**

The following are the disclosure requirements as per CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.

- a) Whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year were applied for the purposes for which those are raised, if not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;
- b) Whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have

been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of noncompliance;

**Question 53:****(ICAI SM)**

**Discuss which class of companies are specifically exempt from the applicability of CARO 2020?**

**Answer:**

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

- a)** A banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
- b)** An insurance company as defined under the Insurance Act, 1938 (4 of 1938);
- c)** A company licensed to operate under section 8 of the Companies Act;
- d)** A One Person Company as defined in clause (62) of section 2 of the Companies Act and a small company as defined in clause (85) of section 2 of the Companies Act; and
- e)** A private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than one crore rupees as on the balance sheet date and which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

## **Questions from ICAI Model Test Paper**

**Question 54:****(Model Test Paper-1) / (MTP-I Mar.24)**

**DOX Limited, a service provider company engaged in providing courier services pan-India as well as internationally, has appointed an internal auditor, Mr. G, in accordance with requirements of the Companies Act, 2013 during financial year 2023-24. The company's annual turnover during year 2022-23 and 2023-24 has been about Rs.300 crores during each of above years. Business of the company has been profitable. Mr. G heads internal**

audit department of the company assessing governance activities, assisting in improving risk management activities and reviewing controls. Discuss reporting responsibility of statutory auditor of the company under the Companies Act, 2013 specifically in relation to internal audit and related matters for the year 2023-24.

**Answer:**

DOX Limited is in business of providing courier services. As name of the company and given facts suggest: -

- a) It is not a small company under section 2(85) of the Companies Act, 2013.
- b) It is not a private company.
- c) It is not a one person company.
- d) It is not a banking or insurance company.
- e) It is not a Section 8 company as it does not has charitable objectsetc.

Therefore, it does not qualify for any exemption from applicability of CARO, 2020. Hence, reporting requirements under CARO, 2020 are applicable. While reporting under CARO, 2020, statutory auditor is required to report under clause (xiv) of paragraph 3 as under:

- i) Whether the company has an internal audit system commensurate with the size and nature of its business
- ii) Whether the reports of the internal auditors for the period under audit were considered by the statutory auditor

**Question 55:**

**(Model Test Paper-3) / (Sept.24)**

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

**Answer:**

**Reporting responsibility of the auditor under paragraph 3 of CARO, 2020:**

- 1) The auditor is required to report as per clause (vii) (a) of Paragraph 3 of CARO, 2020 that whether the company is regular in depositing undisputed statutory dues including Goods and

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

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

**Question 56:****(Model Test Paper-4) / (MTP-I July 24)**

**Mr. Chetan is appointed as an auditor of Spot Limited, a small company. Mr. Chetan is aware that CARO 2020 is not applicable to small company. List out the classes of companies that are specifically exempt from the applicability of CARO 2020.**

**Answer:**

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

- a) A banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;
- b) An insurance company as defined under the Insurance Act, 1938;
- c) A company licensed to operate under section 8 of the Companies Act;
- d) A One Person Company as defined in clause (62) of section 2 of the Companies Act and a small company as defined in clause (85) of section 2 of the Companies Act; and
- e) A private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than one crore rupees as on the balance sheet date and which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

**Question 57:****(Model Test Paper-5) / (MTP-II Aug. 24)**

**Section 143(1) of Companies Act, 2013 states that every auditor of a company shall have access to books of accounts and vouchers of company and shall be entitled to**

require from officers of company such information and explanation as considered necessary and shall inquire into certain matters. State those matters to be inquired.

**Answer:**

Under section 143(1) of the Companies Act, 2013 auditor shall inquire into following matters given as under: -

- a) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members
- b) Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company
- c) Where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company
- d) Whether loans and advances made by the company have been shown as deposits
- e) Whether personal expenses have been charged to revenue account
- f) Where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

**Question 58:**

**(Model Test Paper-6) / (MTP-I Nov.24)**

During the audit of a limited company as a statutory auditor you discovered that a fraud amounting to ₹ 5 lakh has been committed by the company. What are the reporting requirements regarding fraud under the Companies Auditor's Report Order, 2020?

**Answer:**

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

- a) Whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated;
- b) Whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government;

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

**Question 59:****(Model Test Paper-7) / (MTP-II Dec.24)**

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

**Answer:**

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

- (i) A banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
- (ii) An insurance company as defined under the Insurance Act, 1938 (4 of 1938);
- (iii) A company licensed to operate under section 8 of the Companies Act;
- (iv) A One Person Company as defined in clause (62) of section 2 of the Companies Act and a small company as defined in clause (85) of section 2 of the Companies Act; and
- (v) A private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than one crore rupees as on the balance sheet date and which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

**Question 60:****(Model Test Paper-8) / (May 24)**

**You have been appointed as the statutory auditor of a limited company. The company is registered as a Nidhi company. What are the reporting requirements of a Nidhi company under the Companies Auditor's Report Order, 2020?**

**Answer:**

**Reporting requirements of a Nidhi Company under the CARO 2020:** The auditor is required to report under clause (xii) of Paragraph 3 of CARO 2020:

- a) Whether the Nidhi Company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability;
- b) Whether the Nidhi Company is maintaining ten per cent. unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;
- c) Whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof.

## Questions from ICAI RTP, MTP and Past Exam

Question 61:

(MTP-I Mar.25)

SKN Ltd. a biopharma company and global manufacturers of select critical care medical products has been sanctioned working capital limits of ₹ 5.99 crores from a nationalized bank on the basis of security of current assets. During the year under audit, the statutory auditor of SKN Ltd. considers that inventory is material to the financial statements and performs audit procedures over the company's final inventory records to determine whether they accurately reflect actual inventory count and without any major discrepancies for each class of inventory. What are the reporting requirements regarding physical verification of inventory under CARO 2020 in this case?

**Answer:**

As per clause (ii) of Paragraph 3 of CARO, 2020 the auditor is required to report, in respect of physical verification of inventory and in respect of sanctioned working capital, that:

- (i) Whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account.
- (ii) Whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details.



**Question 62:****(RTP Sept.24)**

Discuss the reporting requirements as per CARO, 2020, regarding:

- (i) Statutory Dues
- (ii) Transactions with Related Parties

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

- a) Whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;
- b) Where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned (a mere representation to the concerned Department shall not be treated as a dispute);

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

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

**Question 63:****(May 25)**

TS Ltd. has raised funds by issuing fully convertible debentures. These funds were raised for the expansion and diversification of the business. The company had clearly outlined in its board resolution that these funds will be used for business expansion and diversification purposes only.

However, the company utilised these funds for repayment of long-term loans and advances rather than for the intended purpose of business growth and expansion.

State the reporting responsibility of the auditor under paragraph 3, clause (x) of the Companies Auditor's Report Order, 2020 (CARO 2020).

**Answer:**

The auditor is required to report under Clause (x) of Paragraph 3 of CARO 2020 that:

- a) Whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year were applied for the purposes for which those are raised, if not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported.
- b) Whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of noncompliance.



## CHAPTER

## 9

# Special features of Audit of different types of Entities

## Case Study

Consider the following five descriptions: -

- A) Audit of "Implementation of Nagpur Metro Rail Project" was conducted by the Comptroller and Auditor General of India. Following is extract of few audit findings placed on website [cag.gov.in](http://cag.gov.in). "The location of New Airport station was not ideal from the viewpoint of ridership due to sparse population in and around the station and also from the accessibility point of view. Cotton Market station, the second additional station was projected to have high peak hour peak direction trips but the work was kept on hold midway citing fund crunch due to non-release of pending contribution from stakeholders. However, the situation could have been managed through prioritization of works."
- B) Another set of audit findings in respect of audit of Haryana Power Generation Corporation Limited, a wholly owned government company responsible for operation of power generation plants in state of Haryana is as under: - "The main reason for low generation was higher variable cost of thermal power stations which resulted in backing down of plants."
- C) A report was tabled in Parliament highlighting main features of direct taxes administration of country as mandated in Constitution of India. This report primarily discussed compliance to the provisions of the Income Tax Act, 1961 and the associated rules and procedures etc. as applied to administration of direct taxes including irregularities noticed in finalizing assessments etc.
- D) Radial finance corporation Limited is a government company. The audit of the company is conducted by statutory auditors appointed by Comptroller and Auditor General of India.
- E) Bharat Insurance Company Limited is a general insurance government owned company. The statutory auditor is appointed by Comptroller and Auditor General of India. The annual report for a particular year also contains comments of statutory auditors on

matters such as whether company has carried out reconciliations in respect of its inter-company balances with other government owned insurance companies.

**Based upon above, answer the following questions:**

- 1) Based upon plain reading of audit findings stated at Para (A), identify type of audit carried out by office of the Comptroller and Auditor General of India.
  - a) Audit against provision of funds
  - b) Propriety audit
  - c) Performance audit
  - d) Compliance audit
- 2) Keeping in view audit findings in respect of Haryana Power Generation Corporation Limited, identify type of audit carried out.
  - a) Audit of Government Company
  - b) Audit against rules and orders
  - c) Compliance audit
  - d) Performance audit
- 3) Which of the following is the most appropriate statement in context of report tabled in Parliament regarding administration of direct taxes?
  - a) It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Comptroller and Auditor General of India.
  - b) It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by an independent task force of experts.
  - c) It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Central Board of Direct Taxes.
  - d) It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by Central Board of Direct Taxes.
- 4) Who is empowered to conduct "supplementary audit" in case of Radial finance Corporation Limited, a government company?
  - a) Central Government
  - b) Another independent auditor appointed by CAG
  - c) CAG
  - d) Another independent auditor appointed by Ministry of Corporate Affairs

- 5) As regards comments of auditors specified in respect of audit report of above insurance company, which of the following is likely to be most appropriate statement?
- a) Such are likely to be comments of test audit carried out by CAG.
  - b) Such are likely to be comments in respect of directions to statutory auditor by CAG for reporting on specific aspect of their audit work.
  - c) Such are likely to be comments of supplementary audit carried out by CAG
  - d) Such are likely to be comments of statutory auditors in accordance with requirements of Standards on Auditing

### Answers to Case Study

- 1) c)
- 2) d)
- 3) a)
- 4) c)
- 5) b)

## Independent MCQ's

- 1) The audit of Municipal Corporation of a large metro city is in progress. Which of the following is not likely an objective of such as audit?
- a) To report on the adherence to legal and administrative requirements
  - b) To report on whether value is being fully received for money spent
  - c) To report on the weakness of systems of financial control
  - d) To provide better civic amenities to residents of metro city
- 2) "Save Democracy" is an NGO working in cause of promoting democracy and democratic institutions in many countries including India. Its Indian counterpart has received funds from a renowned "Flower Trust" of US. As auditor of NGO, which of the following laws/orders would be relevant to you in context of above information?
- a) Income Tax Act, 1961
  - b) Foreign Contribution Regulation Act, 2010
  - c) Companies Act, 2013
  - d) Orders issued by Ministry of Social Justice and Empowerment

- 3) The appointment of first auditor of a multi-state cooperative society is made by:
- a) Central Registrar
  - b) Board of society
  - c) Members of society
  - d) Central Government
- 4) Consider following revenue sources of Union Government.
- (P) Revenues from direct taxes
  - (Q) Revenues from Goods and Services Tax
  - (R) Revenues from Custom Duties
  - (S) Revenues from Excise Duties
- Out of P, Q, R and S, which of the following flow to "Consolidated Fund of India"?
- a) P, Q and R
  - b) P, Q and S
  - c) P and Q
  - d) P, Q, R and S
- 5) An LLP files compliance returns with:
- a) Registrar of firms & societies
  - b) Central Registrar
  - c) Registrar of Companies
  - d) Local fund audit wing

**Answers to the MCQs based Questions:**

- 1) d)
- 2) b)
- 3) b)
- 4) b)
- 5) c)

## Descriptive Questions

### Questions from ICAI Study Material

**Question 1:****(ICAI SM)**

It is the duty of Comptroller and Auditor General of India to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it. Discuss, in above context, what is understood by "Consolidated Fund of India"? What is its importance?

**Answer:**

- 1) Consolidated Fund of India consists of all the revenue received from direct and indirect taxes, all the loans taken by the Govt. of India and all the amount of repayment of loans received by the Govt. of India.
- 2) Its importance lies in the fact that all government expenditure is incurred from this fund. No moneys out of the Consolidated Fund of India shall be appropriated except in accordance with law and for the purposes and in the manner provided in the Constitution.

**Question 2:****(ICAI SM)**

CA Akash Virmani is auditor of a partnership firm consisting of 4 partners. During the year, one of the partners has retired and another partner has joined the next day. Discuss, any one point, which shall be considered by you to ensure that financial statements of firm are not misstated due to change of constitution of firm.

**Answer:**

The auditor shall consider provisions of retirement deed/partnership deed for date of retiring and joining of partners. It should be ensured that profits are appropriately distributed up to date of retirement. Further, profits after retirement should have been distributed among partners as per terms of new partnership deed.

**Question 3:****(ICAI SM)**

You are auditor of a school operating in your city. During audit of a year, it is noticed that fees concessions to students have been provided in substantial number of cases. Discuss, how, you as an auditor, would proceed to verify the same?

