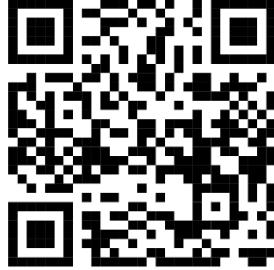
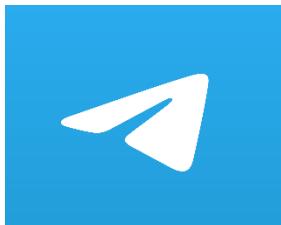


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# Ch-1 Introduction to Audit

## Test your Understanding

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

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

2. Good deeds Limited is engaged in business of recycling of wastes from dumping grounds of municipal corporation of Indore to usable manure. It is, in this way, also, helping to make the city clean. During course of audit by Zoha & Zoha, a firm of auditors, it is observed by auditors that company has received a notice from Central Bench of National Green Tribunal for not following certain environmental regulations involving imposition of hefty monetary penalty on the company. The company is yet to reply to the notice. The auditors point out that same is not stated in notes to accounts in financial statements. The company points out that auditors are going beyond scope of their work. Does such a matter fall within scope of audit?

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

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

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

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

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

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

It is example of failure of internal controls of the firm. The internal control has not operated due to collusion between employees which is a limitation of internal control itself. The auditor has relied upon internal controls. It is

## Ch-1 Introduction to Audit

very nature of financial reporting that management is responsible for devising suitable internal controls. This is an inherent limitation of audit.

5. The management of Exotic Tours and Travels Limited requests its auditor Raja & Co. to provide an assurance report on the financial information for first quarter of a year by skipping required detailed procedures. Can Raja & Co. provide such a report? What would be nature of such a report? Would it be necessary for them to obtain sufficient appropriate evidence in such a case?

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

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

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

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.

7. 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?

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.

### Correct/Incorrect

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

[ICAI SM]

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

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

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

**Correct:** As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to enhance the degree of confidence of intended users in

## Ch-1 Introduction to Audit

the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

**(iii) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.**

**Correct:** As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

**(iv) According to Mr. H, one of the team members of the auditor of Very Essential Limited was of the view that no relation exists between accounting and auditing from the point of view of a company.**

**Incorrect:** The viewpoint of Mr. H is incorrect because there exists a proper relation between accounting and auditing from the point of view of a company. Audit is conducted for financial statements of a company and those financial statements are prepared with the help of books of accounts of that company. In order to properly conduct an audit of a company, an auditor is required to be aware of accounting principles and accounting policies of that company.

**(v) The term "Engagement Standards" refer to Standards on Auditing only.**

**Incorrect:** Engagement Standards refer not only to Standards on auditing but also to Standards on review engagements, Standards on assurance engagements and Standards on related services.

**(vi) There is no difference between "audit" and "review." [RTP Nov-22]**

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

**(vii) For auditor's opinion, reasonable assurance is an absolute level of assurance.**

**Incorrect:** Reasonable assurance is a high level but not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive

**(viii) Historical financial information relates to financial information based on assumptions about occurrence of future events and possible actions by an entity [Nov-22]**

**Incorrect:** Historical financial information relates to information expressed in financial terms of an entity about economic events, conditions or circumstances occurring in past periods. Whereas financial information based on assumptions about occurrence of future events and possible actions by an entity relates to prospective financial information.

## Descriptive Questions

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

Choosing of appropriate accounting policies is responsibility of management.

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.

2. Assurance engagements are not restricted to audit of financial statements alone. Discuss. [SM]

Type of assurance engagement

- **Audit of financial Statements:** Reasonable assurance engagement
- **Review of financial Statements:** Limited assurance engagement
- **Examination of Prospective financial information:** Provides assurance regarding reasonability of assumptions forming basis of projections and related matters
- **Report on controls operating at an organization:** Provides assurance regarding design and operation of controls

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

A three party relationship involving a practitioner, a responsible party, and intended users. An assurance engagement involves abovesaid three parties.

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

A responsible party is the party responsible for preparation of subject matter.

Intended users are the persons for whom an assurance report is prepared. These persons may use the report in making decisions.

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

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

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

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.

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

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

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

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

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

**6. The person conducting audit should take care to ensure that financial statements would not mislead anybody.**  
**Explain stating clearly the meaning of Auditing. [RTP May-20 + MTP Oct-21] OR**

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

**Explain stating clearly how the person conducting this task should take care to ensure that financial statements would not mislead anybody. [MTP Oct-19 + ICAI SM]**

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

1. Audit is **Independent examination of Financial information**.
2. of any entity – that **entity may be profit oriented or not** and irrespective of its size or legal form. For example – Profit oriented – Audit of Listed company engaged in business.  
On the other hand, Audit of NGO – not profit oriented.
3. The **objective of the audit is to express an opinion on the financial statements**.

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

- (i) the accounts have been drawn up with reference to entries in the books of account;
- (ii) the entries in the books of account are adequately supported by sufficient and appropriate evidence;
- (iii) **none of the entries in the books of account has been omitted** in the process of compilation and nothing which is not in the books of account has found place in the statements;
- (iv) the information conveyed by the statements is **clear and unambiguous**;
- (v) the financial statement amounts are properly classified, described and disclosed in **conformity with accounting standards**; and

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(vi) the statement of accounts present a true and fair picture of the operational results and of the assets and liabilities.

### 7. Explain the objectives of an Audit as per SA 200. [RTP May-22]

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

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

8. PACE is proprietorship firm of Mr Abhinav engaged in the manufacturing of textile and handloom products. It sells its finished products both in the domestic as well as in the international market. The company is making total turnover of Rs. 50 crores. It has also availed cash credit limit of Rs. 5 crores from Axis Bank. In the year 2017-18, proprietor of the firm is worried about the financial position of the company and is under the impression that since he is out of India, therefore firm might run into losses. He approaches CA Mahesh about advantages of getting his accounts audited throughout the year so that he may not suffer due to accounting weaknesses. Advise regarding advantages of getting accounts audited. [MTP Mar-19]

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

9. CA N is the auditor of SR Ltd. The auditor expressed his opinion on the financial statements without ascertaining as to whether the financial statements as a whole were free from material misstatements or not. In your opinion, whether CA N has complied with objectives of audit considering the applicability of relevant SA? [May-22]

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

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

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

**10. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism. Explain. [RTP Nov-22]**

The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated.

Professional skepticism includes being alert to, for example:

- ✓ Audit evidence that **contradicts** other audit evidence obtained.
- ✓ Information that brings into **question the reliability of documents and responses to inquiries** to be used as audit evidence.
- ✓ Conditions that may indicate **possible fraud**.
- ✓ Circumstances that suggest the **need for audit procedures in addition** to those required by the SAs.

Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- ✓ Overlooking unusual circumstances.
- ✓ Over generalising when drawing conclusions from audit observations.
- ✓ Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.
- Professional skepticism is necessary to the critical assessment of audit evidence. It also includes **consideration of the sufficiency and appropriateness of audit evidence** obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.
- The auditor may **accept records and documents as genuine** unless the auditor has reason to believe the contrary.
- Nevertheless, the auditor is required to **consider the reliability of information** to be used as audit evidence. In **cases of doubt** about the reliability of information or indications of possible fraud, the SAs require that the auditor **investigate further** and determine what modifications or additions to audit procedures are necessary to resolve the matter.
- The auditor **cannot be expected to disregard past experience of the honesty and integrity** of the entity's management and those charged with governance.
- Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism.

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

**[RTP May-22]**

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

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

Some examples of Standards on Auditing are :

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

Examples of Standards on Review engagements are

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

12. There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance. Explain. [MTP Oct-20]

There are two interlinked perspectives of independence of auditors , one, independence of mind; and two, independence in appearance. The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term 'Independence' as follows:  
"Independence is:

- (i) **Independence of mind** – the state of mind that permits the provision of an opinion **without being affected by influences** allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and
- (ii) **Independence in appearance** – the avoidance of facts and circumstances that are so significant that a **third party** would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised."

13. "Integrity" and "Objectivity" are among the fundamental principles of professional ethics relevant to an auditor enshrined in IESBA code. Distinguish between the two. [SM]

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The principle of "Integrity" requires auditor to be straight forward and honest in all professional and business relationships. It implies fair dealing and truthfulness. It effectively means that he shall not be associated with reports, returns communications or other informations which he believes contains a materially false or misleading statement; contains statements or informations provided recklessly or omits required information where such omission could be misleading

The principle of objectivity requires auditor not to compromise professional judgment because of bias, conflict of interest or undue influence of others.

Hence, integrity requires auditor to be involved in fair dealing and truthfulness with client and not be associated with materially false or misleading statements, reports, returns or communications. However, objectivity requires auditor not to compromise professional judgment because of bias, conflict of interest or undue influence of others.

## 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 on above, answer the following questions: -**

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

- (a) It provides reasonable assurance meaning a moderate level of assurance.
- (b) It provides reasonable assurance meaning a low level of assurance.
- (c) It provides reasonable assurance meaning a high level of assurance.
- (d) It provides reasonable assurance meaning an absolute level of assurance.

**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.

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(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.

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.

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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.

1. c 2. c 3. c 4. d 5. d

## Individual MCQs

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.

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### 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.

1. (c) 2. (a) 3. (c) 4. (d) 5. (b)

### Test your Understanding

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

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.

2. 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?

It is necessary for management to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. It is a necessary precondition for an audit in accordance with SA 210. If the preconditions for an audit are not present, the auditor shall discuss the matter with management.

Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement: -

- (a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable or
- (b) If the agreement of management is not obtained on matters relating to understanding of responsibility of management on preparation of financial statements, internal controls for preparation of financial statements, providing access to all information to auditor and unrestricted access to persons within the entity.

Unless required by law or regulation to do so, such a refusal on the part of auditor is necessary as management is not willing to accept its responsibility for preparation of financial statements in accordance with applicable financial reporting framework. An audit is conducted on this basic premise according to SA 210. When basic premise on which audit is conducted is not fulfilled, refusal by auditor is necessary.

### Correct/Incorrect

(i) The audit engagement letter is sent by the client to auditor.

**Incorrect:** As per SA 210 "Agreeing the Terms of Audit Engagements", the Audit engagement letter is sent by the auditor to his client.

### Past Exams/RTPs/MTPs/SM Questions

1. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. The auditor may decide not to send a new audit engagement letter or other written agreement each period. Explain

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the factors an auditor considers to be appropriate to revise the terms of the audit engagement or to remind the entity of existing terms. [RTP May-21]

OR

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. [SM]

On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

The auditor may decide not to send a new audit engagement letter or other written agreement each period.

However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the **entity misunderstands** the objective and scope of the audit.
- Any **revised or special terms** of the audit engagement.
- A **recent change of senior management**.
- A significant change in **ownership**.
- A significant change in **nature or size of the entity's business**.
- A change in **legal or regulatory requirements**.
- A change in the **financial reporting framework** adopted in the preparation of the financial statements.
- A change in **other reporting requirements**.

2. Discuss preconditions for an audit as per SA 210. Explain how would an auditor proceed to establish the presence of pre conditions for an audit. [Dec-21 & RTP May-21]

As per SA 210 "Agreeing the Terms of Audit Engagements", preconditions for an audit may be defined as the use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.

In order to establish whether the preconditions for an audit are present, the auditor shall:

(a) Determine whether the **financial reporting framework** is acceptable; and  
(b) Obtain the **agreement of management** that it acknowledges and understands its responsibility:

(i) For the **preparation of the financial statements** in accordance with the applicable financial reporting framework;

(ii) For the **internal control** as management considers necessary; and

(iii) To provide the auditor with:

- **Access to all information** such as records, documentation and other matters;
- **Additional information** that the auditor may request from management for the purpose of the audit; and
- **Unrestricted access** to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

3. An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so. Explain the circumstances which may contribute towards a request from the client for the auditor to change the engagement.

[RTP Nov-22 + Nov-22]

An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

A request from the client for the auditor to change the engagement may result from

1. a **change in circumstances** affecting the need for the service,
2. a **misunderstanding** as to the nature of an audit or related service originally requested.
3. a **restriction on the scope** of the engagement, whether imposed by management or caused by circumstances.

### Test Your Understanding

1. CA P. Suryakantam has conducted audit of accounts of an entity for a particular year. ICAI has issued a letter to him relating to certain matters concerning audit. He didn't even bother to reply to the letter despite reminders. Discuss which fundamental principle governing professional ethics is disregarded by him.

Failure to reply to professional body smacks of lack of courtesy and professional responsibility. The principle of "Professional behaviour" is disregarded.

2. A Chartered accountant in practice issued a certificate showing original cost of plant and machinery installed in premises of a client for Rs. 9 crores to save some regulatory fees for his client. However, original cost of plant and machinery was Rs.15 crore as per records of client. Which fundamental principle governing professional ethics is violated in this case?

"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.

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

When threats to independence exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level.

Holding of shares involves financial interest in the company and is in nature of self-interest threat. He has come to hold shares due to nomination made by his distant relative before accepting the appointment. Considering above, he should take steps to eliminate the threat by selling shares immediately before accepting appointment. Holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence.

4. A Chartered accountant receives about 40% of his total audit fees from a single client. Discuss how it could affect independence of Chartered accountant as auditor of this client. What are such types of threats referred to as?

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.

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5. CA Murli Madhavan provides accounting and book keeping services to a leading NGO engaged in environmental protection work. He is also offered audit of the accounts of NGO. Identify and discuss what kind of threat to independence may be involved in accepting such an engagement.

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.

6. 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?

Integrity of principal owners has to be considered before accepting an audit engagement in accordance with SA 220. In this regard, SA 220 states requirements on lines of SQC 1. SQC 1 clearly states that in cases where there are indications that the client might be involved in money laundering or other criminal activities, appointment should not be accepted. In the instant case, there have been raids of NIA on suspected links with terror outfits which is a criminal activity. Further, raids by Enforcement Directorate also point towards money laundering. Therefore, proposed offer should not be accepted.