**Answer:**

The fees concessions have to be under proper authority of school management. The auditor would verify internal controls in this regard. Besides, detailed checking of few cases needs to be undertaken to ensure genuineness of fees concessions and proper management approvals.

**Question 4:****(ICAI SM)**

A society has been formed by pan India employees of a public sector bank. The purpose of society is to promote savings habits of members and to grant loan to them up to a small specified amount. Small savings are promoted amongst members by way of compulsory contribution from monthly salary. Identify type of society and also discuss nature of books of accounts to be maintained by such a society.

**Answer:**

- 1) The society is in nature of Multi-state cooperative society as it serves interests of members in more than one state.
- 2) It accepts small savings from its members and grants loan to members. As per Multi-State Co-operative Society Rules 2002, every Multi- State Co-operative society shall keep books of account with respect to:
  - a) all sum of money received and expended and matters in respect of which the receipt and expenditure take place
  - b) the assets and liabilities

**Question 5:****(ICAI SM)**

Discuss, in what circumstances, Central Registrar can hold an inquiry into working and financial condition of a multi-state cooperative society.

**Answer:**

The Central Registrar may, on a request from:

- a) a federal co-operative to which a Multi- State Co-operative society is affiliated or
- b) a creditor or not less than one-third of the members of the board or
- c) not less than one-fifth of the total number of members of a Multi-state co-operative society,



**Question 6:****(ICAI SM)**

**Sporting Club of India is a private club engaged in promotion of sports in the country. As an auditor of this leading club, discuss any two points to ensure that expenditure incurred by club during the year is properly authorised.**

**Answer:**

The special steps involved in such an audit are stated below:

- 1) Entrance Fee:** Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.
- 2) Subscriptions:** Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.

**Question 7:****(ICAI SM)**

**Tomo Construction Engineering LLP approached CA K to understand various returns to be filed by them as part of statutory compliance. Discuss, how, CA K should advise them.**

**Answer:**

**Returns to be maintained and filed by an LLP:**

- 1)** Every LLP would be required to file annual return in Form 11 with ROC within 60 days of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.
- 2)** Every LLP is also required to submit Statement of Account and Solvency in Form 8 which shall be filed within a period of thirty days from the end of six months the financial year to which the Statement of Account and Solvency relates.

**Question 8:****(ICAI SM)**

**A multi-speciality hospital has come up in your city. You are appointed as auditor for first year. Discuss, any four, broad areas to be kept in mind while conducting audit of accounts of such a newly opened multi-speciality hospital.**

**Answer:**

- 1) Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

- 2) **Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.
- 3) **Income from Investments, Rent etc.:** See with reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities have been collected.
- 4) **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

**Question 9:****(ICAI SM)**

**You have been appointed as an auditor of an NGO, briefly state the points on which you would concentrate while planning the audit of such an organisation?**

**Answer:**

**While planning the audit, the auditor may concentrate on the following:**

- 1) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.
- 2) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 2010, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.
- 3) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.
- 4) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
- 5) Examination of minutes of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.
- 6) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
- 7) Setting of materiality levels for audit purposes.
- 8) The nature and timing of reports or other communications.
- 9) The involvement of experts and their reports.
- 10) Review the previous year's Audit Report.

**Question 10:****(ICAI SM)**

Mention the special points to be examined by the auditor in the audit of a charitable institution running hostel for students pursuing the Chartered Accountancy Course and which charges only INR 500 per month from a student for their lodging/boarding.

**Answer:**

- 1) Examining the rent roll and inspecting tenancy agreements, noting in each case:
  - a) the amounts of the rent, and
  - b) the due dates.
- 2) Vouching the rent on to the rent roll from the counterfoils of receipt books and checking the totals of the cash book.

**Question 11:****(ICAI SM)**

Explain in detail the duties of Comptroller and Auditor General of India

**Answer:**

- 1) **Compilation and Submission of Accounts:** He shall compile the accounts of the Union/State/Union Territory and submit those accounts to the President / Governor / Administrator respectively.
- 2) **Audit of Receipts and Expenditure:** He shall audit and report on all receipts and expenditure of any body, which has been substantially financed from the Consolidated Fund of India/State/Union Territory.
- 3) **Audit of Grants or Loans:**
  - a) Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory to any authority or body, not being a foreign State or international organization.
  - b) The Comptroller and Auditor General shall scrutinize the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.
- 4) **Audit of receipts of Union or States:** The CAG shall review rules and procedures designed to secure an effective check on assessment, collection and proper allocation of revenue, for all receipts payable into Consolidated fund of India/State/Union Territory.
- 5) **Audit of Accounts of Stores and Inventory:** The CAG shall have the authority to audit and report on the accounts of stores and inventory kept in any office or department of the

union or state.

- 6) **Audit of Government Companies & Corporations:** CAG shall exercise powers and observe duties as per the provisions of the Companies Act, 2013 in relation to the Government Companies or Corporations.
- 7) **General provisions relating to Audit** It shall be the duty of the CAG
  - a) To audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;
  - b) To audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;
  - c) To audit & report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

#### Question 12

(ICAI SM)

An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations.

#### Answer:

##### **Receipt of Donations:**

- a) **Internal Control System:** Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.
- b) **Custody of Receipt Books:** Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.
- c) **Receipt of Cheques:** Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount,

etc. should be clearly stated.

- d) **Bank Reconciliation:** Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.
- e) **Cash Receipts:** Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.
- f) **Foreign Contributions,** if any, to receive special attention to compliance with applicable laws and regulations.

**Remittance of Donations to Different NGOs:**

- a) **Mode of Sending Remittance:** All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.
- b) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.
- c) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.
- d) **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.
- e) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.
- f) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.

**Question 13:**

**(ICAI SM)**

**As an auditor, what would be your areas of consideration while auditing the element of ROOM SALES during the audit of a 5-Star Hotel.**

**Answer:**

- 1) The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor.
- 2) The source of these entries is invariably the guest register and audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period.
- 3) Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.
- 4) In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room.

- 5) This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill.
- 6) The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts. The auditor should ensure that proper records are maintained for booking of halls and other premises for special parties and recovered on the basis of the tariff.

**Question 14:****(ICAI SM)****Define Government Audit & explain its objectives.****Answer:****Definition of Government Audit:**

**Government auditing** is the objective, systematic, professional and independent examination of financial, administrative and other operations of a public entity made subsequently to their execution for the purpose of evaluating and verifying them, presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions by the responsible officials and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

**Objectives of Govt Audit are:**

- a) **Accounting for Public Funds:** Government audit serves as a mechanism or process for public accounting of government funds.
- b) **Appraisal of Government policies:** It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.
- c) **Base for Corrective actions:** Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.
- d) **Administrative Accountability:** The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration.

**Question 15:****(ICAI SM)**

**CA A is appointed as the auditor of a charitable institutions. Discuss the audit procedure undertaken by him while auditing the Subscription and Donation received by the**

**charitable institution.**

**Answer:**

- a) Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.
- b) Whether official receipts are issued;
  - a) confirming that adequate control is imposed over unused receipt books;
  - b) obtaining all receipt books covering the period under review;
  - c) test checking the counterfoils with the cash book; any cancelled receipts being specially looked into;
  - d) obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;
  - e) examining the system of internal check regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and
  - f) Verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

**Question 16:**

**(ICAI SM)**

**In case of Government entities, audit of accounts of stores and inventories has been developed as a part of expenditure audit. Discuss about the duties and responsibilities entrusted to C&AG.**

**Answer:**

**Audit of Accounts of Stores and Inventories in Government Companies:**

Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted:

- a) To ascertain whether the Regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.
- b) To bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.
- c) To verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.

- d) To ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.
- e) To check the accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding. Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

**Question 17:****(ICAI SM)**

**Local Fund Audit Wing of a State of a State Government has appointed you to audit the accounts of one of the Local body governed by it. As an auditor, what will be your reporting areas?**

**Answer:**

The auditor while auditing the local bodies should report on the

- a) Fairness of the contents and presentation of financial statements,
- b) The strengths and weaknesses of system of financial control,
- c) The adherence to legal and/or administrative requirements;
- d) Whether value is being fully received on money spent. His objective should be to detect errors and fraud and misuse of resources.

**Question 18:****(ICAI SM)**

**You have been appointed as an auditor of VJM Schools. Discuss the points which merit your consideration as an auditor while verifying Assets and Liabilities of VJM Schools.**

**Answer:**

**Points which merit your consideration as an auditor while verifying Assets and Liabilities of VJM Schools.**

- 1) Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing



Committee.

- 2) Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet not transferred to revenue, unless they are not refundable.
- 3) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.
- 4) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
- 5) Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.

## Questions from ICAI Model Test Paper

**Question 19:**

**(Model Test Paper-1) / (MTP-I Mar.24)**

**Goods and Services Tax Network (GSTN) is a not for profit, limited by shares, company. Its 50% shareholding is with Union Government and 50% with different State Governments. The company provides IT infrastructure and services to various stakeholders including governments and tax payers. The company is in operation since past few years and subsequent auditor needs to be appointed during financial year 2023-24. Who appoints statutory auditor of such a company described above in accordance with provisions of the Companies Act, 2013? Can any directions be issued to statutory auditors of above company?**

**Answer:**

The above company is a government company. **Section 143(5) of the Companies Act, 2013** states that, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) of section 139 i.e. appointment of subsequent auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of

India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statements of the company.

**Question 20:****(Model Test Paper-1) / (MTP-I Mar.24)**

The audit of Government expenditure is one of the major components of Government audit. Briefly explain the basic standards set in relation to audit of Government expenditure.

**Answer:**

**Expenditure Audit:** The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorized by competent authority fixing the limits within which expenditure can be incurred. These standards are:

- a) That the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the audit against 'rules and orders'.
- b) That there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the audit of sanctions.
- c) That there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as audit against provision of funds.
- d) That the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as propriety audit. (v) that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the performance audit.

**Question 21:****(Model Test Paper-1) / (MTP-I Mar.24)**

You have been appointed as an auditor of ABC Hotel, a three star hotel, for Financial Year 2022-23. As an auditor what are the special points that need to be considered in verifying the Inventories in the nature of food and beverages?

**Answer:**

**Verification of inventories in the nature of food and beverages:** The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is

therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores' areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed. Therefore, following may be noted in this regard:

- (i) All movement and transfer of inventories must be properly documented.
- (ii) Areas where inventories are kept must be kept locked and the key retained by the departmental manager.
- (iii) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.
- (iv) Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.
- (v) The auditor should ensure that all inventories are valued at the year end and that he should himself be present at the year-end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories.

**Question 22:****(Model Test Paper-1) / (MTP-I Mar.24)**

**Cinescreen Multiplex Ltd. is operating cinemas in different locations in Mumbai and has appointed you as an internal auditor. What are the areas that need to be verified in relation to receipts from sale of Tickets?**

**Answer:**

The special steps involved in the audit of receipts from sale of tickets are stated below-

- a) Verify that entrance to the cinema-hall during show is only through printed tickets;
- b) Verify that they are serially numbered and bound into books. In case bookings are made online, verify the system for online booking;
- c) Verify that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;
- d) Verify that for advance booking a separate series of tickets is issued;
- e) Verify that the inventory of tickets is kept in the custody of a responsible official.
- f) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.
- g) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.
- h) Reconcile the amount of Tax collected with the total number of tickets issued for each class.

- i) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

**Question 23:****(Model Test Paper-2) / (MTP-II Apr.24)**

You are auditor of a college running different courses operating in your city. During audit of a year, it is noticed that fees concessions to students have been provided in substantial number of cases. Discuss, how, you as an auditor, would proceed to verify the same and also explain two other points to verify fees from students.

**Answer:****Fee from Students:**

The fees concessions have to be under proper authority of college management. The auditor would verify internal controls in this regard. Besides, detailed checking of few cases needs to be undertaken to ensure genuineness of fees concessions and proper management approvals.

**Other points to verify fee from students are:**

- 1) Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal control which ensures that demands against the students are properly raised.
- 2) Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
- 3) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
- 4) Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.
- 5) Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
- 6) Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

**Question 24:****(Model Test Paper-2) / (MTP-II Apr.24)**

**Audit against propriety seeks to ensure that expenditure conforms to certain principles which have for long been recognised as standards of financial propriety. Explain those principles.**

**Answer:**

Some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

- 1) The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.
- 2) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
- 3) Public moneys should not be utilised for the benefit of a particular person or section of the community unless:
  - (i) The amount of expenditure involved is insignificant; or
  - (ii) A claim for the amount could be enforced in a Court of law; or
  - (iii) The expenditure is in pursuance of a recognised policy or custom; and
  - (iv) The amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

**Question 25:****(Model Test Paper-3) / (Sept.24)**

**You have been appointed as an auditor of Co-operative society. During the course of audit, you have noticed some serious irregularities in the working of the society. Enumerate those special matters for reporting to the Registrar.**

**Answer:**

**Special report to the Registrar:** During the course of audit, if the auditor notices that there are some serious irregularities in the working of the society he may report these special matters to the Registrar, drawing his specific attention to the points. The Registrar on receipt of such a special report may take necessary action against the society. In the following cases, for instance, a special report may become necessary:

- (i) Personal profiteering by members of managing committee in transactions of the society,

which are ultimately detrimental to the interest of the society.

- (ii) Detection of fraud relating to expenses, purchases, property and stores of the society.
- (iii) Specific examples of mis-management. Decisions of management against co-operative principles.
- (iv) In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery thereof. Cases of reckless advancing, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

**Question 26:**

**(Model Test Paper-3) / (Sept.24)**

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

**Answer:**

**The lease agreement should be examined, and the following points maybe noted:**

- (i) The description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).
- (ii) The amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.
- (iii) Whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.
- (iv) Whether the agreement prohibits the lessee from subletting the equipment and authorises the lessor to do so.

**Question 27:**

**(Model Test Paper-4) / (MTP-I July 24)**

**Section 72(1) of the Multi-State Co-operative Societies Act, 2002 states that only a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can be appointed as an auditor of a multi-state co-operative society. Who, according to Section 72(2), is disqualified from being appointed as auditors of a multi-state co-operative society?**

**Answer:**

As per section 72 of the Multi-State Co-operative Society Act, 2002 following persons are not qualified for appointment as auditors of a multi-state co-operative society:

- a) A body corporate
- b) An officer or employee of the multi-state co-operative society
- c) A person who is a member or who is in employment, of an officer or employee of the multi-state co-operative society.
- d) A person who is indebted to the multi-state co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the multi-state co-operative society for an amount exceeding one thousand rupees.

**Question 28:****(Model Test Paper-5) / (MTP-II Aug.24)**

While auditing the financial statements of Bro Traders LLP, CA L is carefully going through LLP agreement. Briefly discuss the key points CA L should pay attention in the LLP agreement and the reporting responsibilities of CA L concerning the financial statements of Bro Traders LLP?

**Answer:**

The auditor, CA L should read the LLP agreement & note the following provisions: -

- a) Nature of the business of the LLP.
- b) Amount of capital contributed by each partner.
- c) Interest - in respect of additional capital contributed.
- d) Duration of partnership.
- e) Drawings allowed to the partners.
- f) Salaries, commission etc. payable to partners.
- g) Borrowing powers of the LLP.
- h) Rights & duties of partners.
- i) Method of settlement of accounts between partners at the time of admission, retirement, admission etc.
- j) Any loans advanced by the partners.
- k) Profit sharing ratio

**Reporting Responsibilities of CA L/ concerning the financial statements of Bro Traders LLP is as follows:**

The auditor should mention -

- a) Whether the records of the firm appear to be correct & reliable.

- b) Whether he was able to obtain all information & explanation necessary for his work.
- c) Whether any restriction was imposed upon him.

**Question 29:****(Model Test Paper-6) / (MTP-I Nov.24)**

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

**Answer:**

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

- 1) **Entrance Fee:** Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.
- 2) **Subscriptions:** Vouch members' subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.
- 3) **Arrears of Subscriptions:** Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly adjusted.
- 4) **Arithmetical accuracy:** Check totals of various columns of the Register of members and tally them across.
- 5) **Irrecoverable Member Dues:** See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.
- 6) **Pricing:** Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.
- 7) **Member Accounts:** Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.
- 8) **Purchases:** Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.
- 9) **Margins earned:** Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The inventory of unsold provisions and stores, at the end of year, should be verified



physically and its valuation checked.

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

**Question 30:**

(Model Test Paper-7) / (MTP-II Dec.24)

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

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

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

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

Comment on the above transactions of the society with reference to the Co-operative Societies Act, 1912.

**Answer:**

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

**Restrictions on borrowings -**

- Section 30 of the Central Act further puts restriction on borrowings. According to this section, a registered society shall accept loans and deposits from persons who are not members subject to the restrictions and limits of the bye-laws of the society. The auditor will have to examine the bye-laws in this respect."
- In the given situation, Mr. Dhairya, a member of the society, is holding 200 shares amounting to ₹ 2000 from the previous year. In view of the aforementioned restriction on shareholding by a member, Mr. Dhairya
- Further, Aman Co-operative Society had accepted a loan from Mr. Shivam, a non-member. Since, there are no restrictions regarding the acceptance of loan received from non-member in the society's bye-laws, the loan received from Mr. Shivam is permissible. is

allowed to hold a maximum of 100 shares according to the Act.

**Question 31:**

(Model Test Paper-8) / (May 24)

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

**Answer:**

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

The objective of a contribution or grant towards a Revolving Fund is to rotate the amount by giving temporary loans from the fund to other NGO or beneficiaries for their projects and then recover the loan so as to give temporary loans again and so on. However, any interest earned from the beneficiary on such temporary loans from the revolving fund could be either added back to the fund or credited to the Income and Expenditure Account depending on restrictions laid down by the authority providing the contribution (for the revolving fund) or by the rules and regulations laid down by the concerned NGO in this regard.

**Question 32:**

(MTP-I Mar.25)

**No inspection under Section 79 of Multi-State Co-operative Societies Act, 2002 shall be made unless a notice has been given to the multi-state co-operative society. Explain clearly when and how such inspection can be made. Also state the powers available with the Central Registrar in this regard along with provisions relating to communication of the inspection report under the said section.**

**Answer:**

**Inspection of Multi-State Co-operative societies under Section 79**

- 1) **When:** The Central Registrar may, on a request from
  - a) Federal co-operative to which a Multi- State Co-operative society is affiliated or a creditor or
  - b) Not less than one-third of the members of the board or
  - c) Not less than one-fifth of the total number of members of a Multi-State co-operative society

- 2) **How:** By general or special order in writing in this behalf inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into the constitution, working and financial condition of a Multi-State co-operative society.
- 3) **Opportunity of Being heard:** No inspection shall be made unless a notice of not less than fifteen days has been given to the multi-state co-operative society.
- 4) **Powers available:** The Central Registrar or the person authorized by him shall have the following powers:
- (i) He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, take them into custody and shall have power to verify the cash balance of the society and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary.
  - (ii) Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.
- 5) **Inspection Report:** A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection.

**Question 33:**

(MTP-I Mar.25)

Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. Analyse and Explain.

**Answer:****Audit against Rules & Orders:**

Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority.

Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C&AG.

These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

- a) Rules and orders regulating the powers to incur and sanction expenditure from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);
- b) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and
- c) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be.

But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

- a) They are not inconsistent with any provisions of the Constitution or any laws made thereunder;
- b) They are consistent with the essential requirements of audit and accounts as determined by the C&AG;
- c) They do not come in conflict with orders of, or rules made by, any higher authority; and
- d) In case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

**Question 34:****(MTP-II Apr.25)**

While planning the audit of an NGO, the auditor may focus on knowledge of the NGO's work, its mission and vision, updating knowledge of relevant statutes especially with regard to recent amendments, circulars etc. Explain the other relevant points the auditor needs to focus while planning the audit of NGO.

**Answer:**

**While planning the audit, the auditor may concentrate on the following:**

- a) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.
- b) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. The Foreign Contribution (Regulation) Act 1976, The Societies Registration Act, 1860, The Income-tax Act 1961 etc. and the Rules related to the statutes.
- c) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.
- d) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
- e) Examination of minutes of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.
- f) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
- g) Setting of materiality levels for audit purposes.
- h) The nature and timing of reports or other communications.
- i) The involvement of experts and their reports.
- j) Review the previous year's Audit Report.

**Question 35:****(MTP-II Apr.25)**

**While auditing a renowned four-star hotel in Pune, CA Shrey observes a gift shop operating within the hotel premises. On further enquiries, he comes to know that stocks in gift shop belong to gift shop owner and hotel receives rent for letting out this space. Discuss, how, auditor can verify payment of common amenities used by gift shop owner to the hotel.**

**Answer:**

While auditing a renowned four-star hotel in Pune, CA Shrey observes that a gift shop is operating within the hotel premises. Upon further enquiry, he finds that the stock in the gift shop belongs to gift shop owner and the hotel receives rental income for letting out the space. In this context, to verify the payment of common amenities used by the gift shop owner to hotel, the auditor may adopt the following audit procedures:

- a) The auditor should obtain and examine the rental/lease agreement entered into between the hotel and the gift shop owner.
- b) The auditor should verify rent receipts. This would enable the auditor to ensure that controls regarding revenue cycle are in order.
- c) The auditor should satisfy himself that all taxes collected from gift shop have been paid over to the proper authorities.
- d) Evaluate internal controls related to monitoring of utility consumption and collection of recoveries from tenants or concessionaires (like gift shops).
- e) Verify the hotel's utility bills (electricity bill, water bill etc.) and assess whether cost sharing with the gift shop is proportionate and reasonable.
- f) The auditor should verify that amounts charged for such amenities have been appropriately recorded in the hotel's books and that collections are reconciled with receipts.
- g) The auditor should see that costs of repairs and minor renovation and redecoration are treated as revenue expenditure, where as costs of major alterations and additions to the hotel building and facilities capitalised.

**Question 36:****(MTP-II Apr.25)**

**As per Multi-state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the multi-state co-operative society on the accounts examined by him and on every balance sheet and profit and loss account and on every other document required to be part of or annexed to the balance sheet or profit and loss account. Explain.**

**Answer:**

As per sub-section (3) & (4) of section 73 of the Multi-state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State Co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co-operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

- (i) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and
- (ii) In the case of the profit and loss account, of the profit or loss for its financial year.

**The auditor's report shall also state:**

- (i) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.
- (ii) Whether, in his opinion, proper books of account have been kept by the Multi - State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State co-operative society not visited by him.
- (iii) Whether the report on the accounts of any branch office audited by a person other than the Multi - State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.
- (iv) Whether the Multi - State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.
- (v) Where any of the matters referred to in sub-section (3) or (4) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

### Questions from ICAI Model Test Paper

**Question 37:**

**(RTP May 24)**

**Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. Explain.**

**Answer:**

- 1) Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will minimize the leakage as far as possible.
- 2) Evidence of their success is provided by the preparation of regular perhaps weekly, trading accounts for each sales point and a detailed scrutiny of the resulting profit percentages, with any deviation from the anticipated form being investigated.
- 3) The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.
- 4) The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order.

- 5) The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities. If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor.
- 6) As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts. As a result, the scope of his audit tests will necessarily be increased and, in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.

**Question 38:****(RTP May 24)**

**From a lessee's perspective, highlight main differences between an operating lease and finance lease only in relation to accounting treatment and tax benefits.**

**Answer:****Accounting treatment**

Operating lease is generally treated like a renting arrangement. Lease payments are treated as operating expenses and asset does not appear as asset in lessee's balance sheet. Finance lease is treated like a loan arrangement. Hence, asset ownership is considered of that of lessee and thus appears on the balance sheet of the lessee.

**Tax benefits**

Operating lease payment is considered like an expense just as in case of renting. However, no depreciation can be claimed by lessee. In case of finance lease, lessee can claim both interest and depreciation as it is treated like a loan.

**Question 39:****(RTP Sept.24)**

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

**Answer:**

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

- a) That the affairs of any multi-state co-operative society are not being managed in



accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles or ;

- b) That any multi-state co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains or ;
- c) That the financial position of any multi-state co-operative society is such as to endanger its solvency.

**Question 40:****(RTP Jan.25)**

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

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

- 1) **Internal Control System:** Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.
- 2) **Custody of Receipt Books:** Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.
- 3) **Receipt of Cheques:** Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.
- 4) **Bank Reconciliation:** Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.
- 5) **Cash Receipts:** Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.
- 6) **Foreign Contributions,** if any, to receive special attention to compliance with applicable laws and regulations.

**Remittance of Donations to Different NGOs:**

- 1) **Mode of Sending Remittance:** All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.
- 2) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.
- 3) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.
- 4) **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.
- 5) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.
- 6) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.

**Question 41:****(RTP May 25)**

A government department has been allocated a budget for infrastructure development. During the audit, the auditor observes the following:

- (i) Some payments were processed without proper approval from the competent authority.
- (ii) A large-scale project was implemented, but no assessment has been made regarding the expected benefits were achieved or not.
- (iii) Funds were utilised from an account for which no budgetary provision was made.
- (iv) Certain expenditures were made without following the prescribed financial regulations.
- (v) There were instances of unnecessary spending that did not align with financial propriety.

Identify the different types of audits applicable to each of these observations.

**Answer:**

The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred.

- (i) When payments are processed without proper approval from the competent authority, an Audit of Sanctions is required. This ensures that there is sanction, either special or general, accorded by competent authority authorising the expenditure.
- (ii) In cases where a large-scale project has been implemented without any assessment of whether the expected benefits were achieved, a Performance Audit is necessary. This

type of audit ensures that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them.

- (iii) When funds were utilised from an account for which no budgetary provision was made, an Audit Against Provision of Funds is conducted. This ensures that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority.
- (iv) If expenditures are made without adhering to the prescribed financial regulations, an Audit Against Rules and Orders is applicable. This audit ensures that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority.
- (v) Instances of unnecessary spending that do not align with financial propriety fall under the scope of a Propriety Audit. It ensures that the expenditure is incurred with due regard to broad and general principles of financial propriety.