7. 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.

SQC 1 requires that before accepting an engagement, competence (including capabilities, time and resources) to perform engagement have to be considered.

In the given case, the proposed engagements involve use of technology and data analytics. The firm has no prior experience of audits in emerging "fintech" sector. The firm does not have trained personnel to carry out these audits. Hence, offer for these audits should not be accepted.

### MCQs

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. 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

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### 3. 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.

1. c 2. d 3. a

### 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.

#### 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

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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

1. c 2. d 3. b 4. d 5. a

### Correct/Incorrect

(i) An Auditor is considered to lack independence if the partner of the audit firm deals with shares and securities of the audited entity.

**Correct:** If partner of the firm deals with shares and securities of the audited firm then such threat is known as the Advocacy Threats and auditor will be lacking independence.

(ii) The Audit Engagement documentations should ordinarily be retained by the auditor for minimum of six years from the date of the auditor's report or the date of the group auditor's report, whichever is later.

**Incorrect:** SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

(iii) Familiarity threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

**Incorrect:** Intimidation threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

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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.

(iv) There is a very thin difference between advocacy threats and intimidation threats to an auditor while performing his duty.

**Incorrect:** Advocacy threats, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised. e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.

Intimidation threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

So, it can be concluded that there is not very thin difference between the advocacy threats and intimidation threats.

(v) **Advocacy threat**, is the threat which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. [MTP Mar-23]

**Incorrect:** Self-interest threat is the threat which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.

Further, Advocacy threat is the threat which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.

### Past Exams/RTPs/MTPs/SM Questions

1. Briefly outline how principles-based approach differs from rules-based approach to ethics. [SM]

#### Principles Based Approach VS Rules Based Approach

Ethical guidance may follow principles-based approach or rules-based approach. The **essence of principles-based approach to ethics** is that it requires **compliance with spirit of ethics**. It requires accountants to **exercise professional judgment** in every situation based upon their **professional knowledge, skill and expertise**. It requires that accountants should use professional judgment to evaluate every situation to arrive at conclusions.

However, **rules-based approach to ethics** strictly follows clearly established rules. It may lead to a **narrow outlook and spirit of ethics** may be overlooked while strictly adhering to rules. Further, rules-based approach is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules.

Therefore, it is necessary that **spirit of code is followed**.

2. How does SQC 1 ensure that independence in engagements is not breached by an audit firm? [SM]

Observance of "Independence" in all engagements is the basic requirement.

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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.

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.

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.

**3. As per SA 220, the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. While taking responsibility for the overall quality on each audit engagement, analyse and explain the emphasis of the actions of the engagement partner and appropriate messages to the other members of the engagement team. Also define engagement partner.**

**[RTP Nov'20]**

As per SA 220 "Quality Control for an Audit of Financial Statements", the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise:

(a) The importance to audit quality of:

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

(b) The fact that quality is essential in performing audit engagements.

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

**4. As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new client. Explain stating clearly the information that would assist the auditor in accepting and continuing of relationship with the client.**

**Information which assist the Auditor in accepting and continuing of relationship with Client:** As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should obtain information considered necessary

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in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement and when considering acceptance of a new engagement with an existing client. The following information would assist the auditor in accepting and continuing of relationship with the client:

- (i) The **integrity** of the principal owners, key management and those charged with governance of the entity;
- (ii) Whether the engagement team is **competent** to perform the audit engagement and has the necessary capabilities, including time and resources;
- (iii) Whether the firm and the engagement team can **comply with relevant ethical requirements**; and
- (iv) **Significant matters** that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

**5. The firm's system of quality control should include policies and procedures addressing each and every element of system of quality control. State those elements. [MTP Oct-19]**

**ELEMENTS OF A SYSTEM OF QUALITY CONTROL:** The firm's system of quality control should include policies and procedures addressing each of the following elements:

- (a) Leadership responsibilities for quality within the firm.
- (b) Ethical requirements.
- (c) Acceptance and continuance of client relationships and specific engagements.
- (d) Human resources.
- (e) Engagement performance.
- (f) Monitoring.

**6. The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles. Discuss the personnel issues addressed by such policies and procedures. Also explain how addressing the personnel issues would empower the firm. [MTP Oct-19]**

The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

Such policies and procedures should address relevant HR issues including recruitment, compensation, training, career development, performance evaluation etc.

There should be emphasis on the continuing professional development of firm's personnel.

**7. The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded as being incompatible with integrity and objectivity. Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist requiring the application of different safeguards. Explain stating clearly the five types of threats as contained in Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC). [MTP Oct-18 + SM]**

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## Threats to Independence

**1. Self-interest threats**, which occur when an auditing firm, its partner or associate could benefit from a **financial interest** in an audit client. Examples include

- (i) direct financial interest or materially significant indirect financial interest in a client,
- (ii) loan or guarantee to or from the concerned client,
- (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement,
- (iv) close business relationship with an audit client,
- (v) potential employment with the client, and
- (vi) contingent fees for the audit engagement.

**2. Self-review threats**, which occur when during a **review of any judgement or conclusion reached in a previous audit or non-audit engagement** (Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.), or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are

- (i) when an auditor having recently been a director or senior officer of the company, and
- (ii) when auditors perform services that are themselves subject matters of audit.

**3. Advocacy threats**, which occur when the auditor **promotes, or is perceived to promote, a client's opinion** to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.

**4. Familiarity threats are self-evident**, and occur when auditors form relationships with the client where they end up being **too sympathetic** to the client's interests. This can occur in many ways:

- (i) **close relative** of the audit team working in a senior position in the client company,
- (ii) **former partner** of the audit firm being a director or senior employee of the client,
- (iii) **long association** between specific auditors and their specific client counterparts, and
- (iv) **acceptance of significant gifts or hospitality** from the client company, its directors or employees.

**5. Intimidation threats**, which occur when auditors are **deterred from acting objectively** with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

**8. Discuss fundamental principles of professional ethics. [RTP May-19+ Jan-21]**

Fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements:

- (a) Integrity
- (b) Objectivity
- (c) Professional competence and due care
- (d) Confidentiality and
- (e) Professional behavior.

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9. The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats. Explain the guiding principles in this regard. [RTP May-21]

The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

**The following are the guiding principles in this regard: -**

- i) For the public to have confidence in the quality of audit, it is essential that auditors should **always be and appears to be independent** of the entities that they are auditing.
- ii) In the case of audit, the **key fundamental principles are integrity, objectivity and professional skepticism**, which necessarily require the auditor to be independent.
- iii) Before taking on any work, an auditor must conscientiously **consider whether it involves threats to his independence**.
- iv) When such threats exist, the auditor should either **desist from the task or put in place safeguards that eliminate them**.
- v) If the auditor is unable to fully implement credible and adequate safeguards, then he must **not accept the work**.

*"If there is no struggle, there is no progress"*

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

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.

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

In the case, CA Kartik has reached office of the company without sharing with management his intention to test the controls. The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement without compromising effectiveness of audit.

Sharing details of visit to test controls does not compromise effectiveness of audit. It is for the better facilitation and conduct of audit. Therefore, **approach of CA Kartik is not proper**.

**3. 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?

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. Such planned risk assessment procedures are included in audit plan in accordance with SA-300.

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

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. 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.

## Ch-2 Audit Strategy, Planning & Programme

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

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

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.

### MCQs

**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 a proof of work done by auditor.

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

- (a) Gaining knowledge of client's workforce
- (b) Gaining knowledge of client's business
- (c) Gaining knowledge of client's vendors
- (d) Gaining knowledge of tax laws applicable to client

1. (c) 2. (d) 3. (d) 4. (c) 5. (b)

## Ch-2 Audit Strategy, Planning & 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.

**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?**

## Ch-2 Audit Strategy, Planning & Programme

- (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.

1. (b) 2. (b) 3. (b) 4. (c) 5. (b)

### Correct/Incorrect

**1. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely interrelated since changes in one may result in consequential changes to the other.**

**Correct:** Once the overall audit strategy has been established, an audit plan can be developed to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

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

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

**3. Planning is a discrete phase of an audit**

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

**5. A detailed Audit Programme once prepared for a business can be used for all business under all circumstances**  
[+MTP Nov-21]

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

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

**Correct.** The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.

**7. Once the audit plan has been drafted and communicated, it is obligatory on the auditor to follow the same.**  
[May-22 + MTP Apr-23]

## Ch-2 Audit Strategy, Planning & Programme

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

**8. Development of an audit plan is important before the establishment of the overall audit strategy to address the various matters. [RTP Nov-22]**

**Incorrect:** As per SA-300, "Planning an Audit of Financial Statements", the auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.

**9. The auditor should update and revise the audit plan as and when required, however, the overall audit strategy once established cannot be changed during the course of audit. [MTP Mar-21]**

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

### Descriptive Questions

**1. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors. Discuss those factors. [RTP Nov-22 + RTP Nov-21]**

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

- The size and complexity of the entity.
- The area of the audit.
- The assessed risks of material misstatement (for example, an increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work).
- Capabilities and competence of the individual team members performing the audit work.

**2. Explain what do you mean by documentation of audit plan. Discuss the purpose served by it and also elaborate the tools used by the auditor to reflect the particular engagement circumstances. [RTP Nov-22]**

- **Meaning:** 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.
- **Purpose:** It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.

## Ch-2 Audit Strategy, Planning & Programme

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

3. While developing an audit programme, the auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. Explain stating clearly the points to be kept in mind while developing an audit programme. [RTP Nov-22]

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

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

- (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.

4. You have been appointed as an auditor of MKP Ltd. for the first time. Discuss briefly, the factors to be considered by you while establishing overall audit strategy. [MTP May-22] **OR**

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

[MTP Oct-21]

As per SA-300, "Planning an Audit of Financial Statements", the auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. 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.

5. CA Vikas Jain discussed with his audit team about advantages and disadvantages of audit programme. He explained to his team that –"work may become mechanical" as disadvantage of the audit programme. Discuss explaining the disadvantages of an audit programme. [MTP Apr-22]

## Ch-2 Audit Strategy, Planning & Programme

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

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

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

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

- (i) The nature, timing and extent of planned risk assessment procedures, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".
- (ii) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SA 330 "The Auditor's Responses to Assessed Risks".
- (iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

The audit plan is more detailed than the overall audit strategy that includes the nature, timing and extent of audit procedures to be performed by engagement team members.

Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.

### Example

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

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

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

**The Assistant Engaged – Be Encouraged to Keep an Open Mind:** To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme.

- As experience is gained by actually carrying out the work, the programme may be altered to take care of situations which were left out originally, but are found relevant for the particular concern.

## Ch-2 Audit Strategy, Planning & Programme

- Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped.
- The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him.
- He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

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

**8. In establishing overall audit strategy, the auditor shall ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required. Elucidate those cases by which auditor can ascertain the reporting objectives of the engagement.**

[MTP Nov-21/Apr-23]

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

- The entity's timetable for reporting, such as at interim and final stages.
- The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
- The discussion with management regarding the expected communications on the status of audit work throughout the engagement.

**9. Surya and Chand Ltd is a manufacturing company engaged in the production of miscellaneous electrical goods. Trilochan and Co. has been appointed as the auditors to carry out its audit. Auditor thinks that Planning an audit would involve establishing the overall audit strategy for the engagement and developing an audit plan. Also, Adequate planning benefits the audit of financial statements in several ways. Analyse and Advise explaining the benefits of adequate planning. [RTP Nov-21 + Nov-18 + RTP May-18]**

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

- Helping the auditor to devote appropriate attention to important areas of the audit.
- Helping the auditor identify and resolve potential problems on a timely basis.
- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
- 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.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting, where applicable, in coordination of work done by auditors of components and experts.

**10. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after the completion of the previous audit and continues until the completion of the current audit.**

## Ch-2 Audit Strategy, Planning & Programme

engagement. Planning includes the need to consider certain matters prior to the auditor's identification and assessment of the risks of material misstatement. Explain clearly stating those matters also. [RTP May-21/19]

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

For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

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

**11. The auditor shall document the overall audit strategy, the audit plan and any significant changes made to the overall audit strategy or the audit plan. Explain in detail. [RTP Nov-20/ 18 + MTP Aug-18]**

The auditor shall document:

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

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

### Example

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

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

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

**12. Evolving one audit programme applicable to all business under all circumstances is not practicable. Explain clearly stating in detail the meaning of audit programme. [RTP Nov-20]**

## Ch-2 Audit Strategy, Planning & Programme

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

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

**13. In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. An auditor picks up evidence from a variety of fields. Analyse and explain with the help of examples. [RTP Nov-20]**

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.

An auditor picks up evidence from a variety of fields and it is generally of the following broad types:

- (a) Documentary examination,
- (b) Physical examination,
- (c) Statements and explanation of management, officials and employees,
- (d) Statements and explanations of third parties,
- (e) Arithmetical calculations by the auditor,
- (f) State of internal controls and internal checks,
- (g) Inter-relationship of the various accounting data,
- (h) Subsidiary and memorandum records,
- (i) Minutes,
- (j) Subsequent action by the client and by others.

### Example

1. For cash in hand, the best evidence is 'count'
2. For investment pledged with a bank, the banker's certificate.
3. For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary.

In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion.

The auditor, however, has to place appropriate weight on each piece of evidence and accordingly should prescribe the priority of verification. It is true that in all cases one procedure may not bring the highest satisfaction and it may be dangerous for the auditor to ignore any evidence that is available. By the word "available" we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage.

**14. Plans should be further developed and revised as necessary during the course of the audit. Explain. [RTP May-20]**

## Ch-2 Audit Strategy, Planning & Programme

SA-300, "Planning an Audit of Financial Statements" further expounds this principle. According to it, planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

**15. Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. The process of establishing the overall audit strategy assists the auditor to determine such matters as for example – 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. Explain the other three such matters. [RTP May-20] OR**

The engagement partner of AST AND ASSOCIATES, firm of Chartered Accountants appointed as auditor of Fabric India Ltd is considering as to management of key resources to be employed to conduct audit. Discuss how overall audit strategy would assist the auditor. [MTP May-18]

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; and
- (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.

**16. "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". Explain. [SM] OR**

The establishment of the overall audit strategy and the detailed audit plan are closely inter-related. Explain [MTP Mar-19]

**Audit strategy sets broad overall approach** to the audit whereas audit plan addresses the various matters identified in the overall audit strategy. Audit strategy determines scope, timing and direction of audit.

**Audit plan describes how strategy is going to be implemented.** 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.

## Ch-2 Audit Strategy, Planning & Programme

Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops.

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.

**17. The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. Explain [RTP May-19]**

### Periodic Review of The Audit Programme

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

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

However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an **element of rigidity** in the audit programme.

This is not true provided the periodic review is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

*"Happiness is sticking to the Routine &  
feeling the High of Completing a Topic"*

## Test Your Understanding

1. During the course of audit of a company, an issue arose relating to treatment of interest costs of company on its restructured loans taken from a bank. This important matter was discussed with CFO of the company and was properly resolved. Is it necessary for the auditor to include in its working papers?

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.

2. CA Sonali Morarka has completed audit of a listed company. The audit report dated 15th July, 2022 has been issued. However, audit working papers including record of discussions with management, details of audit procedures performed to obtain audit evidence and conclusions reached by her have not been properly assembled. More than six months have elapsed after issue of audit report. Subsequently, she has received a letter from regulator in connection with audit of the company requesting her to share copy of audit file. Standard on Quality Control (SQC) 1 provides that audit documentation is the property of the auditor. He may make portions of, or extracts from, audit documentation available to clients subject to some conditions.

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".

An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

Further, preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

In the given case, even after passage of more than six months, she has not assembled audit file. Besides, she has put in some papers with current date which is not permissible at all. It shows that part of audit documentation has been prepared afterwards putting a question mark on quality of audit.

### 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.

## Ch-3 Audit Documentation

(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

## Ch-3 Audit Documentation

- (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.

1. c 2. c 3. d 4. d 5. d

### Correct/Incorrect

**1. The auditor must include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking etc. [RTP Nov-21]**

**Incorrect:** The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

**2. As per SA 230 on "Audit Documentation", the working papers are not the property of the auditor. [SM]**

**Incorrect:** As per SA 230 on "Audit Documentation" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

**3. Mr. A is a statutory auditor of ABC Ltd. The branch of ABC Ltd. is audited by Mr. B, another Chartered Accountant. Mr. A requests for the photocopies of the audit documentation of Mr. B pertaining to the branch audit.**

**Incorrect:** SA 230 issued by ICAI on Audit Documentation, and "Standard on Quality Control (SQC) 1, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

**4. The auditor shall assemble the audit documentation in the audit file and complete the administrative process of assembling the final audit file before the date of the auditor's report. [Nov-22]**

**Incorrect:** The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.

**Alternative reason:** An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

## Ch-3 Audit Documentation

Past Exams/RTPs/MTPs/SM Questions

### 1. Define audit documentation. Also give some examples. [SM]

Audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as "working papers" or "work papers" are also sometimes used.)

Audit Documentation include: Audit programmes, Analyses, Issues memoranda, Summaries of significant matters, Letters of confirmation and representation, Checklists, Correspondence (including e-mail) concerning significant matters

### 2. What do you mean by Audit Documentation? Also explain the nature and purpose of audit documentation.

[RTP May-19 + MTP Nov-21 + Nov-22]

**SA 230 on "Audit Documentation",** audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. (terms such as "working papers" or "work papers" are also sometimes used.)

#### Nature of Audit Documentation

Audit documentation provides:

- evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and
- evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

#### The following are the purpose of Audit documentation:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team to direct and supervise the audit work, and to discharge their review responsibilities.
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

### 3. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor to understand significant matters arising during the audit. Explain the above statement and also give examples of significant matters. [RTP Nov-22/20]

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. Judging the significance of a matter requires an objective analysis of the facts and circumstances.

Examples of significant matters include:

- Matters that give rise to significant risks.
- Results of audit procedures indicating
  - that the financial statements could be materially misstated, or
  - a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.

## Ch-3 Audit Documentation

- Circumstances that cause the auditor **significant difficulty** in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor's report.

### 4. Give some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment where the matters and judgments are significant. [MTP Oct-20]

Some examples of circumstances in which it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- ✓ The rationale for the auditor's conclusion when a requirement provides that the auditor '**shall consider**' certain **information or factors**, and that consideration is significant in the context of the particular engagement.
- ✓ The basis for the auditor's conclusion on the **reasonableness of areas of subjective judgments** (for example, the reasonableness of significant accounting estimates).
- ✓ The basis for the auditor's conclusions about the **authenticity of a document** when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.

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

[MTP Apr-19]

**Form, Content and Extent of Audit Documentation:** Working papers should record the audit plan, nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

The form, content and extent of working papers depend on factors such as:

- The **size and complexity** of the entity.
- The **nature of the audit procedures** to be performed.
- The identified **risks of material misstatement**.
- The **significance** of the audit evidence obtained.
- The **nature and extent of exceptions** identified.
- The need to document a **conclusion** or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- The **audit methodology** and tools used.

### 6. CA R comes to know some very critical information with regards to the business cycle of an entity for which he has issued the audit report, which become known to him as an auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report. He wants to perform additional audit procedures to satisfy himself. As an auditor what he shall document, on the matters arising after the date of audit report? [RTP Nov-22]

As per SA 230, "Audit Documentation", if, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document:

- (i) The circumstances encountered;
- (ii) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and
- (iii) When and by whom the resulting changes to audit documentation were made and reviewed.

### 7. TRS & Associates, Chartered Accountants, having completed the audit of Genuine Leathers Ltd has started the assembling of final audit file. TRS & Associates has established policies and procedures for the timely completion

### Ch-3 Audit Documentation

of the assembly of audit files. Explain the various aspects related to final audit file discussed in SA 230 giving specific reference to SQC-1, wherever required. [RTP May-22]

Auditor TRS & Associates, CAs shall assemble audit documentation in an audit file and complete administrative process of assembling final audit file on a timely basis after the date of the auditor's report.

(i) SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files.

(ii) An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.

(iii) Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

**Examples of such changes include:**

(i) Deleting or discarding superseded documentation.

(ii) Sorting, collating and cross-referencing working papers.

(iii) Signing off on completion checklists relating to the file assembly process.

(iv) 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.

(v) 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.

(vi) 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.

**8. Audit documentation provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered. Further, it is unnecessary for the auditor to document separately compliance with matters for which compliance is demonstrated by documents included within the audit file. Explain giving examples. [MTP Oct-21]**

Audit documentation provides evidence that the audit complies with SAs.

However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file.

**For example:**

- ✓ The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- ✓ The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.

## Ch-3 Audit Documentation

- ✓ An auditor's report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.

In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:

- For example, there may be **no single way in which the auditor's professional skepticism is documented**. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with SAs. Such evidence **may include specific procedures performed to corroborate management's responses to the auditor's inquiries**.
- Similarly, that the engagement partner has taken **responsibility for the direction, supervision and performance of the audit** in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's **timely involvement in aspects of the audit**, such as **participation in the team discussion** required by SA 315.

### 9. "Completion Memorandum" is helpful as part of the audit documentation. Explain. [May-19]

#### **Completion Memorandum or Audit Documentation Summary.**

The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-

- the significant matters identified** during the audit.
- 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.

### 10. While documenting the nature, timing and extent of audit procedures performed in case of audit of PQR Ltd, explain the important matters its auditor should record. [RTP May-21]

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

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

### 11. 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. [SM]

Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

## Ch-3 Audit Documentation

12. 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. [SM]

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

13. The working papers of the branch auditor are also the property of the Principal Auditor and the Management of the Company, so they have right to access them. State the relevant SA and comment. [MTP Mar-21]

**Ownership of Working Papers:** As per SA 230 "Audit Documentation", working papers are the property of the auditor. He may at his discretion, make available portions or extracts from his working paper to his client. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers.

An auditor is **not required** to provide the management/ clients or other auditors' access to his working papers. **Main auditor of the company does not have right of access to the working papers of the branch auditor.**

In the case of a company, the main auditor has to consider the report of the branch auditor and has a right to see clarification and to visit the branch but cannot ask for the copy of working paper and therefore, the branch auditor is under no compulsion to give photocopies of his working paper to the principal auditor.

From above, it is clear that working papers of the branch auditor are his property only and neither the Principal auditor nor management has right to access that. Therefore, **statement given in the question is incorrect.**

14. 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. [SM]

Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

## Ch-4 Risk Assessment & Internal Control

### Test your Understanding

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

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."

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

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".

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

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".

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

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.

6. 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?

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.

## Ch-4 Risk Assessment & Internal Control

7. 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.

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.

8. 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?

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

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

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

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

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

10. 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.

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.

11. 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.

## Ch-4 Risk Assessment & Internal Control

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.

**12. 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.**

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.

**13. 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.**

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.

**14. 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.**

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

**15. 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.**

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.

**16. 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.**

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

**17. 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**

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

## Ch-4 Risk Assessment & Internal Control

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

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.

19. 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.

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.

### Correct/Incorrect

(i) **Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.**

**Incorrect:** Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

(ii) **Maintenance of Internal Control System is the responsibility of the Statutory Auditor.**

**Incorrect:** The management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. Maintenance of Internal Control System is responsibility of management because the internal control is the process designed, implemented and maintained by those charged with governance/management to provide reasonable assurance about the achievement of entity's objectives.

(iii) **Mr. W, one of the team members of auditor of Different Limited was of the view that understanding the Internal Control of Different Limited will not help in developing an Audit Programme.**

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

# Ch-4 Risk Assessment & Internal Control

## Past Exams/RTPs/MTPs Questions

1. The assessment of risks is a matter of professional judgment. Explain stating clearly what is not included in Audit Risk? [MTP Aug-18 + May-23]

### Assessment of Risks - Matter of Professional Judgement

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

### What is not included in Audit Risk ?

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

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

2. The risks of material misstatement may exist at the financial statement level and assertion level. Explain the two levels. [RTP Nov-20]

The risks of material misstatement may exist at two levels:

(i) **The overall financial statement level**- Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

(ii) **The assertion level** for classes of transactions, account balances, and disclosures-Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

3. 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. Analyse and explain giving examples. [RTP May-20] OR

Obtaining an understanding of the entity and its environment establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit. Explain by giving examples.

[RTP Nov-23]

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, for example, when:

- **Assessing risks of material misstatement** of the financial statements;
- **Determining materiality in accordance with SA 320;**
- **Considering the appropriateness of the selection and application of accounting policies;**

## Ch-4 Risk Assessment & Internal Control

- Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

4. 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. [RTP Nov-21 + May-23]

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

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

- Whether the risk is a risk of fraud;
- Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
- The complexity of transactions;
- Whether the risk involves significant transactions with related parties;
- 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
- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

5. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as complex calculations. Also, risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as accounting principles for accounting estimates may be subject to differing interpretation etc. Explain in detail. [MTP Nov-23] OR

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 the view of the auditor correct? Specify the other matters due to which the risk of material misstatement is greater for significant non-routine transactions. [Dec-21 + RTP Nov-21 + SM]

### Risks of Material Misstatement—Greater for Significant Non-Routine Transactions

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

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

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### Risks of material misstatement— Greater for Significant Judgmental Matters

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

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

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

**6. Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control. [RTP May-20]**

**Objectives of Internal Control are :**

- (i) transactions are executed in accordance with managements **general or specific authorization**;
- (ii) **all transactions are promptly recorded** in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;
- (iii) **assets are safeguarded** from unauthorised access, use or disposition; and
- (iv) the **recorded assets are compared with the existing assets** at reasonable intervals and appropriate action is taken with regard to any differences.

**7. Briefly discuss the limitations of Internal Control. [MTP Apr-19]**

**Limitations of Internal Control:**

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

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

(iii) **Lack of understanding the purpose:** Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

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

## Ch-4 Risk Assessment & Internal Control

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

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

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

**8. The division of internal control into five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. Mention those components of internal control. [MTP Oct-21/Mar-23]**

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

- (i) The control environment;
- (ii) The entity's risk assessment process;
- (iii) Monitoring of controls.
- (iv) Control activities; and
- (v) The information system, including the related business processes, relevant to financial reporting, and communication;

**9. "A satisfactory control environment is not an absolute deterrent to fraud although it may help reduce the risk of fraud." Explain. [RTP May-18]**

**Satisfactory Control Environment – not an absolute deterrent to fraud:** Existence of a satisfactory control environment can be a positive factor when auditor assesses risks of material misstatement.

However, although it may help reduce risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in control environment may undermine effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, control environment also influences the nature, timing, and extent of the auditor's further procedures.

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

**10. The auditor of XYZ Ltd, engaged in FMCG (Fast Moving Consumable Goods) obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:**

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

## Ch-4 Risk Assessment & Internal Control

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

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

[Nov-22 + RTP Nov-19]

**Control Environment – Component of Internal Control:** The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

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

### What is included in Control Environment?

The control environment includes:

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

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

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

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

**(c) Participation by those charged with governance** – Attributes of those charged with governance such as:

- Their independence from management.
- Their experience and stature.
- The extent of their involvement and the information they receive, and the scrutiny of activities.
- The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

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

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

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

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

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

## Ch-4 Risk Assessment & Internal Control

11. Define Monitoring of Controls and in respect of monitoring of controls, answer the following questions:

- (i) How monitoring of controls would be helpful in assessing the effectiveness of controls?
- (ii) How can management accomplish monitoring of controls?
- (iii) What is included in the Management's monitoring activities? [RTP Nov-22]

**Monitoring of controls Defined:** Monitoring of controls is a process to assess the effectiveness of internal control performance over time.