**Question 42:****(RTP Sept.25)**

You are appointed as an auditor of M/s Shine & Co., a partnership firm. During your review, you observed that:

- The audit appointment was informal and not documented properly.
- The firm started a new business activity which is not covered in the partnership deed.
- Major financial decisions were made without proper records.

As an auditor, briefly explain the matters that should be specially considered by you while auditing the accounts of the partnership firm, M/s Shine & Co.

**Answer:**

While auditing the accounts of M/s Shine & Co., a partnership firm, it is important to ensure that they have formal appointment. Further, deviation from the partnership deed, and absence of documentation for key decisions raise concerns about the validity, transparency, and legal compliance of the firm's operations. Thus, the auditor should specially consider the following matters in the audit of accounts of a partnership:

- (i) **Letter of Appointment:** Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.
- (ii) **Partnership Documents:** Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary

and capital expenditure, raising of loans; purchase of assets, extraordinary contracts entered into and other such matters as are not of a routine nature.

- (iii) **Objects of Partnership:** Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.
- (iv) **Books of Account:** Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.
- (v) **Mutual Interest:** Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.
- (vi) **Provision for Taxes:** Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.
- (vii) **Division of Profits:** Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

#### Question 43:

(Jan.25)

Helping Hands Co-operative society is working for the welfare of its members since last 10 years. Governing body observed that the society had some idle funds during the F.Y. 2023-24 and considering the equity markets growth, decided to invest the same in blue chip mutual funds. Decision brought fortune and society earned handsome return on the investment made. Auditor of the society however gave a qualified opinion. Management has hired you to guide where they went wrong. Give your comments considering section 32 of the Central Act?

#### Answer:

According to section 32 of the Central Act, a society may invest its funds in any one or more of the following:

- (i) In the Central or State Co-operative Bank.
- (ii) In any of the securities specified in section 20 of the Indian Trusts Act, 1882.
- (iii) In the shares, securities, bonds or debentures of any other society with limited liability.
- (iv) In any co-operative bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.
- (v) In any other moneys permitted by the Central or State Government.

In the given case, Helping Hands Co-operative society invested the funds in blue chip mutual funds due to which auditor gave a qualified opinion. Helping Hands Co-operative society should invest the funds in accordance with Section 32 of Central Act as investment in blue chip mutual funds is not permissible.

**Question 44:****(Jan.25)**

CA P was consulted by one of his friends, Mr. Robin. Robin informed him that he wants to enter in education sector and invest in one of the schools being operated in the city. The operations of the school will be managed by Robin only and the proposed investment will be made once CA P confirms the revenue figures given to him (Robin) by existing management of the school. CA P said that main source of revenue to school is fee from students and that will be verified.

What special steps are involved in the verification of fees collected from students?

**Answer:****Steps involved in the verification of fees collected from students:**

- (i) Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.
- (ii) Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
- (iii) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
- (iv) Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.
- (v) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the Rules prepared by the Managing Committee.
- (vi) Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
- (vii) Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

**Question 45:****(May 25)**

M/S PQ & Co., Chartered Accountants have been appointed as statutory auditors of CBD Multiplex Cinema Ltd. The audit team started the audit and verified the ledger and other books of accounts for the F.Y. 2024-2025. However, one of the team members is of the view that the internal control mechanism of the company should also be verified. Can you guide the audit team about the areas that will be covered in verifying the internal control mechanism?

**Answer:**

Areas that will be covered in verifying the internal control mechanism of CBD Multiplex Cinema Ltd. are:

- a) That entrance to the cinema-hall during show is only through printed tickets;
- b) That they are serially numbered and bound into books;
- c) That the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;
- d) That for advance booking a separate series of tickets is issued; and
- e) That the inventory of tickets is kept in the custody of a responsible official.



# Audit of Banks

## Case Study

CA M is conducting statutory audit of branch of MMC Bank. During the course of audit, it is noticed as under:-

- (i) Loans under "Kisan credit card" are given by Bank to farmers to meet their short-term credit needs for cultivation of crops. In respect of one agricultural advance classified under "Kisan Credit Card" having an outstanding balance of ₹ 20 lacs as at year end, there is no transaction in account since last 90 days. The said loan has been granted for cultivation of paddy which is harvested in a period of 3-4 months from sowing. The branch has classified the said advance as "Standard asset".
- (ii) It is also observed that account of one borrower availing cash credit limit of ₹50 lacs was taken over from another bank. The proposal was sanctioned by branch manager instead of immediate next higher authority as required in "Manual of Delegation of Powers" of Bank.
- (iii) It is noticed that head office of bank has flagged a savings account maintained in branch in which interest was wrongly paid at higher rate due to wrong data feeding entry. Now, situation has been rectified by debiting excess interest paid in the account. Since there was little balance in savings account, a debit balance of ₹1.50 lac was created in the said savings account due to above reversal. The matter was immediately informed to account holder. However, he has not turned up for payment since matter was informed to him about six months ago.
- (iv) There are many cash credit accounts in the branch. Such borrowers are required to submit monthly stock statements to branch showing calculation of drawing power.
- (v) One borrower has availed a housing loan and a car loan from the branch. Housing loan EMIs are overdue for 120 days as on date of Balance sheet. Car loan EMIs are overdue for 60 days as on date of Balance sheet.

**Based upon above, answer the following questions:**

- 1) As regards description of agricultural advance, which of the following statements is most appropriate in this regard?**
  - a) The branch has erred in making classification as per RBI norms. It is a "Sub-standard" asset.
  - b) The classification made by branch is proper. However, there are no transactions in account since last 90 days, it is SMA.
  - c) The classification made by branch is proper.
  - d) The branch has erred in making classification as per RBI norms. It is a "doubtful" asset.
  
- 2) Regarding taken over account from another bank, which of following statements is most appropriate?**
  - a) It is an internal issue of Bank and auditor is not concerned with it.
  - b) It is an internal issue of Bank. However, the auditor may, at his discretion, report it.
  - c) It is a serious violation of laid down procedures of bank for sanction of advances and should be reported by auditor without fail.
  - d) There is no issue involved as credit facility was properly sanctioned.
  
- 3) As regards debit balance of ₹ 1.50 lacs in Savings account, which of the following is correct from point of view of an auditor?**
  - a) The situation does not attract RBI norms on asset classification.
  - b) The debit balance of ₹ 1.50 lacs should be classified as NPA.
  - c) The situation does not attract RBI norms on asset classification as no credit facility was granted.
  - d) The bank cannot demand excess interest paid to account holder.
  
- 4) Which of the following statements is not true about "drawing power" (DP)?**
  - a) Drawing Power refers to the amount calculated based on primary security less margin as on particular date.
  - b) It is always less than sanctioned limit.
  - c) It can be different from sanctioned limit.
  - d) Creditors for goods are reduced for purpose of calculating Drawing Power.



- 5) Considering housing loan and car loan availed by a borrower, which of the following statements is appropriate?
- a) Both Housing loan as well as car loan should be classified as "Non-Performing Assets" in accordance with RBI norms on asset classification.
  - b) Housing Loan should be classified as "Non-Performing Asset" in accordance with RBI norms on asset classification. However, Car loan should be classified as Standard asset.
  - c) Car Loan should be classified as "Non-Performing Asset" in accordance with RBI norms on asset classification. However, Housing Loan should be classified as Standard asset.
  - d) Both Housing as well as car loans should be classified as Standard assets.

**Answers to Case Study:**

- 1) c)
- 2) c)
- 3) b)
- 4) b)
- 5) a)

## Independent MCQ's

- 1) Which of the following is included in "Interest Earned" in Profit & loss A/c of a bank?
- a) Discount on Bills
  - b) Loan Processing fees
  - c) Commission on bills for collection
  - d) Credit Card Fees
- 2) While auditing advances of a bank as statutory auditor, which of the following is not a likely concern of auditor?
- a) Appropriate documentation of advances
  - b) Ensuring budgeted targets of advances given by bank management
  - c) Compliance of sanctioned terms and conditions
  - d) Operations in advance accounts

- 3) Any amount due to the bank under any credit facility is 'overdue' if:
- a) it is not paid on the due date fixed by the bank
  - b) it is not paid within 30 days of due date fixed by the bank
  - c) it is not paid within 60 days of due date fixed by the bank
  - d) it is not paid within 90 days of due date fixed by the bank
- 4) Which of the following statement is true regarding appointment of statutory branch auditor of a nationalized bank?
- a) The appointment is made by bank acting through its board of directors with prior approval of Central govt.
  - b) The appointment is made by bank acting through its board of directors with prior approval of RBI
  - c) The appointment is made by bank acting through its board of directors with prior approval of ICAI
  - d) The appointment is made by shareholders in AGM.
- 5) Identify the correct statement:
- a) Income from non-performing assets is recognized on accrual basis
  - b) Income from non-performing assets is never recognized.
  - c) Income from non-performing assets is recognized on basis of actual recovery
  - d) Income from non-performing assets is recognized only when such assets are upgraded to standard assets

**Answers to the MCQs based Questions:**

- 1) a)
- 2) b)
- 3) a)
- 4) b)
- 5) c)

## Descriptive Questions

### Questions from ICAI Study Material

**Question 1:**

**(ICAI SM)**

The financial statements of a bank are prepared in a specified format. Discuss legal provisions in this regard as applicable to financial statements of a nationalized bank.

**Answer:**

- 1) Sub-sections (1) and (2) of Section 29 of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their authentication. These provisions are also applicable to nationalised banks.
- 2) Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit.
- 3) **Form A** of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and **Form B** contains the form of Profit and Loss Account.

**Question 2:**

**(ICAI SM)**

Ranjana Ceramic Private Limited is sanctioned a cash credit facility of ₹100 lacs from a branch of LMO Bank. Besides, branch has also sanctioned a one-time bank guarantee of ₹ 10 lacs on behalf of the company in favour of a statutory authority. Discuss, what type of credit facilities have been sanctioned by branch of LMO bank to the company along with probable purpose for each of credit facility.

**Answer:**

Cash credit facility sanctioned by bank to company is in nature of funded credit facility. Its purpose is to meet working capital requirements of business. Bank guarantee sanctioned to the company is in nature of non-funded credit facility. Its probable purpose could be requirement of a guarantee by a statutory authority in exchange of company fulfilling some statutory obligations.

## Question 3:

(ICAI SM)

During course of audit of branch of a nationalized bank, you find that system has generated a report marking ten term loan accounts as SMA. Discuss, meaning of SMA accounts and significance of such a classification.

Answer:

- 1) **Special Mention Account (SMA)** is an account which is exhibiting signs of incipient stress resulting in the borrower defaulting in timely servicing of debt obligations, though the account has not yet been classified as NPA as per the RBI guidelines.
- 2) In the given case, ten term loan accounts have been classified as SMA. It means that there are overdues in the accounts for a period of 0 to 90 days. Since period of 90 days has not been exceeded as on date, such accounts have not been classified as NPA as per RBI norms.
- 3) Such a classification is significant as early recognition of such accounts enables banks to initiate timely remedial actions to prevent potential slippages of such accounts into NPAs.

## Question 4:

(ICAI SM)

CA P is conducting stock audit of a borrower availing cash credit facility of ₹100 lacs from branch of a bank. The cash credit facility is against security of paid stocks and debtors up to 90 days. Margin stipulated is 25% for stocks and 40% for debtors. Following further information is available as on 31.12.22: -

Value of stocks	₹ 125 lacs
Value of stocks (fully damaged) included in above	5 lacs
Value of debtors	50 lacs
Value of debtors exceeding 90 days included in above	10 lacs
Value of creditors for goods	50 lacs

Is Drawing Power computed by CA P for ₹ 82.50 lacs proper?

Answer:

The computation of Drawing power is as under: -

Particulars	In (₹)
Value of stocks as on 31.12.22	₹ 125 lacs
Less: value of damaged stocks	₹ 5 lacs
	₹ 120 lacs
<b>Less:</b> creditors for goods as on 31.12.22	₹ 50 lacs
Value of Paid stocks	₹ 70.00 lacs

Less: Margin @ 25%	₹ 17.50 lacs
Drawing power (A)	₹ 52.50 lacs
Value of debtors as on 31.12.22	₹ 50 lacs
Less: debtors exceeding 90 days	₹ 10 lacs
	₹ 40 lacs
Less: Margin @ 40%	₹ 16 lacs
Drawing Power (B)	₹ 24 lacs
Drawing Power (A+B)	₹ 76.50 lacs

**Conclusion:**

The drawing power calculated by CA P is not proper. Drawing Power comes to ₹ 76.50 lacs.

**Question 5:****(ICAI SM)**

You are verifying interest on deposits paid by branch of a nationalized bank. Discuss, any two "analytical procedures", to verify interest on deposits paid by branch.

**Answer:**

- 1) The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate.
- 2) The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.
- 3) The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

**Question 6:****(ICAI SM)**

Discuss outline of audit approach including audit procedures while auditing "provisions and contingencies" in financial statements of a bank.

**Answer:**

The auditor should:

- 1) Ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.

- 2) Obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis.
- 3) Obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
- 4) Obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.
- 5) Examine the other provisions for expenses vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

**Question 7:****(ICAI SM)**

Discuss importance of implementation of KYC norms by a bank from perspective of an auditor of bank.