- i. Helps in assessing the effectiveness of controls on a timely basis: It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.
- ii. Management accomplishes through ongoing activities, separate evaluations etc.: Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
- iii. Management's monitoring activities 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

12. Explain the matters which should be included for factors relevant to the auditors' judgement about whether a control is relevant to the audit. [RTP Nov-22 + MTP May-22]

**Controls Relevant to the Audit:** 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:

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

13. Auditor GR and Associates have been appointed to conduct audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditors do not think that it would be necessary to understand internal controls. Advise the auditor in this regard explaining clearly the benefits of understanding the internal control. [RTP May-21]

The auditor shall obtain an understanding of internal control relevant to the audit.

### Benefits of Understanding the Internal Control

An understanding of internal control assists the auditor in:

- (i) identifying types of potential misstatements;
- (ii) identifying factors that affect the risks of material misstatement, and
- (iii) designing the nature, timing, and extent of further audit procedures.

## Ch-4 Risk Assessment & Internal Control

14. The review of internal controls will enable the auditor to know the areas where control is weak. Explain stating clearly the benefits of evaluation of internal control to the auditor. [RTP Nov-22]

### Benefits of Evaluation of Internal Control to the Auditor

The review of internal controls will enable the auditor to know:

- (i) whether **errors and frauds are likely to be located** in the ordinary course of operations of the business;
- (ii) whether an **adequate internal control system** is in use and operating as planned by the management;
- (iii) whether an **effective internal auditing department** is operating;
- (iv) whether any **administrative control** has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);
- (v) whether the **controls adequately safeguard the assets**;
- (vi) how far and how **adequately the management is discharging its function** in so far as correct recording of transactions is concerned;
- (vii) how **reliable the reports, records and the certificates** to the management can be;
- (viii) the **extent and the depth of the examination** that he needs to carry out in the different areas of accounting;
- (ix) what would be **appropriate audit technique** and the audit procedure in the given circumstances;
- (x) what are the **areas where control is weak** and where it is excessive; and
- (xi) whether some **worthwhile suggestions** can be given to improve the control system.

15. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the classes of transactions in the entity's operations that are significant to the financial statements, controls surrounding journal entries etc. Explain the other considerations in this regard. [MTP May-22]

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

- a. The **classes of transactions** in the entity's operations that are significant to the financial statements;
- b. The **procedures** by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
- c. The **related accounting records**, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions;
- d. How the **information system captures events and conditions** that are significant to the financial statements;
- e. The **financial reporting process** used to prepare the entity's financial statements;
- f. **Controls surrounding journal entries.**

16. ABC Ltd. has many divisions and branches across the country. They 3 have an internal control system which is well established and maintained by the management on a regular basis. Explain the meaning of internal control as per SA-315 and also state the benefits of understanding the internal controls of a company. [Nov-22]

As per SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", the internal control may be defined as "the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, safeguarding of assets, and compliance with applicable laws and regulations.

### Benefits of Understanding the Internal Control

## Ch-4 Risk Assessment & Internal Control

An understanding of internal control assists the auditor in:

- (i) identifying types of potential misstatements;
- (ii) identifying factors that affect the risks of material misstatement, and
- (iii) designing the nature, timing, and extent of further audit procedures.

**17. Discuss the various points which auditor needs to consider in determining whether it is appropriate to use audit evidence about operating effectiveness of controls obtained in previous audit, and if so, the length of the time period that may elapse before retesting a control. [MTP Apr-23 + Nov-19]**

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

- i) The **effectiveness of other elements of internal control**, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process
- ii) The **risks arising from the characteristics of the control**, including whether it is manual or automated
- iii) The **effectiveness of general IT-controls**;
- iv) The **effectiveness of the control and its application by the entity**, including the nature and
- v) extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affects the application of the control
- vi) Whether the **lack of a change in a particular control** poses a risk due to changing circumstances; and
- vii) The **risks of material misstatement** and the extent of reliance on the control.

## Test your Understanding

1. 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.

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".

2. 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?

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

### CASE STUDY-1

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

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

Therefore, parts of inventories are lying with third parties.

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.

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**2. The company's products are getting outdated in the market. Which of the following is an audit risk?**

- (a) The company should devise strategies to sell products in the market.
- (b) Inventories may be understated in such a scenario.
- (c) Inventories may be overstated in such a scenario.
- (d) The company should launch a 1+1 free offer for its customers.

**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.

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.

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.

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- (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.

1. (b) 2. (c) 3. (c) 4. (b) 5. (a)

#### Correct/Incorrect

(i) Tests of control are performed to obtain audit evidence about the effectiveness of Internal Controls Systems.

**Correct:** Tests of Control are performed to obtain audit evidence about the effectiveness of:

- a. the design of the accounting and internal control systems that is whether, they are suitably designed to prevent or detect or correct material misstatements and

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b. the operation of the internal controls throughout the period.

(ii) Information obtained by performing risk assessment procedures shall not be used by the auditor as audit evidence to support assessments of the risks of material misstatement.

**Incorrect:** Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement.

### Past Exams/RTPs/MTPs Questions

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

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

- Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
- Assess the Identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- 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
- 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.

2. Discuss what is included in risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls. [RTP May-18]

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

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

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

Explain with the help of examples. [RTP Nov-20]

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

### Examples

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- ✓ Inquiries directed towards **those charged with governance** may help the auditor understand the environment in which the financial statements are prepared.
- ✓ Inquiries directed toward **internal audit personnel** may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- ✓ Inquiries of **employees** involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- ✓ Inquiries directed toward **in-house legal counsel** may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post- sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
- ✓ Inquiries directed towards **marketing or sales personnel** may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- ✓ Inquiries directed to the **risk management function** (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- ✓ Inquiries directed to **information systems personnel** may provide information about system changes, system or control failures, or other information system- related risks.

**4. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Explain in detail. [RTP Nov-20/23]**

Analytical procedures performed as risk assessment procedures **may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.**

Analytical procedures performed as risk assessment procedures **may include both financial and non-financial information**, for example, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical procedures may help identify the **existence of unusual transactions or events, and amounts, ratios, and trends** that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in **identifying risks of material misstatement, especially risks of material misstatement due to fraud.**

However, when such **analytical procedures use data aggregated at a high level** (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a **broad initial indication about whether a material misstatement may exist.**

Accordingly, in such cases, **consideration of other information** that has been gathered when **identifying the risks of material misstatement** together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

**5. CA L is in the process of finalizing his Risk Assessment Procedures of Effluent Limited which include observation and inspection that may support inquiries of management and others. Discuss few examples of audit procedures which include observation or inspection of the entity's operations. [July-21]**

## Ch-5 Audit Procedures

Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment.

**Examples of audit procedures which include observation or inspection of the entity's operations are:**

- a. **Documents** (such as business plans and strategies), **records**, and **internal control manuals**.
- b. **Reports** prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of director's meetings)
- c. **The entity's premises and plant facilities.**

**6. A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls. Explain and also state when will the auditor design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls. [RTP Nov-20]**

Test of controls may be defined as an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

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

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

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

**7. When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control as well as the degree of reliance on controls. Discuss the matters the auditor may consider in determining the extent of test of controls. [RTP Nov-20]**

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

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

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

## Ch-5 Audit Procedures

8. Discuss the various points which auditor needs to consider in determining whether it is appropriate to use audit evidence about operating effectiveness of controls obtained in previous audit, and if so, the length of the time period that may elapse before retesting a control. [MTP Apr-23 + Nov-19]

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

- i) The **effectiveness of other elements of internal control**, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process
- ii) The **risks arising from the characteristics of the control**, including whether it is manual or automated
- iii) The **effectiveness of general IT-controls**;
- iv) The **effectiveness of the control and its application by the entity**, including the nature and
- v) extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affects the application of the control
- vi) Whether the **lack of a change in a particular control** poses a risk due to changing circumstances; and
- vii) The **risks of material misstatement** and the extent of reliance on the control.

## Ch-6A Materiality

### Test your Understanding

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

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**.

2. 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.

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.

### MCQ

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.

### Correct/Incorrect

1. Materiality is not a matter of size. [May-22 + MTP Apr-23]

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

2. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) does not need any revision. [SM]

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

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

[Dec-21]

## Ch-6A Materiality

**Incorrect:** Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

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

[MTP Oct-19]

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

**5. When establishing the overall audit strategy, the auditor need not determine materiality for the financial statements as a whole. [RTP May-21]**

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

**6. There is direct relationship between materiality and the degree of audit risk.**

**Incorrect:** There is an **inverse relationship** between materiality and the degree of audit risk. The **higher the materiality level, the lower the audit risk** and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

**7. Determining materiality involves the exercise of professional judgement. [Jan-21]**

**Correct:** 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.

**8. If during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality. [MTP Nov-22]**

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

### Past Exams/RTPs/MTPs Questions

**1. You are being appointed as the auditor of Track Ltd. for the first time. You want to determine the materiality level and for that you have applied percentage to choose benchmark as a starting point in determining materiality for the financial statements as a whole. What are the factors that may affect the identification of an appropriate benchmark? [RTP May-22 + May-23]**

SA 320 "Materiality in Planning and Performing an Audit" prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

## Ch-6A Materiality

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

- The elements of the financial statements. Example - assets, liabilities, equity, revenue, expenses;
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused. Example - for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets.
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed [Example- if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings];
- The relative volatility of the benchmark.

2. Materiality for the financial statements as a whole may need to be revised as a result of a change in circumstances that occurred during the audit. Explain with the help of example. [MTP Oct-19]

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

### Example

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

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

3. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, explain the auditor's assumptions about users of the financial statements. [RTP May-21 + Nov-23]

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

- 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;
- Understand that financial statements are prepared, presented and audited to levels of materiality;
- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- Make reasonable economic decisions on the basis of the information in the financial statements.

4. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Explain. [RTP May-21]

## Ch-6A Materiality

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

1. **Misstatements, including omissions, are considered to be material** if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
2. **Judgments about materiality** are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
3. Judgments about matters that are material to users of the financial statements are based on a consideration of the **common financial information needs** of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

**5. Whether misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements? Explain with examples [SM]**

Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

1. **Whether law, regulations or the applicable financial reporting framework** affect users' expectations regarding the measurement or disclosure of certain items.

**Example**

Related party transactions, and the remuneration of management and those charged with governance.

2. **The key disclosures** in relation to the industry in which the entity operates.

**Example**

Research and development costs for a pharmaceutical company.

3. Whether attention is focused on a **particular aspect of the entity's business** that is separately disclosed in the financial statements.

**Example**

A newly acquired business.

**6. Is materiality required to be documented by the auditor? What factors have to be considered this regard? [SM]**

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

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.

## Ch-6A Materiality

7. While conducting the audit of Smart TV Ltd, engagement team of HTR& Co, has considered materiality and audit risk throughout the audit. Discuss explaining the meaning of audit risk. [RTP May-22]

**Audit risk** is the risk that the auditor expresses an **inappropriate audit opinion** when the **financial statements are materially misstated**. Audit risk is a function of the risks of material misstatement and detection risk.

Materiality and audit risk are considered throughout the audit, in particular, when:

- (a) Identifying and assessing the risks of material misstatement;
- (b) Determining the nature, timing and extent of further audit procedures; and
- (c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

*"Believe in yourself & soon the world will too"*

## Ch-6B Audit Sampling

### Test your Understanding

1. 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?

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 nonstatistical 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.

### MCQs

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.

### Correct/Incorrect

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

[RTP Nov-22]

**Incorrect:** As per SA 530, "Audit Sampling" the level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

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

**Incorrect:** The method which involves dividing the population into groups of items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.

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

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

4. Non Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

**Incorrect:** Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.

5. Sample need not be representative

**Incorrect:** Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

## Ch-6B Audit Sampling

**6. The objective of stratification is to increase the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.**

**Incorrect:** The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

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

**Incorrect:** Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

**8. Stratified Sampling is used for homogeneous population.**

**Incorrect:** Stratified sampling is used when the population is diversified i.e heterogeneous. The population is divided into sub population having similar characteristics. Sample are then chosen from these sub populations which are called as Stratum. Therefore, stratified sampling is not useful in case of homogeneous population.

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

**Incorrect:** Statistical sampling uses scientific method of choosing samples from a given population. The use of probability theory is involved in statistical sampling so that every sampling unit has an equal chance of getting selected. In the non-statistical sampling, auditors' judgment and past experience is used to choose samples without any scientific method.

**10. In case of Statistical sampling, auditor's bias in choosing sample is involved.**

**Incorrect:** Statistical sampling uses scientific method choosing samples from a given population. The use of probability theory is involved in statistical sampling so that every sampling unit has an equal chance of getting selected. In the non statistical sampling, auditor's judgment and past experience is used to choose samples without any scientific method. Hence, personal bias is involved in Non statistical sampling and not Statistical.

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

[Jan-21]

**Incorrect:** In case of stratified sampling, the conclusions are drawn on the stratum. The combination of all the conclusions on stratum together will be used to determine the possible effect of misstatement or deviation. Hence the samples are used to derive conclusion only on the respective stratum from where they are drawn and not the whole population.

**12. Low acceptable sampling risk requires larger sample size.**

**Correct:** Sampling risk arises from possibility that the auditor's conclusion based upon sample may be different from conclusion that would have been reached if same audit procedures were applied on the entire population. If acceptable sampling risk is low, large sample size is needed

## Ch-6B Audit Sampling

13. Statistical sampling being more scientific and without personal bias bias will always be appropriate to use under all circumstances. [Dec-21 + MTP Apr-23]

**Incorrect:** Statistical sampling is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way. Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort. For instance, when exact accuracy is required or in case of legal requirements etc.

### Past Exams/RTPs/MTPs/SM Questions

1. The approach to audit and extent of checking are undergoing a progressive change in favour of more attention towards the questions of principle and controls with a curtailment of non-consequential routine checking. Discuss the given statement. [May-22 +MTP May-22]

**Sampling: An Audit Procedure:** No conscious effort in human society is divested of economic considerations and auditing is no exception.

There is a growing realisation that traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without any exception. This invariably leads to **more emphasis on routine checking**, which often is not necessary in view of the time and cost involved.

With the shift in favour of formal internal controls in the management of affairs of organisations, the **possibilities of routine errors and frauds have greatly diminished** i.e., the internal controls as designed by the management are for the very purpose of Prevention, Detection and Correction of Frauds and Errors.

Thus, the auditors often find **extensive routine checking as nothing more than a ritual because it seldom reveals anything material**. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of **more attention towards the questions of principles and controls** with a curtailment of non-consequential routine checking. By routine checking, we traditionally think of extensive checking and vouching of all the entries, disregarding the concept of materiality.

The **extent of the checking to be undertaken is primarily a matter of judgment** of the auditor. There is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent it has to be done. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do as an auditor is to express his opinion on the financial statements and become bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking (i.e., sampling), he should **adopt standards and techniques which are widely followed and which have a recognised basis**.

Since **statistical theory of sampling is based on a scientific law**, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability. This enables the auditor to **make conclusions and express fair opinion without having to check all of the items within the financial statements**.

2. Explain the meaning of Audit Sampling as per the relevant standard on auditing. State the requirements relating to audit sampling, sample design, sample size and selection of items for testing. [RTP Nov-22 +MTP Oct-21]

## Ch-6B Audit Sampling

**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 to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The requirements relating to sample design, sample size and selection of items for testing are explained below-

- ✓ **Sample design** - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.
- ✓ **Sample Size** - The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.
- ✓ **Selection of Items for Testing** - The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

**3. In most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries. Explain in detail. [RTP May-21]**

In most of circumstances, evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive absolute satisfaction. This state of uneasiness led **pragmatic auditors to adopt the statistical theory of sampling** to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries.

Auditors realised that they can derive good satisfaction by undertaking much lesser checking by adoption of this technique in the auditing process. It is a **mathematical truth** that the sample, if picked purely on a **random basis** would reveal the **features and characteristics** of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking **provided he can put reliance on the internal controls** and checks within the client's organisation because they provide the reliability of the records.

Sampling is used as a **part of Test of controls**. Auditor will check **few internal controls and their operating effectiveness**. Based on the conclusion derived, he can then design the sample size for test of details (i.e checking of transactions and balances)

- ✓ If the internal control is **satisfactory** in its design and implementation, a **much smaller sample** can give the auditor the necessary reliability of the result he obtains.
- ✓ On the other hand, if in certain areas **controls are slack** or not properly implemented, the auditor may have to take a **much larger sample** for getting satisfactory result.

Another truth about the sampling technique should be noted. It can **never bring complete reliability**; it cannot give precisely accurate results. It is a process of estimation. It may have some error. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular case.

## Ch-6B Audit Sampling

4. Audit testing done through Statistical sampling is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Explain and also state advantages of Statistical sampling? [RTP May-22]

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. 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.

**Advantages of Statistical Sampling in Auditing:** The advantages of statistical sampling may be summarized as follows:

- (i) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- (ii) The sample selection is more objective and thereby more defensible.
- (iii) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
- (iv) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
- (v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

5. When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. Explain in detail. [RTP Nov-21]

Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

When designing an audit sample,

- the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose.
- Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.
- In fulfilling the requirement of relevant portion (paragraph 8) of SA 500, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

The auditor's consideration of the purpose of the audit procedure includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements.

For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not

## Ch-6B Audit Sampling

considered a misstatement. Also, a misposting between customer accounts does not affect the total accounts receivable balance.

Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size.

For example, if the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

**6. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e. it is suitable for a homogeneous population having a similar range. Explain about that method. [RTP Nov-22]**

**Simple Random Sampling:** Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected.

- ✓ It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection.
- ✓ Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum). Today random numbers are also generated using various applications on the cellphones like the random number generator.
- ✓ This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e. it is suitable for a homogeneous population having a similar range.

**7. ABC Ltd is a Large Company with huge purchase and sales transactions. Which sampling approach is recommended in such a company? Explain giving features of such sampling approach along with example.**

**[MTP Apr-22]**

**In larger organisations, with huge transactions, statistical sampling is always recommended as it is unbiased, and the samples selected are not prejudged.**

## Ch-6B Audit Sampling

### Features/Characteristics of Statistical Sampling:

(1) Audit testing done through this approach is **more scientific** than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances.

(2) Statistical sampling has reasonably wide application where a population to be tested consists of a **large number of similar items** and more in the case of transactions involving compliance testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

(3) There is **no personal bias** of the auditor in case of statistical sampling. Since it is scientific, the results of sample can be evaluated and projected on the whole population in a more reliable manner.

**For Example:** An auditor while verifying the Purchases during the year realised that the purchase transactions in that year are more than 45000 in number, then in such case, statistical sampling will be highly recommended in the audit program. Random Sampling (discussed ahead in this topic) is the method you decide to choose sample in such a situation.

**8. With reference to SA 530 "Audit Sampling", explain briefly the following factors that the auditor may consider when determining the sample size for the Test of Details – (i) The desired level of assurance (ii) Stratification of the pollution. [Dec-21]**

### Examples of factors influencing Sample Size for Test of Details:

**(i) Desired Level of Assurance:** An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population will increase the sample size. Hence, greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.

**(ii) Stratification of population:** When stratification of the population is appropriate then sample size will decrease as when there is a wide range (variability) in the monetary size of items in the population, it may be useful to stratify the population. When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

**9. CA X is not sure about the kind of Sampling method to be used for audit of a company. Advise him about the choice of methods (name of methods only) of Sampling to be used in various circumstances. Also explain briefly the advantages of the Sampling to be used by him in auditing. [MTP Nov-21]**

### Sample Selection:

CA. X should obtain the knowledge before using the sampling methods. The principal methods are as follows:

- (1) Random selection.
- (2) Systematic selection.
- (3) Monetary Unit sampling.
- (4) Haphazard selection.
- (5) Block selection.

## Ch-6B Audit Sampling

### Advantages of Statistical Sampling in Auditing:

- (i) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- (ii) The sample selection is **more objective and thereby more defensible**.
- (iii) The method provides a means of estimating the **minimum sample size** associated with a specified risk and precision.
- (iv) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
- (v) It may provide a **better description of a large mass of data** than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

**10. In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. Guide the auditor on the use of stratification and value-weighted sampling techniques. [RTP Nov-21]**

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value - weighted sampling techniques.

**Stratification:** Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic.

The **objective of stratification** is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

When performing **tests of details**, the population is often **stratified by monetary value**. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement.

Similarly, a population may be stratified according to a particular characteristic that indicates a **higher risk of misstatement**, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

**Dividing a population into discrete sub population** which have identifying characteristics is called as **Stratification**. Each **Sub population** is called as **Stratum** and units under those sub population are referred to as **Strata**.

The **results of samples from the units** drawn under each sub population are **projected to that respective stratum**. In order to draw an opinion on the **overall population**, the auditor needs to **combine the results of all the stratum** to check for possible deviation or risk of material misstatement.

**Projected misstatements of each stratum will be combined together** to consider the possible effect of misstatement in the account balances and class of transactions.

### Example

20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the

## Ch-6B Audit Sampling

90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

**Value-Weighted Selection:** When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.

One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

In value weighted selection, the sample size, its selection and evaluation will result in a conclusion in monetary amounts.

**11. Explain the following terms with reference to Audit Sampling :**

- (i) **Stratification**
- (ii) **Tolerable misstatement**
- (iii) **Tolerable rate of deviation [RTP May-21]**

(i) **Stratification** – The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

(ii) **Tolerable misstatement** – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

(iii) **Tolerable rate of deviation** – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

**12. CA B is appointed as an auditor of M/s. Divine Pharmacy, a wholesale medicine supplier. While auditing for the financial year 2020-21, CA B wants to use test checking technique. Advise CA B, what kind of precautions should be taken by him in this regard. [July-21 + SM]**

**The following Precautions should to be taken by CA B while applying test check techniques:**

- ✓ Thorough study of accounting system should be done before adopting sampling
- ✓ Proper study of Internal control systems.
- ✓ Areas which are not suitable for sampling should be carefully considered. eg: compliance with statutory provisions, transactions of unusual nature etc.
- ✓ Proper planning for Sampling methods to be used and explaining the staff,
- ✓ Transactions and balances have to be properly classified (stratified)
- ✓ Sample size should be appropriately determined.
- ✓ Sample should be chosen in unbiased way,
- ✓ Errors located in the sample should be analyzed properly.

## Ch-6B Audit Sampling

13. Explain the factors that should be considered for deciding upon the extent of checking on a sampling plan.  
[RTP Nov-20 + Nov-23]

The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

- (i) Size of the organisation under audit.
- (ii) State of the internal control.
- (iii) Adequacy and reliability of books and records.
- (iv) Tolerable error range.
- (v) Degree of the desired confidence.

14. Explain the sampling method which involves selection of a block(s) of contiguous items from within the population. Also give example. [RTP May-20]

**Block Sampling:** This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.

**Example:** Take the first 200 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.

15. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded. Explain

[RTP May-20]

The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.

When a misstatement has been established as an **anomaly**, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if **uncorrected**, still needs to be considered in addition to the projection of the **non-anomalous misstatements**.

For **tests of details**, the auditor shall **project misstatements found in the sample to the population** whereas for **tests of controls**, **no explicit projection of deviations is necessary** since the sample deviation rate is also the projected deviation rate for the population as a whole.

16. What are the matters that the auditor shall consider while designing an audit sample? [Nov-22]

When designing an audit sample,

- the auditor's consideration includes the **specific purpose to be achieved** and the **combination of audit procedures** that is likely to best achieve that purpose.
- Consideration of the **nature of the audit evidence sought** and **possible deviation or misstatement conditions or other characteristics** relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.

## Ch-6B Audit Sampling

- In fulfilling the requirement of relevant portion (paragraph 8) of SA 500, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

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

As per SA 530 "Audit Sampling", sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.

Sampling risk can lead to two types of erroneous conclusions:

- (i) In the case of a **test of controls**, that **controls are more effective than they actually are**, or in the case of a **test of details**, that a **material misstatement does not exist when in fact it does**. The auditor is primarily concerned with this type of erroneous conclusion because it **affects audit effectiveness** and is more likely to lead to an **inappropriate audit opinion**.
- (ii) In the case of a **test of controls**, that **controls are less effective than they actually are**, or in the case of a **test of details**, that a **material misstatement exists when in fact it does not**. This type of erroneous conclusion **affects audit efficiency** as it would usually lead to **additional work** to establish that initial conclusions were incorrect.

*"Make sure you SAMPLE,*

*Good Questions for Next Revision"*

## Ch-6C SA 450

**1. 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.**

The instances highlighted in above situation are examples of misstatements identified during the audit. Over valuation of inventory of finished goods by Rs. 2 crore and wrongly charging freight of Rs. 10 lacs paid on machinery to statement of profit and loss instead of capitalizing are examples of misstatements.

The auditor should communicate above identified misstatements to those charged with governance and request for correction of these misstatements. In case, these are not corrected, understand the reasons for not making the corrections and reassess materiality.

It should also be considered whether uncorrected statements are material individually or in aggregate. Effect of uncorrected misstatements on the opinion in auditor's report should be communicated to those charged with governance.

**2. Discuss documentation requirements for an auditor regarding misstatements identified during audit under SA 450.**

**The audit documentation shall include: -**

- The amount below which misstatements would be regarded as clearly trivial;
- All misstatements accumulated during the audit and whether they have been corrected; and
- The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

**3. Which of the following is false regarding communication of misstatements identified during course of an audit?**

- The auditor should request those charged with governance for correction of identified misstatements.
- The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is material.
- The auditor should obtain written representation acknowledging management belief that effect of uncorrected misstatements is immaterial.
- The auditor should communicate effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

**Ans. B**

## Ch-7 Automated Environment

### Correct/Incorrect

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

(i) General IT controls support the functioning of Application controls.

**Correct:** General IT controls support the functioning of automated application controls and IT dependent controls.

(ii) Inquiry is often the most efficient audit testing method, but least effective.

**Correct:** Inquiry is the most efficient but least effective. Moreover, testing through inquiry alone is not sufficient. Inquiry should be corroborated by applying any one or a combination of observation, inspection or reperformance.

(iii) Specialised audit tools like IDEA, ACL are required to perform data analytics.

**Incorrect.** Even though specialised audit tools are very useful, such tools are not always required or necessary to carry out data analytics. More commonly available spreadsheet applications like MS-Excel can also be effectively used for carrying out data analytics.

(iv) A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is known as meaningful data.

**Incorrect.** A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is known as Data Analytics.

(v) An automated environment basically refers to a business environment where the processes, operations, accounting except the decisions are carried out by using computer systems.

**Incorrect.** An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems

(vi) Generally, applying inquiry in combination with reperformance as audit testing method gives the most effective and efficient audit evidence

**Incorrect.** Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence

(vii) When auditing in an automated environment, inquiry is often the most efficient and effective audit testing method. [MTP Oct-21]

**Incorrect:** There are basically four types of audit tests that should be used in an automated environment. They are inquiry, observation, inspection and re-performance. Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient. Applying inquiry in combination with inspection gives the most effective and efficient audit evidence.