**Answer:****Assess the Risk of Fraud including Money Laundering:**

- 1) As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately.
- 2) The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.
- 3) The RBI has framed specific guidelines that deal with prevention of money laundering and "Know Your Customer (KYC)" norms.
- 4) The RBI has from time to time issued guidelines ("Know Your Customer Guidelines - Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

**Question 8:****(ICAI SM)**

List out any four points which highlight peculiarities involved in banking operations.

**Answer:**

- 1) Huge volumes and complexity of transactions;

- 2) Wide geographical spread of banks' network;
- 3) Large range of products and services offered;
- 4) Extensive use of technology;
- 5) Strict vigilance by the banking regulator etc.

**Question 9:****(ICAI SM)**

**Is statutory auditor of a bank required to report on the requirements relating to Companies (Auditor's Report) Order, 2020?**

**Answer:**

- 1) It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in his report the matters covered by **Section 143 of the Companies Act, 2013**.
- 2) However, it is pertinent to mention that the reporting requirements relating to the **Companies (Auditor's Report) Order, 2020** is not applicable to a banking company, as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949.

**Question 10:****(ICAI SM)**

**Account of a borrower availing cash credit facility from branch of a bank has become "Out or order." Discuss the term "Out of order".**

**Answer:**

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

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

**Question 11:****(ICAI SM)**

**The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country. Explain**

**Answer:**

- 1) The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country.
- 2) RBI is responsible for:
  - a) Development and supervision of the constituents of the Indian financial system (which comprises banks and non-banking financial institutions)
  - b) Determining, in conjunction with the Central Government, the monetary and credit policies keeping in with the need of the hour.
  - c) Regulating the activities of commercial and other banks
- 3) **Important functions of RBI are:**
  - a) Issuance of currency;
  - b) Regulation of currency issue;
  - c) Acting as banker to the central and state governments; and
  - d) Acting as banker to commercial and other types of banks including term lending institutions. Besides, RBI has also been entrusted with the responsibility of regulating the activities of commercial and other banks.
- 4) No bank can commence the business of banking or open new branches without obtaining license from RBI. The RBI also has the power to inspect any bank.

**Question 12:****(ICAI SM)**

**"The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference". Explain**

**Answer:**

- 1) All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement are known to be the "Engagement Team".
- 2) The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.
- 3) All these discussions should be appropriately documented for future reference. The discussion between the members of the engagement team & the audit engagement partner should be done on the susceptibility of the bank's branch financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit.



- 4) The engagement team discussion ordinarily includes a discussion of the following matters:
- a) Errors that may be more likely to occur;
  - b) Errors which have been identified in prior years;
  - c) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
  - d) Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;
  - e) Need to maintain professional skepticism throughout the audit engagement;
  - f) Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

**Question 13:****(ICAI SM)**

**Write a short note on reversal of income under bank audit.**

**Answer:**

- 1) If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.
- 2) In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.
- 3) Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).
- 4) Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

## Questions from ICAI Model Test Paper

**Question 14:**

**(Model Test Paper-2)/ (MTP-II Apr 24)**

Following is the extract from Schedule no. 10 of Advances as appearing in financial statements of branch of a nationalized bank for year ending 31st March, 2024.

**Schedule 10 - Advances**

S. No.	Particulars	Amount (In ₹ Crores) rounded off
1	Bills Purchased and Discounted	50.00
2	Cash credits, overdrafts and loans repayable on demand	150.00
3	Term Loans	75.00
	<b>Total</b>	<b>275.00</b>

In carrying out audit of above advances as part of statutory audit of branch, a statutory auditor would obtain evidence about certain matters. State those matters.

**Answer:**

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following: -

- a) Amounts are included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.
- b) Advances represent amount due to the bank branch.
- c) Amounts due to the bank branch are appropriately supported by loan documents and other documents as applicable to the nature of advances.
- d) There are no unrecorded advances.
- e) The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.
- f) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
- g) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

## Question 15:

(Model Test Paper-2) / (MTP-II Apr 24)

Column A describes description of certain terms used in banking industry. Complete Column B by suggesting term appropriate to description given.

Column A	Column B
Audit of borrower client of bank carried out at bank's request to verify borrower's current assets	?
Limit up to which an entity can withdraw from sanctioned working capital limit	?
Statutory right of a creditor to adjust debit balance in debtor's account against any credit balance lying in another account of debtor	?
Creation of security in a bank branch by mere delivery of title deeds by a prospective borrower of funds	?

Answer:

- 1) Audit of borrower client of bank carried out at bank's request to verify borrower's current assets- **Stock audit**.
- 2) Limit up to which an entity can withdraw from sanctioned working capital limit- Drawing power.
- 3) Statutory right of a creditor to adjust debit balance in debtor's account against any credit balance lying in another account of debtor- Set-off.
- 4) Creation of security in a bank branch by mere delivery of title deeds by a prospective borrower of funds- **Equitable Mortgage**.

## Question 16:

(Model Test Paper-3)

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

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

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

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

- 1) Ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
- 2) Obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis.
- 3) Obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
- 4) Obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.
- 5) Examine the other provisions for expenses vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

**Question 17:****(Model Test Paper-3)**

Alfa Limited has availed bank overdraft facility from a nationalized bank. The company received balance confirmation certificate for bank overdraft balance as on 31.03.2024 from the bank.

Particulars	Amount (₹)
Bank overdraft balance as per Bank Certificate	25,66,200/-
Bank overdraft balance as per Ledger	26,45,300/-

How will you vouch/verify borrowings from Bank taken by Alfa Limited?

**Answer:**

Vouching /Verification of borrowings from Bank: The auditor is required to roll out and obtain independent balance confirmations in respect of all the borrowings from the lender (banks/ financial institutions etc.) and perform the following:

- 1) Ascertain that the confirmation asks for all information likely to be relevant to the tests of debt and related interest balances (e.g., applicable interest rates, due dates, collateral and security interests).
- 2) Send reminders for non-replies.

- 3) Compare the balances as per the confirmations obtained to the books of the accounts. Ask for reconciliations, if there are any differences and test the supporting documents for the reconciling items on a test check basis.
- 4) Reconcile the balances in the overdrafts or loan accounts with that shown in the pass book(s) and confirm the last-mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
- 5) Obtain independent balance confirmation from the bank showing balances, particulars of securities deposited with the bank as security for the loans or of the charge created on an asset and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
- 6) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorized to raise a loan or borrow from a bank.
- 7) Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.
- 8) Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

**Question 18:****(Model Test Paper-4) / (MTP-I July 24)**

While verifying cash and cash equivalents of a company, CA D engagement partner, is very particular that Bank reconciliation statement(BRS) prepared by the management in respect of bank account maintained by the company is proper to rule out misstatements in cash and cash equivalents reflected in the financial statements of the company. The company does not use net banking and prefers to issue cheques to its creditors and receives substantial payments locally through account payee cheques. Which aspects need to be taken care of and verified by CA D in respect of BRS?

**Answer:**

CA D should ensure that BRS is signed by the authorized personnel so that he is able to assign responsibility in case of any errors.

**Verification of BRS shall entail the following: -**

- a) Tallying the balance as per bank book to the bank confirmation/statement.
- b) Checking of all material reconciling items included under cheques issued but presented for payment to the underlying bank book forming part of books of account. In addition, the auditor should

- c) Request for bank statements of subsequent period and should verify if the cheques issued have subsequently been cleared by the bank. For all cases where cheques have become stale i.e. 3 months or more have lapsed since the issue date, the same should not appear in the BRS and should instead be taken back to liabilities.
- d) Checking of all material reconciling items included under cheques deposited but not credited by bank by requesting for bank deposit slips, duly acknowledged by bank and verifying if the balances were credited by bank subsequently by tallying to the bank statement of subsequent period. For any instances related to cheques not cleared beyond reasonable time, the auditor should seek brief descriptions from the management and in case such explanations are found to be unsatisfactory, the auditor should verify the revenue recognition related to such parties was in order and as per the Company's revenue recognition policy.
- e) Checking of all material reconciling items included under amounts or charges debited/credited by bank but not accounted for by requesting for bank statements for the period under audit and tallying the same. If the amounts are found to be material, the auditor should ensure that the management records the adjustments for the same in its books of account.

**Question 19:****(Model Test Paper-4) / (MTP-I July 24)**

National Bank has advanced cash credit facility of ₹ 25 Lakh to Sun Industries. Following is the extract of account of Sun Industries reflecting in CBS of Bank from December 1, 2023 to March 31, 2024: -

Date	Particulars	Dr.	Cr.	Balance
01/12/2023	To Transfer	45000		24,75,000
31/12/2023	By Clearing		1,00,000	23,75,000
31/12/2023	To Interest	25,000		24,00,000
31/01/2024	To Interest	24,700		24,24,700
29/02/2024	To Interest	24,800		24,49,500
31/03/2024	To Inspection charges	1,000		24,50,500
31/03/2024	To Transfer	24,900		24,75,400

Drawing power during the above period was consistent at ₹ 25 Lakh. The account was classified as "Standard asset" as on 31.12.2023 in books of Bank. The security charged with the bank remains intact throughout this period.

**Comment on "asset classification" of above account as on 31st March 2024 in books of Bank in accordance with RBI norms.**

**Answer:**

In accordance with RBI norms on asset classification, a non-performing asset is a loan or advance where the account remains "out of order" in respect of an Overdraft/Cash Credit.

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

- a) The outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
- b) In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- c) Credits are there but are not enough to cover the interest debited during the same period.

In the given case, although outstanding balance in account is less than sanctioned limit/drawing power of ₹ 25 lacs, there are no credits continuously for 90 days as on the date of Balance sheet. Therefore, it has become out of order and is required to be classified as NPA.

**Under non-performing assets, it would be classified as "Sub-Standard Asset" as it has remained NPA for a period of less than or equal to 12 months.**

**Question 20:**

**(Model Test Paper-5) / (MTP-II Aug.24)**

During the course of statutory branch audit of a nationalized bank, CA Amrish is performing audit procedures in relation to the advances. He has verified the selected sample of borrower accounts representing advances and found nothing unusual. In a banking environment, there exist documentary evidence containing observations/comments on advances which can be useful to the statutory branch auditor in performing an effective audit. List out few such documentary evidence which can be made use of by CA Amrish.

**Answer:**

In a banking environment, there exist documentary evidence containing observations/comments on advances which can be useful to the statutory branch auditor in performing an effective audit. CA Amrish, the auditor should take into account the adverse comments, if any, on advances appearing in the following:-

- a) Previous year's audit reports.
- b) Latest internal inspection reports of bank officials.
- c) Reserve Bank's latest inspection report.

- d) Concurrent / Internal audit report.
- e) Report on verification of security.
- f) Any other internal reports specially related to particular accounts.
- g) Manager's charge-handing-over report when incumbent is changed.

**Question 21:****(Model Test Paper-6) / (MTP-I Nov.24)**

**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 ₹ 10,00,000, reducing the outstanding loan balance to ₹ 40,00,000. However, on April 4, 2024, Sidharth Industries initiated a reversal transaction of ₹ 8,00,000, increasing the outstanding loan balance back to ₹ 48,00,000. The payment and subsequent reversal occurred within a short period, with the final outstanding balance remaining ₹ 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:**

- 1) 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.
- 2) 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.
- 3) 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 ₹40,00,000. and subsequently reversed by ₹8,00,000 on April 4, 2024. Thus, Mahavir and Associates should carefully assess the classification of Sidharth Industries' Account, and determine if the payment and reversal transactions indicate an attempt to prevent the account from slipping into the NPA



category. If yes, the account should be classified as an NPA in compliance with regulatory guidelines.

**Question 22:****(Model Test Paper-7) / (MTP-II Dec.24)**

During the audit of Smile Bank, CA Sweety focused on understanding the risk management process of the bank. She reviewed how management developed controls and used performance indicators to monitor key business and financial risks. CA Sweety also assessed whether the risk management system effectively identified and mitigated risks in required areas. How should CA Sweety evaluate the adequacy of the bank's risk management controls?

**Answer:**

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

- (i) **Oversight and involvement in the control process by those charged with governance:** Those charged with governance (Board of Directors/Managing Director) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.
- (ii) **Identification, measurement and monitoring of risks:** Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.
- (iii) **Control activities:** A bank should have appropriate controls to mitigate its risks including effective segregation of duties (particularly between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting up limits, reporting and approval of exceptions, physical security and contingency planning.
- (iv) **Monitoring activities:** Risk management models, methodologies and assumptions used to measure and mitigate risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.
- (v) **Reliable information systems:** Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information

that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

**Question 23:****(Model Test Paper-8)**

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

**Answer:**

**Government Guaranteed Advances (In case of accounts overdue for more than 90 days):**

- a) CG Guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.
- b) The situation would be different if the advance is guaranteed by State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

**Alternative Solution:**

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

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

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

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

## Questions from ICAI RTP, MTP and Past Exam

**Question 24:****(MTP-I Mar.25)**

**Advances generally constitute a major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances**

requires the major attention from the auditors. Explain the broad considerations about which the auditor is primarily concerned with obtaining evidence in carrying out audit of advances.