(viii) The Complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be less complex. [Jan-21 + MTP Apr-23]

## Ch-7 Automated Environment

**Incorrect:** The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex. If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit. On the other hand, if a company is using an off-the-shelf accounting software, then it is likely to be less automated and hence less complex environment.

**(ix). With reference to General IT control, the objective of Data Center and Network Operations is to ensure that systems are developed, configured and implemented to meet financial reporting objectives. [July-21]**

**Incorrect:** Objective of Data Center and Network Operations is to ensure that production systems are processed to meet financial reporting objectives. Objective of Application system acquisition, development, and maintenance is to ensure that systems are developed, configured and implemented to meet financial reporting objectives.

**(x) In an automated environment, the relationship between the application controls and the General IT controls over IT systems are not interrelated. [Nov-22]**

**Incorrect:** The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems. These two categories of control over IT systems are interrelated.

### MCQs

- 1. 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.
- 2. 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
- 3. 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

**1. a 2. d 3. d**

# Ch-7 Automated Environment

## Past Exams/RTPs/MTPs/SM Questions

1. Explain the meaning of automated environment. Also discuss the key features of an automated environment. [RTP May-19]

An **automated environment** basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems. Nowadays, it is very common to see computer systems being used in almost every type of business.

**Some of the key features of an automated environment are as follows:**

- ✓ Enable Faster Business Operations
- ✓ Connectivity & Networking Capability
- ✓ Accuracy in Data Processing & Computation
- ✓ Ability to process Large Volumes of Transn
- ✓ Better Security & Controls
- ✓ Less prone to Human Errors

2. List the points that an auditor should consider to obtain an understanding of the Company's automated environment. [RTP Nov-22 +MTP May-22+Oct-21]

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

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

3. Which are specific risks to the company's internal control having IT environment? [RTP Nov-22]

**Given below are some such risks that should be considered:**

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

## Ch-7 Automated Environment

4. Discuss the impact of IT related risks on Substantive Audit, Controls and Reporting. [RTP May-18]

### Impact on substantive checking

Inability to address above discussed 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.

### 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.

### Impact on reporting

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

5. Objective of Data Center and Network Operations is to ensure that production systems are processed to meet financial reporting objectives. Discuss the activities performed by Data Center and Network operations. Also explain the meaning of General IT Controls in detail. [RTP May-21]

"General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments.

General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:"

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

These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as "pervasive" controls or "indirect" controls.

### Data Center and Network Operations

**Objective:** To ensure that production systems are processed to meet financial reporting objectives.

#### Activities:

- Overall management of computer operation activities, preparing, scheduling and executing of batch jobs, monitoring, storage and retention of backups.
- Such controls also help in performance monitoring of operating system, database and networks.
- Matters such as BCP (Business continuity plan) and DRP (Disaster recovery plan) which deal with recovery from failures are also taken care of by such type of controls.

6. 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 selection of audit samples. Explain giving other relevant points also in the above context of data analytics. [RTP May-21 + May-23]

## Ch-7 Automated Environment

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

- ✓ Check completeness of data and population that is used in either test of controls or substantive audit tests.
- ✓ Selection of audit samples – random sampling, systematic sampling.
- ✓ Re-computation of balances – reconstruction of trial balance from transaction data.
- ✓ Reperformance of mathematical calculations – depreciation, bank interest calculation.
- ✓ Analysis of journal entries as required by SA 240.
- ✓ Fraud investigation.
- ✓ Evaluating impact of control deficiencies.

7. The Auditor of HK Limited completed the audit of the company in an automated environment. Management of the company requested the auditor to give an idea about any exceptions observed in IT environment that need to be assessed. How the auditor should consider this request and report in light of an audit perspective?

[May-22] or

Foreceful Limited is a company dealing in mobile spare parts and having its showrooms in almost all the states in the country. For FY 2020-21, the company transferred its accounts from manual to computerized system (SAP). PQR & Co., Chartered Accountants have specialization in the system audit and have been appointed as the system auditor. PQR & Co., at the end of the audit concludes that there are certain findings or exceptions in IT environment and IT controls of the company which needs to be assessed and reported. Mention those points of consideration. [July-21 + MTP May-23]

At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee.

Some points to consider are as follows:

- ✓ Are there any weaknesses in IT controls?
- ✓ What is the impact of these weaknesses on overall audit?
- ✓ Report deficiencies to management – Internal Controls Memo or Management Letter.
- ✓ Communicate in writing any significant deficiencies to Those Charged With Governance.

The auditor needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control.

8. Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence. However, which audit test to use, when and in what combination is a matter of professional judgement. Discuss stating the different ways testing is performed in an automated environment.

[MTP Oct-18]

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

There are basically four types of audit tests that should be used. They are Inquiry, observation, inspection and reperformance.

Inquiry is the most efficient audit test but it is also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.

## Ch-7 Automated Environment

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

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

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

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

**9. In an automated environment, General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. One such area is access security. What is the objective of access security and what are the activities included in it? [Nov-22]**

### Access Security

**Objective:** To ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.

#### Activities:

- Security Organization & Management
- Security Policies & Procedures
- Application Security
- Data Security
- Operating System Security
- Network Security
- Physical Security

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

[SM]

#### General IT Controls vs. Application Controls

- 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.

*Very few students diligently cover Question Banks,*

*Kudos for being among the Top!*

## SA 500 Audit Evidence

### Test Your Understanding

1. On perusal of financial statements of a company, auditor of company finds that notes to accounts contain aging of trade payables in accordance with requirements of Schedule III of Companies Act, 2013. The accountant of company is responsible for ensuring proper aging of trade payables included in notes to accounts. The auditor wants to verify whether aging of trade payables made in financial statements is proper or not. Identify what he is trying to do.

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

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

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.

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

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.

### Correct/Incorrect

1. While auditing the books of accounts of ABC Ltd., the auditor of the company looked at the inventory counting process to obtain audit evidence. In the present case, audit procedure used by the auditor is known as “Inspection”. [Jan-21]

**Incorrect:** The audit procedure used by the auditor of ABC Ltd. is known as “observation”. Whereas inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.

2. Inquiry alone ordinarily does not provide sufficient audit evidence. [MTP Oct-21]

**Correct:** Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry

## Ch-8 SA 500/501/505/510

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.

### 3. Sufficiency is the measure of the quantity of audit evidence. [SM]

**Correct:** 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).

### 4. Purchase invoice is an example of internal evidence. [SM]

**Incorrect:** Internal evidence is the evidence that originates within the client's organisation. Since purchase invoice originates outside the client's organisation, therefore, it is an example of external evidence.

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

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

### 6. For an auditor, the Risk assessment procedure provides sufficient appropriate audit evidence to base the audit opinion. [MTP Mar-23]

**Incorrect:** The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion.

#### Past Exams/RTPs/MTPs/SM Questions

1. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively. Explain. [RTP Nov-22]

Auditing is a **logical process**. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination **connotes critical examination and scrutiny** of the accounting statements of the undertaking with a view to assessing how far the statements present the **actual state of affairs** in the correct context and whether they **give a true and fair view** about the financial results and state of affairs. An opinion founded on a rather **reckless and negligent examination** and evaluation may expose the auditor to **legal action** with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgement.

**SA 500 – “Audit Evidence”,** explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to **obtain sufficient appropriate audit evidence** to be able to draw reasonable conclusions on which to base the auditor's opinion.

2. Manya Textiles is manufacturer of bed sheets, curtain cloths, other handloom items etc. having its plant at Panipat. Auditors SJ & Co. is having doubts over the reliability of information given to him as audit evidence. Also, auditors observed inconsistent information while conducting audit. Guide the auditor as to how they should proceed in the given situation. [RTP Nov-22]

If:

(a) audit evidence obtained from one source is **inconsistent** with that obtained from another; or  
(b) the auditor has **doubts over the reliability** of information to be used as audit evidence,  
the auditor shall **determine what modifications or additions to audit procedures** are necessary to resolve the matter, and shall **consider the effect** of the matter, if any, on other aspects of the audit.

3. **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 and also by the quality of such audit evidence. Obtaining more audit evidence, however, may not compensate for its poor quality. Explain also stating the factors affecting auditor's judgment as to sufficiency of audit evidence. [RTP Nov-20 + MTP Apr-23]

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. Auditor's judgement as to sufficiency may be affected by the factors such as:

- (i) **Materiality**
- (ii) **Risk of material misstatement**
- (iii) **Size and characteristics of the population.**

(a) **Materiality** 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.

(2) **Risk of material misstatement** 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

(a) **Inherent risk**—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls.

(b) **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** 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.

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4. The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. Explain with the help of examples. [RTP Nov-20]

The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time.

For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

5. The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source, its nature and the circumstances under which it is obtained. Explain and elucidate the guiding principles which are useful in assessing the reliability of audit evidence. [MTP Apr-22]

**Reliability of Audit Evidence:** As per SA 500 on "Audit Evidence", the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions.

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

- (i) The reliability of audit evidence is increased when it is obtained from **independent sources outside the entity**.
- (ii) The reliability of audit evidence that is **generated internally** is increased when the related **controls**, including those over its preparation and maintenance, imposed by the entity **are effective**.
- (iii) Audit evidence obtained **directly by the auditor** (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- (iv) Audit evidence in **documentary form**, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- (v) Audit evidence provided by **original documents** is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

6. While conducting the audit of Pummy Limited, the statutory auditors collected written representations from the Management. The audit was finalized in addition to other audit procedures but, without making any inquiries, as the statutory auditors were short of time. In the light of this information, state the importance of inquiry as one of the methods of collecting Audit Evidence. [RTP May-22]

Inquiry: As per SA 500 Audit Evidence: -

(i) Inquiry consists of seeking information of knowledgeable persons, financial and non - financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

(ii) Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

(iii) Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

(iv) In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

**7. CA K audited the books of accounts of E Ltd. for the financial year 2020-2021. The auditor used an audit procedure according to which all the documents and records maintained by the company were checked in detail to obtain audit evidence. Explain the audit procedure used by the auditor and its reliability.**

[Dec-21]

#### **Audit Procedure:**

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

**8. In the course of audit of SMP Limited for the financial year ended 31st March, 2020 you have observed as an auditor that the company has provided a sum of ₹ 20 Lakhs in the books of account as Gratuity payable to employees based on certificate obtained from an actuary. Give your comments with reference to the Standard on Auditing. [MTP Nov-21]**

**Certificate from a Management's Expert:** In the given case, SMP Limited has provided a sum of 20 lakh in the books of accounts as gratuity payable on the basis of certificate obtained from an actuary. The liability towards gratuity

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payable to the employees at the time of cessation of service should be ascertained and provided for in the accounts when the employees are in service, it is an ascertained present liability accruing over the period of service but payable upon cessation of service.

The auditor should **check the quantification** of the gratuity liability. He should ascertain whether the same had been **actuarially determined**. The auditor should **treat the actuary as managements' expert** and conduct procedures relevant to checking the opinion of an expert in accordance with SA 500.

As per SA 500, "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

1. Evaluate the **competence, capabilities and objectivity** of that expert;
2. Obtain an **understanding** of the work of that expert; and
3. Evaluate the **appropriateness** of that expert's work as audit evidence for the relevant assertion.

**9. The objective of auditing is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. This can be obtained by performing which procedures? Name the types of audit procedures the auditor can perform to obtain audit evidence? [Nov-22]**

**Audit Procedures to Obtain Audit Evidence:** Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(I) Risk assessment procedures; and  
(II) Further audit procedures, which comprise:  
i. Test of controls, when required by the SAs or when the auditor has chosen to do so; and  
ii. Substantive procedures, including tests of details and substantive analytical procedures.

**Audit procedures to obtain audit evidence can include**

- (a) Inspection
- (b) Observation
- (c) External Confirmation
- (d) Recalculation
- (e) Reperformance
- (f) Analytical Procedures
- (g) Inquiry

**10. Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively. He needs evidence to obtain information for arriving at his judgment. Discuss explaining clearly the meaning of audit evidence in detail.**

**[MTP Nov-23 + Nov-23]**

**Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truth and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.**

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgment.

**Audit evidence** may be defined as the **information used by the auditor** in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

**(1) Information contained in the accounting records:** Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

**(2) Other information** that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements: Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

## SA 501- "Audit Evidence—Specific Considerations for Selected Items"

### Inventory

1. ABC Ltd is engaged in manufacturing of different type of yarns. On going through its financial statements for the past years, it is observed that inventory is material to the financial statements.

You as an auditor of the company wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss, how would you proceed as an auditor. [MTP May-20]

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; and

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

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

[RTP May-20]

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.

3. When inventory under the custody and control of a third party is material to the financial statements, the auditor can obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by taking written representation from management. [Dec-21]

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

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

### Litigation & Claims

1. Pachranga International Ltd is manufacturer of pickles, ginger garlic paste, jams etc having its plant at Jaipur. Being in food industry, the company is facing many litigations in various courts across India. Auditors SPV & Co. wants to identify such litigations and claims involving the company which may give rise to risk of material misstatement. Guide the auditor as to how they should proceed for the purpose. [MTP Apr-21]

The auditor SPV & Co. shall design and perform audit procedures in order to identify litigation and claims involving the entity (Pachranga International Ltd) which may give rise to a risk of material misstatement, including:

- (i) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel.
- (ii) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- (iii) Reviewing legal expense accounts.

2. SPR Ltd has been into the media business since 1990. During the F.Y 2021-2022 many notices were received by the company for hurting public sentiments and financial claims were filed against the company. As an auditor of the company, you requested the management for arranging the meeting with company's external legal counsel. Management is of the view that such meetings are necessary in some certain circumstances only. Can you list down those certain circumstances? [May-22]

**Circumstances when becoming necessary to meet with external legal counsel:** In the given case of SPR Ltd., Auditor requested the management for meeting with SPR's external legal counsel.