**Answer:**

Advances generally constitute a major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

**In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:**

- a) Amounts included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.
- b) Advances represent amount due to the bank.
- c) Amounts due to the bank are appropriately supported by loan documents and other documents as applicable to the nature of advances.
- d) There are no unrecorded advances.
- e) The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.
- f) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
- g) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

**Question 25:**

**(RTP May 24)**

While conducting statutory audit of branch of a nationalized bank, it is noticed by CA Z that credit facilities granted to a borrower consisting solely of term loan have been classified as "Sub-standard Asset" during the year 2022-23 due to failure of borrower to pay EMIs on time. Such EMIs were outstanding for more than 90 days and account was, therefore, classified as "Sub-Standard Asset". CA Z has also agreed to above asset classification made by branch management.

**What are CA Z's responsibilities regarding verification of compliance with income recognition norms by branch in respect of above credit facilities?**

**Answer:**

- 1) RBI norms stipulate that if any advance account becomes NPA as at close of any year, the entire interest accrued or credited to income account in past periods should be reversed or provided for, if the same is not realized.
- 2) Further, in respect of NPAs, fees, commission and other similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.
- 3) In the given case, account has turned Sub-standard asset which is a type of NPA.
- 4) Therefore, auditor should make compliance of above norms relating to income recognition.

**Question 26:****(RTP May 24)**

While verifying provisions of advances of a branch of MCO Bank as part of statutory branch audit, CA Z notices that credit facilities consisting of term loan to KRT Enterprises have been classified under doubtful asset (D1) category. The outstanding balance in above term loan account as on 31.3.2023 is ₹ 50 lakhs. Value of security held in account is ₹ 40 lakhs. The branch has made provision of ₹ 7.50 lakhs. Is provision made by branch proper? Discuss.

**Answer:**

The provision for advances falling in D1 category is required @ 25% of secured portion and 100% of unsecured portion. Therefore, provision in above case is arrived as under:

Outstanding balance as on 31.3.23	50 lakhs
Less: Value of security	<u>40 lakhs</u>
Unsecured portion	<u>10 lakhs</u>

Therefore, outstanding balance of ₹ 50 lakhs is secured to the tune of ₹ 40 lakhs and balance ₹ 10 lakhs is unsecured.

**Provision calculation**

25% of secured part i.e., 25% of ₹ 40 lakhs	₹ 10 lakhs
100% of unsecured part i.e., 100% of ₹ 10 lakhs	<u>₹ 10 lakhs</u>
Required provision	<u>₹ 20 lakhs</u>

Therefore, provision made by branch is not proper. It should have made provision of ₹ 20 lakhs instead of ₹ 7.50 lakhs.

**Question 27:**

(RTP Sept. 24)

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

Particulars	(Amount in ₹)
Stock	60,000
Debtors (Including Debtor of ₹ 15,000 for an invoice dated 20.10.2023)	55,000
Sundry creditors	10,000
Sanctioned Limit	48,000
Margin on stock is 30% and on debtors is 40%.	

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

**Answer:**

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

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

**Question 28:**

(RTP Jan.25)

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

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

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

Agrim is in dilemma regarding classification of above accounts as NPA although these are fully secured or guaranteed. Guide him.

**Answer:**

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

Categories of Non-Performing Assets:	Provision required
a) <b>Substandard Assets:</b> Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
b) <b>Doubtful Assets:</b> Would be one which has remained in the substandard category for a period of 12 months. <b>Sub-categories:</b> Doubtful up to 1 Year (D1) Doubtful 1 to 3 Years (D2) Doubtful more than 3 Years (D3)	(Secured + Unsecured) 25% + 100% 40% + 100% 100% + 100%
c) <b>Loss Assets</b>	100%

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

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

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

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

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

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

**Question 29:****(RTP May 25)**

While conducting the statutory audit of a large branch of KNB Bank for the year 2023-24, CA Hema observed that Profit and Loss account of branch reflects interest income of ₹ 80 crores and other income of ₹ 5 crores. She also noticed that few borrower accounts at branch have slipped into NPA category in past periods as well as in current year. Which audit procedures should be performed by her to verify reversal of income in the books of branch?

**Answer:**

The following audit procedures should be performed to verify reversal of income in books of branch:

- If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.
- In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.
- Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).



- d) Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

**Question 30:****(RTP May 25)**

**CBC Bank Ltd. has multiple loan accounts classified as Non-Performing Assets (NPAs). During the financial year, some borrowers made partial payments towards their outstanding dues. However, there was no explicit agreement between the bank and the borrowers regarding the appropriation of these recoveries i.e., whether they should be adjusted against principal or interest.**

**The bank's finance team decided to recognise the recovered amount as interest income in its financial statements. However, during the statutory audit, the auditors raised concerns about the treatment of these recoveries.**

**Discuss the appropriate accounting treatment of partial recoveries in NPAs. Also, explain the principles that banks should follow in recognising interest income from NPAs.**

**Answer:****Appropriate accounting treatment of partial recoveries in NPAs:**

- 1) In the absence of a clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to adopt an accounting policy and exercise the right of appropriation of recoveries in a uniform and consistent manner.
- 2) The appropriate policy to be followed is to recognise income as per AS 9, "Revenue Recognition", when certainty attaches to realisation and accordingly amount reversed/derecognised or not recognised in the past should be accounted.
- 3) Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

**Question 31:****(RTP Sept.25)**

**M/s JKL & Associates, Chartered Accountants, are the statutory auditors of M/s IBS Bank Limited for the financial year 2024-25. During the audit, they observed the following items included under interest income in the financial statements of the bank:**



- An amount of ₹ 5 lakh relating to a short-term crop loan, where the instalment was overdue for one crop season.
- An amount of ₹ 7 lakh relating to an advance guaranteed equally by the Government of India and the Government of Tamil Nadu, where the instalment has been overdue for more than six months.

From the above facts and details, what should be the correct treatment of the above interest income in the bank's financial statements? State the amount that can be recognised as interest income with appropriate reasoning. Also, determine the amount to be classified as Non-Performing Asset (NPA), with reference to applicable RBI norms.

**Answer:**

**Classification of Non-Performing Asset (NPA) & Treatment of Interest Income:**

**(i) Short-Term Crop Loan:**

As per RBI norms, a loan granted for short-duration crops is to be classified as NPA only if the installment remains overdue for two crop seasons.

In the given case, the installment is overdue for only one crop season, hence, the account is not classified as NPA. Therefore, the interest income of ₹ 5 lakh can be recognised in the financial statements.

**(ii) Advance Guaranteed Equally by Government of India and Government of Tamil Nadu:**

- a) If an advance is guaranteed by the Central Government, it need not be classified as NPA until the guarantee is invoked and repudiated. Thus, Central Government guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets but regarded as NPA for Income Recognition purpose.
- b) The situation would be different if the advance is guaranteed by the State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.
- c) In the given case, since the guarantee is shared equally between the Central Government and the State Government (Tamil Nadu), and the installment is overdue for more than 6 months, the portion of loan guaranteed by the Central Government (50%) is not to be classified as NPA unless the guarantee is invoked and repudiated.
- d) The remaining 50%, guaranteed by the State Government, must be classified as NPA as the installment is overdue for more than 90 days. Thus, Amount to be classified as NPA will be ₹ 3.5 lakh (i.e., 50% of ₹ 7 lakh) and amount of interest income to be recognised will be ₹ 5 lakh.

Question 32:

(May 25)

Compute the Drawing power for Cash Credit limit granted to S Ltd. by Trust Bank for the month of March 2025 from the following information:

Particulars	Amount in (₹)
Value of stocks	50,000
Value of debtors (including debtors of 5,000 for an invoice dated 17.11.2024)	45,000
Value of creditors for goods	15,000
Sanctioned limit	45,000

Margin on stock is 20% and on debtors is 50%.

Note: Debtors older than 3 months are ineligible for calculation of D.P.

Answer:

Computation of Drawing power of S Ltd. for the month of March 2025:

Value of stocks	₹ 50,000
Less: creditors for goods	₹ 15,000
	-----
Value of Paid stocks	₹ 35,000
Less: Margin @ 20%	₹ 7,000
	-----
Drawing power (A)	₹ 28,000
	-----
Value of debtors	₹ 45,000
Less: debtors exceeding 90 days	₹ 5,000
	-----
	₹ 40,000
Less: Margin @ 50%	₹ 20,000
	-----
Drawing Power (B)	₹ 20,000
	-----
Drawing Power (A+B)	₹ 48,000

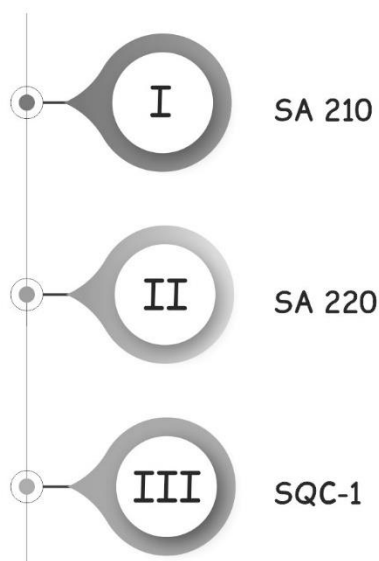


## CHAPTER

## 11

# Ethics and Terms of Audit Engagements

## CHAPTER OVERVIEW:



## Case Study

Das & Co, a firm of auditors, is offered appointment as auditor of a company, a prospective new client. CA Sukanya, one of partners, is dealing with new client. While meeting with officers of the company, she comes to know that Sushant, CFO of the company, was her class mate. In fact, both of them had started CA together. However, Sushant had left CA mid-way due to repeated failures and tried his luck to pursue MBA (finance) from one of leading institutions.

During initial discussions, it transpires that company is going to launch new services in the field of "weather-forecasting". Such services would be available on web site of company and micro weather information would be available on payment of charges. The company requests audit firm to be visibly associated with their marketing blitz.

Assume that firm chooses to accept the offer and writes to previous auditor, Walker & Co., to advise whether there exist any professional reasons for them not to accept the proposed offer. However, Walker & Co. do not reply to the request of Das & Co.

During preliminary discussions, it also became known that the said company has acquired all shares of another company. Under relevant provisions of law, financial statements of both companies needed to be consolidated and audited. Despite this knowledge, Das & Co. failed to advise their client regarding audit of consolidated financial statements. The company also offers auditors contract for providing IT services pertaining to information system of company.

**Based upon above, answer the following questions:**

- 1) Considering discussion about Sukanya and Sushant, which of the following statements seems most appropriate?
  - a) The above discussion is irrelevant in context of proposed offer.
  - b) The proposed offer should be accepted by firm. The engagement team may be headed by CA Sukanya for better coordination and results.
  - c) The proposed offer should be accepted by firm. The engagement team may be headed by a different partner of the firm.
  - d) The matter is too trivial to be reported by CA Sukanya to other partners of firm.
- 2) Keeping in view request of the company to be visibly associated with company's new services, identify which type of threat is being faced by audit firm.
  - a) Self-interest threat
  - b) Familiarity threat
  - c) Self-review threat
  - d) Advocacy threat
- 3) The previous auditors, Walker & Co., have not replied to communication of Das & Co. Which fundamental principle of professional ethics is not followed by them?
  - a) Objectivity
  - b) Professional behaviour
  - c) Professional competence and due care
  - d) Integrity
- 4) Das & Co. have failed to advise the company regarding audit of consolidated financial statements. Which fundamental principle of professional ethics is violated by Das & Co.?

- a) Professional behaviour
  - b) Integrity
  - c) Objectivity
  - d) Professional competence and due care
- 5) Which of the following statements is most appropriate regarding providing offer of work of IT services by auditors to the company?
- a) Such offer may create a self-review threat.
  - b) Such offer may create an advocacy threat.
  - c) Such offer does not constitute any threat.
  - d) Such offer may create self-review and advocacy threats.

**Answers to Case Study:**

- 1) c)
- 2) d)
- 3) b)
- 4) d)
- 5) a)

## Independent MCQ's

- 1) Identify the most appropriate statement:
- a) SA 220 applies at the level of firm.
  - b) SQC 1 is premised on the basis that firm is subject to SA 220.
  - c) SA 220 is premised on the basis that firm is subject to SQC 1.
  - d) SA 220 applies to all engagements.
- 2) Professional skepticism includes:
- a) Overlooking unusual circumstances.
  - b) Using inappropriate assumptions in determining extent of audit procedures.
  - c) Over generalising when drawing conclusions from audit observations.
  - d) Being vigilant to conditions that might indicate possibilities of fraud.

- 3) Which of the following is not a fundamental principle governing professional ethics?
- a) Professional competence and due care
  - b) Integrity
  - c) Objectivity
  - d) Safeguards to independence
- 4) Which of the following is not necessary to establish preconditions for an audit?
- a) Acceptability of financial reporting framework.
  - b) Acknowledgment of cooperation from management in designing audit procedures.
  - c) Acknowledgment from management of providing access to persons within company.
  - d) Acknowledgment of management in understanding its responsibility for preparation of financial statements.
- 5) Identify the most appropriate statement in context of SQC 1.
- a) Assembly of engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements.
  - b) Engagement files should be completed before date of auditor's report in case of audit engagements.
  - c) Engagement files should be completed in not more than 60 days after completion of an engagement.
  - d) Engagement files should be completed on date on which audit report is signed in case of audit engagements.