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

This may be the case, for example, where:

- (i) The auditor determines that the matter is a **significant risk**.
- (ii) The matter is **complex**.
- (iii) There is **disagreement** between management and the entity's external legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

**3. 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?**

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.

#### Segment Information

**1. TRM Ltd. is a company engaged in manufacture of beauty products. It has hair care segment, skin care segment and kids' beauty products. The auditor wants to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework. Suggest the audit procedures in the given case. [MTP Nov-21]**

The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:

- (1) Obtaining an **understanding of the methods used by management** in determining segment information. Further,
  - (i) **Evaluating whether such methods** are likely to result in disclosure in accordance with the applicable financial reporting framework; and
  - (ii) **Where appropriate, testing the application of such methods**; and
- (2) **Performing analytical procedures** or other audit procedures appropriate in the circumstances.

**2. GPS & Co, Chartered Accountants, conducting the audit of Pratibha Ltd., a listed company for the year ended 31.03.2022 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GPS & Co wanted to ensure that methods adopted by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework. Guide GPS & Co with 'Examples of Matters' that may be relevant when obtaining an understanding of the methods used by the management with reference to the relevant SA. [May-22]**

Auditors, GPS & Co wanted to ensure and obtain sufficient appropriate audit evidence regarding presentation and disclosure of segment information in accordance with applicable financial reporting framework by obtaining understanding of methods used by management in determining segment information.

As per SA 501- "Audit Evidence—Specific Considerations for Selected Items", example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment

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information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

- (i) **Sales, transfers and charges between segments**, and elimination of intersegment amounts.
- (ii) **Comparisons with budgets** and other expected results, for example, operating profits as a percentage of sales.
- (iii) The allocation of assets and costs among segments.
- (iv) **Consistency** with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

## SA 505 External Confirmations

### 1. Define the following :

- (i) **Positive confirmation request**
- (ii) **Negative confirmation request**
- (iii) **Non-response**
- (iv) **Exception [RTP May-20]**

- **Positive confirmation request** – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
- **Negative confirmation request** – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
- **Non-response** – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.
- **Exception** – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

### 2. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests. [RTP May-20]

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.

### 3. What are the factors to be considered while designing a confirmation request? [Nov-12]

#### Factors to consider when designing confirmation requests include:

- Specific identified risks of **material misstatement**, including fraud risks.
- The **layout and presentation** of the confirmation request.
- **Prior experience** on the audit or similar engagements.
- The **assertions** being addressed.
- The **method of communication** [for example, in paper form, or by electronic mode (like e-mail) or other medium].

- **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.
- **The ability of the intended confirming party** to confirm or provide the requested information (for example, individual invoice amount versus total balance).

4. CA Rohit is appointed as an auditor of Grace Ltd., he wants to design a suitable confirmation request letter for a few debtors of Grace Ltd. As a senior auditor of the firm, explain to him with reference to SA 505 "External Confirmation" all the conditions that should be present to use Negative Confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level. [July-21]

Negative confirmations is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative information provide less persuasive audit evidence than positive confirmations.

Accordingly, CA Rohit, Auditor of Grace Ltd, shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

- (a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
- (b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
- (c) A very low exception rate is expected; and
- (d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

5. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements but need not be restricted to these items. Apart from confirmations for bank balances and accounts receivables, what are the other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement? [RTP Nov-22 +MTP May-22]

Other examples of situations where external confirmations may be used include the following:

- Inventories held by third parties at bonded warehouses for processing or on consignment
- Property title deeds held by lawyers or financiers for safe custody or as security
- Investments held for safekeeping by third parties, or purchases from stockbrokers but not delivered at the balance sheet date
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms
- Long outstanding share application money.

6. R Ltd. has asked for email responses for the purpose of external confirmation. The auditor, however, feels that external confirmation received electronically involves the risk of its reliability. [MTP May-22]

Correct: SA 505, "External Confirmations", responses received electronically, for example by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of respondent may be difficult to establish,

and alterations may be difficult to detect. Hence R Ltd. Should avoid using email responses as evidence for external confirmation.

### 7. Audit evidence obtained from external confirmation is always reliable. [MTP Oct-21]

**Incorrect:** The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability.

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

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

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

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

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

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.

## SA 510: Initial Audit Engagement Opening Balances

1. 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? [May-22 + MTP Apr-23]

**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.

2. Auditors of M/s Tender India (P) Ltd. were changed for the accounting year 2016-17. The closing inventory of the company as on 31.3.2016 amounting to Rs. 100 lacs continued as it is and became closing inventory as on 31.3.2017. The auditors of the company propose to exclude from their audit programme the audit of closing inventory of Rs. 100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor. [MTP Oct-19]

**Verification of Inventory:** As per SA 510 "Initial Audit Engagements – Opening Balances", in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether-

- (i) **Opening balances contain misstatements that materially affect the current period's financial statements**; and
- (ii) **Appropriate accounting policies** reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

When the financial statements for the preceding period were audited by predecessor auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by **perusing the copies of the audited financial statements** including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements.

Ordinarily, the current auditor **can place reliance on the closing balances** contained in the financial statements for the preceding period, **except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated**.

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General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the Balance Sheet date.

The contention of the management that the inventory has not undergone any change **cannot be accepted**, it forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the inventory lying as it is might have **deteriorated** and the same need to be examined.

The auditor is advised **not to exclude the audit of closing inventory from his audit programme.**

*"Dream for success & work for it,  
I'm glad you're doing that"*

## SA 550 Related Parties

**1. The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Explain with the help of at least three examples. [RTP May-20 + Nov-23]**

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

**Example**

- Related parties may operate through an **extensive and complex range of relationships and structures**, with a corresponding increase in the complexity of related party transactions.
- **Information systems** may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- Related party transactions **may not be conducted under normal market terms and conditions**; for example, some related party transactions may be conducted with no exchange of consideration.

**2. The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances. During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the records or documents that may provide information about related party relationships and transactions. Explain in detail with examples. [RTP Nov-21 + MTP Nov-23]**

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)

**3. P Ltd. is a company from a business group "ABCD" and is engaged in trading of garments. The promoters of the company are promoters and directors of some other group companies also. You have been appointed as an auditor of P Ltd. P Ltd has entered into various inter-company transactions (within group companies) during the year which are outside its normal course of business. What will be your duties as an auditor in relation to those transactions? [May-22]**

**Duties of Auditor in identifying Significant Related Party Transactions:** For identified significant related party transactions outside the P Ltd.'s normal course of business, the auditor shall:

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

- (i) The **business rationale** (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
- (ii) The terms of the transactions are **consistent with management's explanations**; and
- (iii) The transactions have been appropriately **accounted for and disclosed** in accordance with the applicable financial reporting framework; and

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

**4. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater.**

**Correct:** In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- ◆ Management may be unaware of the existence of all related party relationships.
- ◆ Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

## SA 560 Subsequent Events

### Test Your Understanding

**1. CA PK Jacob is conducting audit of a company for year 2021-22. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2022. However, it becomes known to the auditor that one of overseas buyers has made a legal claim against the company on 1st June 2022 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August, 2021. The management of company has decided to agree to an out of court settlement of Rs.5 crore to protect its reputation. The financial statements of the company are silent on this issue. Discuss, how, CA PK Jacob should proceed to deal with above issue.**

In the given case, the auditor has come to know of legal claim against the company before issue of audit report. It has also come to his knowledge that management of company has agreed to an out of court settlement of Rs.5 crore. It is an example of **subsequent event between the date of the financial statements and the date of the auditor's report**. It provides evidence of conditions that existed at the date of the financial statements and requires **adjustment** in financial statements. He should **ask company management to make necessary adjustment** to the financial statements. If **adjustment is not made** by management, he should **consider impact on auditor's report**.

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

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

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

The rationale of obtaining written representations is that even after performing abovesaid procedures, she may not come to know all subsequent events. Therefore, it is necessary from an auditor's point of view to obtain acknowledgment from management in the form of Written representations that all such events for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

### 3. 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.

#### Past Exams/RTPs/MTPs/SM Questions

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 requires adjustment of, or disclosure in, the financial statements have been identified. With reference to SA 560, what are the audit procedures included in the auditor's risk assessment? [July-21 Suggested]

- The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.
- The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.
- The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto.

The auditor shall take into account the auditor's risk assessment which shall include the following:

- a. Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- b. Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- c. Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- d. Reading the entity's latest subsequent interim financial statements, if any.

2. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report. Explain the auditor's obligation in the above situation. [MTP Nov-21]

## Ch-9 SA 550/560/570/580

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- a. Discuss the matter with management and, where appropriate, those charged with governance.
- b. Determine whether the financial statements **need amendment** and if so,
- c. Inquire how management intends to address the matter in the financial statements.

**3. SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Explain those events and also define subsequent events. [RTP Nov-21]**

**SA 560, "Subsequent Events"** deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. Financial statements may be affected by certain events that occur after the date of the financial statements.

Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:

- (a) Those that provide **evidence of conditions that existed** at the date of the financial statements; and
- (b) Those that provide **evidence of conditions that arose** after the date of the financial statements.

SA 700 explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.

Subsequent events refer to events occurring **between the date of the financial statements and the date of the auditor's report**, and facts that become known to the auditor after the date of the auditor's report.

**4. Inquiry from Management is helpful for Auditor to evaluate subsequent events. Discuss specific enquiries in reference of SA 560, which might have effect on the financial statements. [Nov-17]**

**Inquiring from Management to Evaluate Subsequent Event:** As per SA 560 —Subsequent Events]], in inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters-

- (i) Whether **new commitments, borrowings or guarantees** have been entered into.
- (ii) Whether **sales or acquisitions of assets** have occurred or are planned.
- (iii) Whether there have been **increases in capital or issuance of debt instruments**, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- (iv) Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
- (v) Whether there have been any developments regarding contingencies.
- (vi) Whether any **unusual accounting adjustments** have been made or are contemplated.
- (vii) Whether any events have occurred or are likely to occur which will bring into question the appropriateness of **accounting policies** used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
- (viii) Whether any events have occurred that are **relevant to the measurement of estimates or provisions** made in the financial statements.

(ix) Whether any events have occurred that are relevant to the recoverability of assets.

5. Discuss meaning of "Date the financial statements are issued" under SA 560.

**Meaning of "Date the financial statements are issued"**

It reflects the date that the auditor's report and audited financial statements are made available to third parties. The date the financial statements are issued generally depends on the regulatory environment of the entity. In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority. Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report, but must also be at or later than the date the auditor's report is provided to the entity.

## SA 570 Going Concern

### Test Your Understanding

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?

Significant shortage of skilled labour, inability to pay creditors on time and overall liquidity crisis faced by the company are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

In such a situation, management should try to address auditor's concerns by preparing its future plan of action including preparation of cash flow forecast showing inflow and outflow of cash. Such a cash flow forecast should address auditor's concerns regarding liquidity crisis being faced by the company.

The auditor should perform audit procedures to evaluate the reliability of the underlying data to prepare the forecast and determining whether there is adequate support for the assumptions underlying the forecast. The auditor should also consider whether any additional facts or information have become available since the date on which management made its assessment.

### Past Exams/RTPs/MTPs/SM Questions

1. On the basis of which assumption the financial statements of a company are prepared. Explain. [RTP May-19]

#### Going Concern Basis of Accounting

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

2. Management's assessment of the entity's ability to continue as a going concern involves making a judgement about inherently uncertain future outcomes of events or conditions. What are relevant factors to that judgement? [Jan-21]

Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgment:

- The **degree of uncertainty** associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.
- The **size and complexity of the entity**, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any **judgment about the future** is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

3. While doing audit of ABC Pvt Ltd, on the basis of sufficient and appropriate evidence, auditor comes to a conclusion that use of the Going Concern Basis of Accounting is appropriate, but a material uncertainty exists. Discuss the implications for auditor's report if:

- (a) Adequate Disclosure of a Material Uncertainty is Made in the Financial Statements
- (b) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements

[RTP Nov-21 + May-23]

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

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

#### **(a) Adequate Disclosure of a Material Uncertainty is Made in the Financial Statements**

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

#### **(b) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements**

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

- (a) Express a **qualified opinion or adverse opinion**, as appropriate, in accordance with SA 705 (Revised); and
- (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.

4. Give examples of financial events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. [RTP Nov-21]

The following are examples of Financial events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern :

- ✓ Net liability or net current liability position.

- ✓ Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- ✓ Indications of withdrawal of financial support by creditors.
- ✓ Negative operating cash flows indicated by historical or prospective financial statements.
- ✓ Adverse key financial ratios.

5. When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor has determined that management of XYZ Ltd has already performed a preliminary assessment of the entity's ability to continue as a going concern. Explain how would auditor of XYZ Ltd proceed in the above case.

Also explain how would the auditor proceed if such an assessment has not yet been performed by the management.

(RTP May-21)

When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern.

In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:

(i) If such an **assessment has been performed**, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or

(ii) If such an **assessment has not yet been performed**, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

6. As described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. Explain stating the auditor's responsibilities with regard to going concern. (RTP May-21)

The auditor's responsibilities are:

- (1) to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and
- (2) to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

However, as described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions.

Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

7. M/s ANS & Associates has been appointed as the statutory auditors of MNO Ltd. The company has been suffering losses due to the emergence of highly successful competitor, thereby leading to negative networth. Also, the sales head, key management personnel, of the company left the company due to health issues. When CA Amar, the engagement partner discussed the scenario with the management of the company, he did not get any satisfactory reply from the management. What is the responsibility of M/s ANS & Associates with regard to SA 570? [SM]

As per SA 570, one of the objectives of the auditor regarding going concern is to obtain sufficient and appropriate audit evidence regarding the same and to conclude on the appropriateness of the management's use of the going concern basis of accounting in the preparation of the financial statements.