**Answers to the MCQs based Questions:**

- 1) c)
- 2) d)
- 3) d)
- 4) b)
- 5) a)

## SA 210 - Agreeing the Terms of Audit Engagement

### Questions from ICAI Study Material

**Question 1:****(ICAI SM)**

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.

**Question 2:****(ICAI SM)**

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:**

- 1) 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.
- 2) If the preconditions for an audit are not present, the auditor shall discuss the matter with management.

- 3) 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
  - 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.
- 4) 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.
- 5) An audit is conducted on this basic premise according to SA 210. When basic premise on which audit is conducted is not fulfilled, refusal by auditor is necessary.

**Question 3:****(ICAI SM)**

A Chartered accountant is conducting audit of a client for last two years. Before proceeding to start audit for next year, he notices that there is substantial change in management. Besides, client has ventured into areas of business activity which were not present at time of accepting initial audit engagement. Discuss responsibility of auditor in this regard in context of SA 210.

**Answer:**

- Recurring audit is an audit which is performed by an auditor over years. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.
- The auditor may decide not to send a new audit engagement letter or other written agreement each period.
- However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:
  - Any indication that the entity misunderstands the objective and scope of the audit.
  - Any revised or special terms of the audit engagement.
  - A recent change of senior management.
  - A significant change in ownership.
  - A significant change in nature or size of the entity's business.



- f) A change in legal or regulatory requirements.
- g) A change in the financial reporting framework adopted in the preparation of the financial statements.
- h) A change in other reporting requirements.

## Questions from ICAI Model Test Paper

### Question 4:

(Model Test Paper-2) / (MTP-II Apr 24)

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. Who gives engagement letter to whom and what is included in such a letter?

#### Answer:

The audit engagement letter is sent by the auditor to his client. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent. Such a letter includes:

- (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.

### Question 5:

(Model Test Paper-3) / (Sept 24)

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

#### Answer:

**Audit Engagement Letter:** The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed terms of the audit

engagement are recorded in a letter or other the suitable form of written agreement. Such an agreement is known as Audit Engagement Letter. The audit engagement letter is sent by the auditor to his client. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent.

**Audit Engagement letter includes: -**

- 1) The objective and scope of the audit of the financial statements
- 2) The responsibilities of the auditor
- 3) The responsibilities of management
- 4) Identification of the applicable financial reporting framework for the preparation of the financial statements and
- 5) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

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

**Question 6:**

**(Model Test Paper-3) / (MTP-I July 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:**

- 1) As per SA 210, "Agreeing the Terms of Audit Engagements", the auditor shall agree the terms of audit engagement with management or TCWG, as appropriate.
- 2) 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.

- 3) 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.
- 4) 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.
- 5) 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.
- 6) 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:****(Model Test Paper-6) / (MTP-I Nov.24)**

**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.

**Question 8:****(Model Test Paper-7) / (MTP-II Dec.24)**

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

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

**Answer:**

- 1) As per SA 210, "Agreeing the Terms of Audit Engagements", a request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances.
- 2) The auditor considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.  
A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.
- 3) In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.
- 4) Hence Deepa Ltd.'s request for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion is not reasonable.

**Questions from ICAI RTP, MTP and Past Exam****Question 9:****(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:**

- 1) 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.
- 2) 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.
- 3) 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.
- 4) 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.
- 5) 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.
- 6) 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 10:

(RTP Sept.25)

CA Rohit is conducting the audit of Taste Ltd., a food production company, for the last two years. Before commencing the audit for the year, he observed that the company has undergone a major shift in its product line by expanding into pharmaceuticals. Besides this, the company is now subject to new regulatory reporting requirements. These developments were not present at the time of accepting the initial audit engagement. CA Rohit is of the view that there is no need to issue a new audit engagement letter. Examine whether the viewpoint of CA Rohit is appropriate in accordance with the relevant Standards on Auditing.

**Answer:**

As per SA 210, "Agreeing the terms of audit engagements", recurring audit is an audit which is performed by an auditor over years. In case of recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- a) Any indication that the entity misunderstands the objective and scope of the audit.
- b) Any revised or special terms of the audit engagement.
- c) A recent change of senior management.
- d) A significant change in ownership.
- e) A significant change in nature or size of the entity's business.
- f) A change in legal or regulatory requirements.
- g) A change in the financial reporting framework adopted in the preparation of the financial statements.
- h) A change in other reporting requirements.

In the given case, Taste Ltd., a food production company, has undergone a major shift in its product line by expanding into Pharmaceuticals and the company is also subject to new regulatory reporting requirements. In view of the abovementioned factors, it is appropriate to revise the terms of the audit engagement in accordance with SA 210. Thus, the viewpoint of CA Rohit regarding no need for issuance of a new engagement letter is not correct, CA Rohit is required to send the revise audit engagement letter.

**Question 11:****(RTP May 25)**

CA Puneet is appointed as an auditor of Kamla Limited for the F.Y. 2023-24. The management of Kamla Limited has requested the auditor to change the terms of original engagement as the company has diversified its business and a few new products have been introduced by the company. Whether CA Puneet can agree to the request made by the management? Under which circumstances can the client make a request to the auditor for a change in the terms of engagement?

**Answer:**

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, a significant change in nature or size of the entity's business is one of the factors which may make it appropriate to revise the terms of the audit engagement.

In the given situation, Kamla Limited has diversified its business, and few new products have also been introduced by the company which is indicative of significant change in nature or size of the entity's business.

In view of the above, CA. Puneet can agree to the request made by the management to change the terms of the audit engagement. Therefore, the request of Management to change the terms of audit engagement is appropriate.

**A request from the client for the auditor to change the engagement may result from:**

- 1) A change in circumstances affecting the need for the service.
- 2) A misunderstanding as to the nature of an audit or related service originally requested.
- 3) A restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

**Question 12:****(May 25)**

Luck Ltd., a mid-sized manufacturing company, has approached CA S, a qualified Chartered Accountant, to conduct the audit for the financial year ended March 31, 2025. The company requests CA S to give acceptance for the audit so that audit can be commenced within time.

With reference to SA 210, how the auditor will establish that whether the preconditions for an audit are present?

**Answer:**

In order to establish whether the preconditions for an audit are present, CA S shall:

- 1) Determine whether the financial reporting framework is acceptable and

- 2) Obtain the agreement of management that it acknowledges and understands its responsibility:
- a) For the preparation of the financial statements in accordance with the applicable financial reporting framework including where relevant their fair representation;
  - b) For such internal control as management considers necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
  - c) To provide the auditor with:
    - (i) Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
    - (ii) Additional information that the auditor may request from management for the purpose of the audit; and
    - (iii) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

## SA 220 - Quality Control for an Audit of Financial Statements

### Questions from ICAI Study Material

#### Question 13:

(ICAI SM)

CA PK Nair is offered appointment as auditor of a company engaged in providing tourism services. While making due diligence of the proposed client, he comes to know that there have been raids on premises of the company and residences of its directors by National Investigation Agency (NIA) on suspicion of links with terror outfits. It has been followed up with searches by Enforcement Directorate hunting for illicit money trail. There is a strong suspicion of tourism services provided by company being façade of terror funds. Should proposed offer be accepted by him?

#### Answer:

- 1) Integrity of principal owners has to be considered before accepting an audit engagement in accordance with SA 220. In this regard, SA 220 states requirements on lines of SQC 1.



- 2) SQC 1 clearly states that in cases where there are indications that the client might be involved in money laundering or other criminal activities, appointment should not be accepted.
- 3) In the instant case, there have been raids of NIA on suspected links with terror outfits which is a criminal activity. Further, raids by Enforcement Directorate also point towards money laundering. Therefore, proposed offer should not be accepted.

**Question 14:** (ICAI SM)/ (Model Test Paper-1) / (MTP-I Mar 24)

**An engagement partner takes overall responsibility for maintaining audit quality in an audit engagement in accordance with SA 220. What are his objectives in taking and emphasizing such responsibility?**

**Answer:**

- 1) Leadership responsibility of an engagement partner is to take responsibility for the overall quality on each audit engagement.
- 2) The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise
  - a) The importance to audit quality of: -
    - (i) Performing work that complies with professional standards and regulatory and legal requirements;
    - (ii) Complying with the firm's quality control policies and procedures as applicable;
    - (iii) Issuing auditor's reports that are appropriate in the circumstances; and
    - (iv) The engagement team's ability to raise concerns without fear of reprisals.
  - b) The fact that quality is essential in performing audit engagements.

## Questions from ICAI Model Test Paper

**Question 15:** (Model Test Paper-8) / (May 24)

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

**Answer:**

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

- a) Determine that an engagement quality control reviewer has been appointed.
- b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer.
- c) Not date the auditor's report until the completion of the engagement quality control review.
- d) If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

### Questions from ICAI RTP, MTP and Past Exam

**Question 16:****(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:**

- 1) 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.**
- 2) 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.
- 3) **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.

**Question 17:****(May 25)**

M/S ABC & Co., Chartered Accountants, have been appointed as the statutory auditors of DEF Ltd., which is a listed company, for the Financial Year 2024-25. CA X, a seasoned Chartered Accountant with over 15 years of experience has been assigned as the engagement partner for this audit. CA X takes responsibility for maintaining overall quality on this audit engagement in accordance with SA 220.

What do the actions of engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on audit engagement emphasize?

**Answer:**

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

1) The importance to audit quality of:

- a) Performing work that complies with professional standards and regulatory and legal requirements;
- b) Complying with the firm's quality control policies and procedures as applicable;
- c) Issuing auditor's reports that are appropriate in the circumstances; and
- d) The engagement team's ability to raise concerns without fear of reprisals.

2) The fact that quality is essential in performing audit engagements.

## SQC 1 - Quality Control for firms that Perform Audits & Reviews of Historical Financial Information, & other Assurance & Related Services Engagements

### Questions from ICAI Study Material

Question 18:

(ICAI SM)

CA Arpita has joined a mid-sized CA firm recently. She finds that partners remain too busy and the firm is proposing to accept audit work in areas in which it has no experience or capabilities. The firm is proposing to accept audit of some entities engaged in emerging "fin-tech" sector. Such audits may be requiring extensive use of technology and data analytics. However, the said firm has no such capabilities and trained personnel. Discuss, whether, firm should accept such audits with reason.

Answer:

- 1) **SQC 1** requires that before accepting an engagement, competence (including capabilities, time and resources) to perform engagement have to be considered.
- 2) In the given case, the proposed engagements involve use of technology and data analytics. The firm has no prior experience of audits in emerging "fintech" sector.
- 3) The firm does not have trained personnel to carry out these audits. Hence, offer for these audits should not be accepted.

Question 19:

(ICAI SM)

How does **SQC 1** ensure that independence in engagements is not breached by an audit firm?

Answer:

- 1) The firm should **establish policies and procedures** designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements contained in the **Code of ethics issued by ICAI**.
- 2) The Code establishes the **fundamental principles** of professional ethics which include
  - a) Integrity,
  - b) Objectivity,
  - c) Professional competence and due care,

- d) Confidentiality and
  - e) Professional behaviour.
- 3) Observance of "Independence" in all engagements is the basic requirement.
- 4) The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and (including experts contracted by the firm and network firm personnel) maintain independence where required by the Code. Such policies and procedures should enable the firm to: -
- a) Communicate its independence requirements to its personnel
  - b) Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.
- 5) There should exist a mechanism in the firm by which engagement partners provide the firm with relevant information about client engagements and personnel of firm promptly notify firm of circumstances and relationships that create a threat to independence.
- 6) All breaches of independence should be promptly notified to firm for appropriate action. Its objective is to ensure that independence requirements are satisfied. At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.

### Questions from ICAI Model Test Paper

**Question 20:**

**(Model Test Paper-1) / (MTP-1 Mar.24)**

**SQC 1 dwells upon engagement quality control review (EQCR) as part of system of quality control in a firm. Why is such a review required? For which type of engagements EQCR is mandatory?**

**What should be approach of firm for engagements for which EQCR is not mandatory?**

**Answer:**

- 1) Significant judgments made in an engagement should be reviewed by an engagement quality control reviewer for taking an objective view before the report is issued. Engagement quality control review is mandatory for all audits of financial statements of **listed entities**.
- 2) In respect of other engagements, firm should devise criteria to determine cases requiring performance of engagement quality control review.

**Question 21:****(Model Test Paper-4) / (MTP-I July 24)**

**SQC 1 requires assumption of leadership responsibilities for quality within firm. Are such leadership responsibilities required for audit engagements only? Who assumes such leadership responsibilities within firm? How it is important for audit quality?**

**Answer:**

- 1) **SQC 1** requires firms to establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Therefore, such leadership responsibilities are required for all engagements and not for audit engagements only.
- 2) Such policies and procedures should require the firm's chief executive officer or the firm's managing partners to assume ultimate responsibility for the firm's system of quality control. The example set by firm's leadership encourages an inner culture that recognizes high quality audit work.
- 3) Further, persons assigned operational responsibilities for the firm's quality control system by the firm's chief executive officer or managing partners should have sufficient and appropriate experience, ability and the necessary authority to assume that responsibility.

**Question 22:****(Model Test Paper-5) / (MTP-II Aug.24)**

**CA N, statutory auditor of QST Limited, appointed for a term of 5 years has completed audit for the first financial year ending on 31st March 2024. In compliance with requirements of professional standards, an audit file has been assembled. After about a period of six months from date of issue of audit report, he gets a call from CFO of the company to share complete audit file so that financial reporting of company can be improved upon in coming periods. Is it mandatory for statutory auditors to share audit files with client? What are the requirements for making audit documentation available to clients?**

**Answer:**

- 1) **Standard on Quality Control 1 (SQC 1), "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements"**, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. Therefore, it is not mandatory for CA N to share audit file with client.
- 2) He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed,

or, in the case of assurance engagements, the independence of the auditor or of his personnel.

**Question 23:****(Model Test Paper-6) / (MTP-I Nov.24)**

M/s KSJS & Associates are the statutory auditors of Moon Ltd. for the financial year 2023-24. During an audit briefing, CA Sanket, the engagement partner, explained that the auditor must assemble the audit documentation in an audit file and complete the administrative process of finalising the audit file on a timely basis after the date of the auditor's report. He also highlighted the requirements of SQC 1 regarding establishment of policies and procedures for the retention of engagement documentation in a firm. Explain the requirements related to the timely assembly and retention of audit files in accordance with relevant Engagement and Quality Control Standards.

**Answer:**

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

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

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

## Questions from ICAI RTP, MTP and Past Exam

### Question 24:

(RTP Sept.24)

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

### Answer:

With regard to the integrity of a client, matters that ABC & Associates should consider include, for example:

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

### Question 25:

(MTP-I Mar.25)

Sigma Ltd. has approached CJK & Associates to appoint them as their auditor for a period of 5 years in accordance with provisions of the Companies Act, 2013. The prospective client company is new to audit firm. SQC 1 requires that a firm before accepting engagement should inquire vital information about the client which helps firm to decide about integrity of client. Apart from integrity, obtaining such vital information



about client is helpful to audit firm in deciding about which other matters? Which matters would be considered by audit firm with regard to integrity of client?

**Answer:**

A firm before accepting an engagement should acquire vital information about the client. Such an information should help firm to decide about:

- a) Integrity of Client
- b) Competence (including capabilities, time and resources) to perform engagement
- c) Compliance with ethical requirements

With regard to the integrity of a client, matters that the firm considers include, for example:

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

## Ethics & Independence of Auditors

### Questions from ICAI Study Material

**Question 26:**

(ICAI SM)

CA P. Suryakantam has conducted audit of accounts of an entity for a particular year. ICAI has issued a letter to him relating to certain matters concerning audit. He didn't even bother to reply to the letter despite reminders. Discuss which fundamental principle governing professional ethics is disregarded by him.

**Answer:**

Failure to reply to professional body smacks of lack of courtesy and professional responsibility. The principle of **"Professional behaviour"** is disregarded.

**Question 27:****(ICAI SM)**

A Chartered accountant in practice issued a certificate showing original cost of plant and machinery installed in premises of a client for ₹ 9 crores to save some regulatory fees for his client. However, original cost of plant and machinery was ₹ 15 crore as per records of client. Which fundamental principle governing professional ethics is violated in this case?

**Answer:**

**"Integrity"** requires that a professional accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information contains a materially false or misleading statement; contains statements or information provided negligently or omits or obscures required information where such omission or obscurity would be misleading.

In the given case, a false certificate is knowingly issued showing misstated original cost of machinery. **Therefore, fundamental principle of "integrity" is violated.**

**Question 28:****(ICAI SM)**

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:**

- 1) 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.
- 2) 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.

- 3) Considering above, he should take steps to eliminate the threat by selling shares immediately before accepting appointment. Holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence.

**Question 29:****(ICAI SM)**

A Chartered accountant receives about 40% of his total audit fees from a single client. Discuss how it could affect independence of Chartered accountant as auditor of this client. What are such types of threats referred to as?

**Answer:**

Undue dependence on fees of a client constitutes a threat as there is fear of losing the client. Such threats are referred to as self-interest threats.

**Question 30:****(ICAI SM)**

CA Murli Madhavan provides accounting and book keeping services to a leading NGO engaged in environmental protection work. He is also offered audit of the accounts of NGO. Identify and discuss what kind of threat to independence may be involved in accepting such an engagement.

**Answer:**

In this case, Chartered Accountant is already rendering accounting and book keeping services to an NGO. If he accepts audit, he would be involved in reviewing own work. Therefore, the same constitutes "self-review" threat.

**Question 31:****(ICAI SM)**

The auditors of a company have only relied upon management representation letter regarding treatment of certain tax matters under appeal by the company. The auditors have not carried out any other audit procedures to justify management's treatment of the said tax matters under appeal in the financial statements. What is lacking on part of auditors in such a situation?

**Answer:**

In the given case, auditors have relied only upon management representation letter regarding treatment of certain tax matters under appeal by the company. No other audit procedures to verify management's treatment of such matters under appeal have been performed by auditors. It shows lack of "professional skepticism" on part of auditors.

**Question 32:****(ICAI SM)**

**Briefly outline how principles-based approach differs from rules-based approach to ethics.**

**Answer:**

- 1) Ethical guidance may follow principles-based approach or rules-based approach.
- 2) The essence of principles-based approach to ethics is that it requires compliance with spirit of ethics. It requires accountants to exercise professional judgment in every situation based upon their professional knowledge, skill and expertise.
- 3) It requires that accountants should use professional judgment to evaluate every situation to arrive at conclusions.
- 4) However, rules-based approach to ethics strictly follows clearly established rules. It may lead to narrow outlook & spirit of ethics may be overlooked while strictly adhering to rules.
- 5) Further, rules-based approach is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules. Therefore, it is necessary that spirit of code is followed.

**Question 33:****(ICAI SM)**

**How application of professional skepticism throughout audit is helpful in reducing audit risk?**

**Answer:**

- 1) Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
- 2) It signifies that auditor has to remain alert forever. The auditor's attitude should be of questioning mind- of challenging the things in light of available evidence. The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.
- 3) Professional skepticism includes being alert to, for example:
  - a) Audit evidence that contradicts other audit evidence obtained.
  - b) Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
  - c) Conditions that may indicate possible fraud.
  - d) Circumstances that suggest the need for audit procedures in addition to those required by the SAs.

- 4) Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:
  - a) Overlooking unusual circumstances.
  - b) Over generalising when drawing conclusions from audit observations.
  - c) Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.
  - d) Professional skepticism is necessary to the critical assessment of audit evidence.
- 5) It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.
- 6) The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary.
- 7) Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud, the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.
- 8) The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism.

### Questions from ICAI Model Test Paper

**Question 34:****(Model Test Paper-1) / (MTP-1 Mar.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 member's 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:**

- 1) 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.
- 2) 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.
- 3) 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.
- 4) In this way, familiarity threats are created in the situation.

**Question 35:****(Model Test Paper-1) / (MTP-I Mar.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:**

- 1) 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.
- 2) 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.

**Question 36:****(Model Test Paper-3) / (Sept 24)**

**CA P is a professional accountant in service. In terms of employment and professional relationships with employer he has to be alert to the possibility of inadvertent disclosure of any information outside the employing organization. However, in view of disclosure required by law, CAP had to divulge the information and documents as evidence in course**

of legal proceedings. Whether CA P has violated any fundamental principle governing professional ethics in this case? Explain.

**Answer:**

- 1) Confidentiality principle requires a professional accountant to respect the confidentiality of information acquired as a result of professional or business relationships.
- 2) Confidentiality serves the public interest because it facilitates the free flow of information from the professional accountant's client or employing organization to the accountant with the understanding that the information will not be disclosed to a third party.
- 3) However, such confidential information may be disclosed, for example, when it is required by law, when it is permitted by law and is authorized by the client or employer or there is a professional duty or right to disclose when not prohibited by law.
- 4) In the given situation, CA P, who is a professional accountant in service, and in terms of employment and professional relationships with the employer he is alert to the possibility of inadvertent disclosures of any information outside the employing organization. However, CA P had to divulge the information and documents as evidence in the course of legal proceedings and same was required by law. Therefore, CA P will not be held responsible for violation of fundamental principle of "Confidentiality" governing professional ethics.

**Question 37:**

**(Model Test Paper-7) / (MTP-II Dec.24)**

Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. Explain.

**Answer:**

**Familiarity threats:**

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

- a) Close relative of the audit team working in a senior position in the client company;
- b) Former partner of the audit firm being a director or senior employee of the client;
- c) Long association between specific auditors and their specific client counterparts; and
- d) Acceptance of significant gifts or hospitality from the client company, its directors or employees.

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

## Question 38:

(Model Test Paper-8) / (May 24)

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

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

Answer:**Fundamental Principles:**

- 1) **Objectivity:** The principle of objectivity requires that a professional accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity. Objectivity principle will be violated in the given situation where a chartered accountant in practice accepted the appointment as an auditor of a firm in which his sister was a partner.
- 2) **Confidentiality:** Confidentiality principle requires a professional accountant to respect the confidentiality of information acquired as a result of professional or business relationships. Confidentiality principle will be violated in the given situation where a chartered accountant in practice could not refuse his friends requested to seek some insider information about a client company of the chartered accountant.
- 3) **Professional Competence and Due care:** A professional accountant shall comply with the principle of professional competence and due care, which requires an accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and act diligently and in accordance with applicable technical and professional standards. Professional Competence and Due Care principle will be violated in the situation where a chartered accountant in practice failed to inform his client about the change in laws applicable to his client.



**Questions from ICAI RTP, MTP and Past Exam****Question 39:****(RTP Jan 25)**

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

**Answer:**

- 1) In the given situation, holding shares by CA Sudhakar involves financial interest in the company and is in nature of self-interest threat. Though he has come to hold shares due to nomination made by his distant relative before accepting the appointment.
- 2) Chartered Accountants have a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to address the threats.
- 3) Safeguards are actions, individually or in combination, that the professional accountant takes that effectively reduce threats to comply with the fundamental principles to an acceptable level.
- 4) **To address the issue, the following guiding principles are to be applied:**
  - a) For the public to have confidence in the quality of audit, it is essential that auditors should always be and appear to be independent of the entities that they are auditing.
  - b) Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
  - c) When such threats exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level. All such safeguard measures need to be recorded in a form that can serve as evidence of compliance with due process.
  - d) If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

Considering above, holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence. Therefore, CA Sudhakar

should take steps to eliminate the threat by selling shares immediately before accepting the appointment and in the absence of same, he should not accept the appointment as an auditor.

**Question 40:****(Jan 25)**

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

- (i) CA J, partner of the firm, performed statutory audit as well as non audit engagement for M/s. Take Away Private Limited.
- (ii) CA M, partner of the firm, who has done income tax audit for M/s. Happy Associates where in CA M has material significant indirect financial interest.
- (iii) The costs of air travel and stay accommodation of family members of audit team for audit of Chennai was borne by the client stationed at Chennai.
- (iv) One of the clients, M/s. Chalk Limited, threatened to replace them as auditors because the audit team insisted to make provision for expected credit loss which the company was not willing to provide.
- (v) CA N, partner of the firm, who audited M/s. NM Private Limited became arbitrator for dispute between M/s. NM Private Limited and one of its vendors.
- (vi) CA N accepted the assignment of Tax audit (on behalf of firm) of TRF Industries. Management agreed to pay him contingent fee for tax audit.

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

In case such threats exist, what should the auditor do?

**Answer:****Type of Threats to Independence**

S. No.	Situation	Threat to Independence
(i)	CA J, partner of the firm, performed statutory audit as well as non- audit engagement for Take Away Private Limited.	Self-review threats

(ii)	CA M, partner of the firm, who has done income tax audit for M/s. Happy Associates where in CA M has material significant indirect financial interest.	Self-interest threats
(iii)	The costs of air travel and stay accommodation of family members. of audit team for audit Chennai was borne by the client stationed at Chennai.	Familiarity threats
(iv)	One of the clients, Chalk Limited, threatened to replace them as auditors because the audit team insisted to make provision for expected credit loss which the company was not willing to provide.	Intimidation threats
(v)	CA N, partner of the firm, who audited NM Private Limited became arbitrator for dispute between. NM Private Limited and one of its vendors.	Advocacy threats
(vi)	CA N accepted the assignment of Tax audit (on behalf of firm) of TRF Industries. Management agreed to pay him contingent fee for tax audit.	Self-interest threats

**Question 41:****(Jan.25)**

**Identify and explain the fundamental principles being referred to in the following cases.**

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

**Answer:****Fundamental Principles:**

- (i) Act diligently and in accordance with applicable technical and professional standards: In the given case, professional competence and due care fundamental principle is being referred to since a professional accountant shall comply with the principle of professional competence and due care, which requires an accountant to attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and act diligently and in accordance with applicable technical and professional standards.

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

**Question 42:****(MTP-II Apr.25)**

**The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. Discuss any five examples of professional skepticism.**

**Answer:**

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

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