- Further it also contains the list of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern which are:
  - ✓ Financial indicator- Negative networth
  - ✓ Operating indicator- Loss of key management and emergence of highly successful competitor.

In the present case, MNO Ltd. has negative networth on account of emergence of highly successful competitor and the sales head of the company has also left the company.

Also, CA Amar did not get any satisfactory reply when he discussed the going concern matter with the management.

Thus, from the above facts, it appears that MNO Ltd. is not going concern.

- If the management of MNO Ltd. has used the going concern basis of accounting, the auditor should first ask the management to **adjust the financial statements**.
- If the management of MNO Ltd. **does not agree** with the same, CA Amar shall **consider the impact on his audit report**.

8. 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?

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.

9. 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

## SA 580 Written Representations

1. Written representation from management can be a substitute for other evidence that the auditor could expect to be reasonably available.

**Incorrect:** One of the objectives of the written representation is to support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representation. So it is clear that written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available.

2. Explain the objectives of the auditor regarding written representations. [Jan-21 + MTP Oct-21]

The objectives of the auditor regarding written representation:

- (i) **To obtain written representations:** To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
- (ii) **To support other evidence:** To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and
- (iii) **To respond appropriately**

To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

3. CA K is re-appointed as the auditor of B Ltd. He wants to re-confirm certain matters and has asked the management to give written representations for the same. Under what circumstances can an auditor ask the management to reconfirm its acknowledgement and understanding of responsibilities in written representation? [Dec-21]

**Other Written Representation:** Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations.

The written representations draw on the agreed acknowledgement and understanding of management of its responsibilities by requesting confirmation that it has fulfilled them. The auditor, CA K of B Ltd, may also ask management of B Ltd to reconfirm its acknowledgement and understanding of those responsibilities in written representations.

This is particularly appropriate when:

- (i) Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
- (ii) The terms of the audit engagement were prepared in a previous year;
- (iii) There is any indication that management misunderstands those responsibilities; or
- (iv) Changes in circumstances make it appropriate to do so.

4. Written representation from management can be a substitute for other evidence that the auditor could expect to be reasonably available. (RTP May-22)

**Incorrect:** One of the objectives of the written representation is to support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representation. So it is clear that written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available.

5. The auditor P of PAR and Co., a firm of Chartered Accountants is conducting audit of Kapur Industries Ltd. The auditor requests management to provide Banker's certificate in support of Fixed deposits whereas management provides only written representation on the matter. Discuss how would you deal as an auditor. **OR**

"Although written representations provide necessary audit evidence yet they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal". Discuss. **[SM]**

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters to support other audit evidence to confirm certain matters or provided to the auditor written statement by management with which they deal.

Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

Applying the above to the given problem, the auditor would further request the management to provide him with the Banker's certificate in support of fixed deposits held by the company.

6. Akash & Associates are the statutory auditors of Deluxe Ltd. for the FY 2020-21. During the course of audit, CA Akash, the engagement partner requested the management of the company to provide written representation with respect to valuation of a transaction. The management, however does not provide the same to CA Akash. What course of action should CA Akash follow in such situation? **[MTP Mar-23]**

If management of Deluxe Ltd. does not provide one or more of the requested written representations, CA Akash should:

- Discuss the matter with management;
- Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
- Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705.

7. 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?

The view of management is **not proper**. Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of

transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities. In case of refusal of management to provide such a confirmation, it may lead to disclaimer of opinion by the auditor.

**8. Written representations are: -**

- (a) Necessary audit evidence
- (b) Sufficient appropriate audit evidence
- (c) Not audit evidence
- (d) Audit evidence depending upon auditor's professional judgment

Ans (A)

*"You are like a Flower, one day you'll Blossom,  
keep watering your Destiny with Hardwork"*

1. 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.

While pointing out significant deficiencies in internal control, auditor has **not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information** to those charged with governance and management to understand context of communication.

Therefore, the **above communication is not proper**.

Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of not carrying out physical verification of inventories at regular intervals as stipulated by management. It should **explain that such a significant deficiency can lead to misstatement of inventories impacting profits** of the company.

**Highlighting importance of such a control**, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

2. 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".

**Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency**

- **The likelihood of the deficiencies leading to material misstatements** in the financial statements in the future.
- **The susceptibility to loss or fraud** of the related asset or liability.
- **The subjectivity and complexity of determining estimated amounts**, such as fair value accounting estimates.
- **The financial statement amounts exposed to the deficiencies**.
- **The volume of activity** that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- **The importance of the controls** to the financial reporting process, for example:
  - ✓ **General monitoring controls** (such as oversight of management).
  - ✓ **Controls over the prevention and detection of fraud**.
  - ✓ **Controls over the selection and application of significant accounting policies**.
  - ✓ **Controls over significant transactions with related parties**.
  - ✓ **Controls over significant transactions outside the entity's normal course of business**.
  - ✓ **Controls over the period-end financial reporting process** (such as controls over non-recurring journal entries).
- **The cause and frequency of the exceptions** detected as a result of the deficiencies in the controls.

3. In what ways an effective two-way communication between auditor and those charged with governance is important?

Communication from auditor is important with those charged with governance.  
An effective two-way communication is important in assisting: -

- a. The auditor and those charged with governance in **understanding matters related to the audit in context**, and in **developing a constructive working relationship**. This relationship is developed while maintaining the auditor's independence and objectivity.
- b. The auditor in **obtaining from those charged with governance information relevant to the audit**. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and
- c. **Those charged with governance in fulfilling their responsibility to oversee the financial reporting process**, thereby reducing the risks of material misstatement of the financial statements.

### 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 on above, answer the following questions: -

**(1) As regards description of matter above concerning issue of going concern, which of the following statements is most appropriate for auditor's report?**

- a. The auditor should express an unmodified opinion.
- b. The auditor should express a qualified opinion as material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- c. Besides expressing an unmodified opinion, the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" drawing attention to the note in which such disclosure is made in financial statements along with related matters.
- d. Such an issue does not affect auditor's opinion.

**(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.

## Ch-10 SA 260 265

**(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.

1. c 2. c 3. d 4. a 5. a

### MCQ

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.

# Ch-11 Analytical Procedures

## Test your Understanding

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.

**Analytical procedures in relation to revenue can include:-**

- (i) Comparing revenue of current year with previous year and investigating significant fluctuations
- (ii) Comparing revenue of current year with budgeted targets and investigating significant fluctuations

### Correct/Incorrect

**1. As per the Standard on Auditing (SA) 520 "Analytical Procedures" the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among financial data only.**

**Incorrect.** As per the Standard on Auditing (SA) 520 "Analytical Procedures" the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and nonfinancial data. OR

**The term "Analytical Procedures" means evaluation of financial information through analysis of plausible relationships among financial data and non-financial data. [Nov-22]**

**Correct:** As per Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

**2. Auditor can depend on routine checks to disclose all the mistakes or manipulation that may exist in accounts.**

**Incorrect.** Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests.

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

**Incorrect.** Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical procedures are used for the following purposes:

- (i) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
- (ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

**4. Analytical Procedures are required in the planning phase only.**

**Incorrect.** Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.

## Ch-11 Analytical Procedures

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

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

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

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

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

**Incorrect:** Unlike trend analysis, Reasonableness test does not rely on events of prior periods, but upon non-financial data for the audit period under consideration.

**8. The statutory auditor of the company can apply analytical procedures to the standalone financial statements of a company only and not to the consolidated financial statements.**

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

**9. If an entity has a known number of employees at fixed rates of pay throughout the period, there would be more need to perform tests of details on the payroll. [RTP Nov-20]**

**Incorrect:** If an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.

**10. SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit, that assist the auditor in preparation of the financial statements. [May-22]**

**Incorrect:** SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

**11. An unexplained decrease in GP Ratio may result due to fictitious sales. [RTP Nov-22]**

**Incorrect:** A fictitious sale will increase the GP Ratio, instead of decreasing it. GP ratio normally comes down if there are unrecorded sales or reversal of fictitious sale entries recorded in the previous year or fictitious purchase or decrease in closing stock.

## Ch-11 Analytical Procedures

### Past Exams/RTPs/MTPs/SM Questions

1. For the purposes of the SAs, the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Explain giving examples of both. [RTP Nov-21]

Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

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

[MTP Nov-21] **OR**

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk. Explain. [RTP Nov-20]

Analytical Procedures are required in the planning phase and it is often done during the testing phase.

In addition these are also required during the completion phase.

- ✓ Analytical Procedures in Planning the Audit: In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware.
- ✓ This information will assist the auditor in determining the nature, timing and extent of his other audit procedures.
- ✓ Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.
- ✓ For example, analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

3. Explain the aspects to be considered by an auditor when designing and performing substantive analytical procedures, either alone or in combination with test of details, as substantive procedures in accordance with SA 330. [RTP Nov-22]

Analytical procedures used as substantive tests: When designing and performing substantive analytical procedures, either alone or in combination with test of details as, substantive procedures in accordance with SA 330, the auditor shall:

## Ch-11 Analytical Procedures

- (i) Determine the **suitability of particular substantive analytical procedures** for given assertions, taking account of the assessed risks of material misstatement and test of details, if any, for these assertions.
- (ii) Evaluate the **reliability of data** from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation.
- (iii) **Develop an expectation** of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
- (iv) Determine the **amount of any difference** of recorded amounts from expected values that is acceptable without further investigation.

### 4. Discuss with examples the factors that are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures. [RTP Nov-22 + May-23]

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- (i) **Source of the information** available. For example, information may be more reliable when it is obtained from independent sources outside the entity;
- (ii) **Comparability** of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;
- (iii) **Nature and relevance of the information** available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (iv) **Controls over the preparation of the information** that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

### 5. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Explain [MTP May-22]

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

- The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.
- However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
- In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.
- The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

## Ch-11 Analytical Procedures

6. Discuss the matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated. [RTP May-22]

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

(i) **The accuracy with which the expected results of substantive analytical procedures can be predicted.**

For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

(ii) **The degree to which information can be disaggregated.**

For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

(iii) **The availability of the information, both financial and non-financial.**

For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

7. While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence? (MTP Apr-22 + RTP May-21)

While applying the Substantive Analytical Procedures the statutory auditor of a company may use the following techniques to obtain sufficient and appropriate audit evidence.

**Trend analysis** – Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

**Ratio analysis** – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

**Reasonableness tests** – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

**Structural modelling** – A modelling tool constructs a statistical model from financial and/or nonfinancial data of prior accounting periods to predict current account balances (e.g., linear regression).

## Ch-11 Analytical Procedures

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.

**8. Explain the commonly used technique in the comparison of current data with the prior period balance or with a trend in two or more prior period balances. [RTP May-20]**

Trend analysis – Discussed Above

**9. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment. Explain [RTP Nov-20]**

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

**10. Tree Limited presented its financial statements for the F.Y. 2021-2022 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? [May-22]**

**Purpose of Applying Analytical Procedure:** Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

The auditor of Tree Ltd. Would achieve the following by carrying out the comparison stated in the question:

- (i) If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss with that of the previous period, it would be possible to **find out the reasons for increase or decrease in the amount of profits of those years.**
- (ii) By setting up certain expenses' ratios on basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to **ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.**
- (iii) If differences are found to be material, the auditor would **ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.**
- (iv) It would be possible to **identify the existence of unusual transactions, amounts, ratios and trends that might indicate matters that have audit implications.**

**11. If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, how would the auditor investigate such differences. [MTP Nov-23 + Nov-23]**

## Ch-11 Analytical Procedures

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

**(i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses:**  
Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

**(ii) Performing other audit procedures as necessary in the circumstances:** The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

**12. Analysis by computation of ratios includes the study of relationships between financial statement amounts.**

State Commonly used ratios. [RTP Nov-21]

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

**Commonly used ratios include:**

- Elements of income or loss as a percentage of sales
- Gross profit turnover
- Accounts receivable turnover
- Inventory turnover
- Profitability, leverage, and liquidity

**13. Whether it is possible to independently verify the correctness of some of the items of expenses included in the statement of profit and loss? Explain with the help of some examples. [Dec-21]**

Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss.

- ✓ For instance, the **cost of importing goods** which are subjected to an **ad-valorem duty** at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of excise duty/ GST paid.
- ✓ Similarly, the amount of any **income or expenses** which has a **direct relationship with the amount of profits** or that of sales can be verified independently, e.g., **commission paid to a manager** calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.
- ✓ Thus, it is important to note that Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications.
- ✓ **Unusual or unexpected relationships** that are identified may assist the auditor in identifying **risks of material misstatement**, especially risks of material misstatement due to fraud.

## Ch-11 Analytical Procedures

14. With respect to SA 520 "Analytical procedures", explain the following factors to be considered by the auditor for substantive audit procedures.

(i) Account type (ii) Predictability (iii) Nature of Assertion. [Nov-20]

**The auditor should consider the following factors for Substantive Audit Procedures:**

**Account Type** – Substantive analytical procedures are more useful for certain types of accounts than for others. **Income statement accounts tend to be more predictable** because they reflect accumulated transactions over a period, whereas balance sheet accounts represent the net effect of transactions at a point in time or are subject to greater management judgment.

**Predictability** – Substantive analytical procedures are **more appropriate when an account balance or relationships between items of data are predictable** (e.g., between sales and cost of sales or between trade receivables and cash receipts). A predictable relationship is one that may reasonably be expected to exist and continue over time.

**Nature of Assertion** – Substantive analytical procedures may be **more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations)**. Predictive analytical procedures using data analytics can be used to address completeness, valuation/ measurement and occurrence.

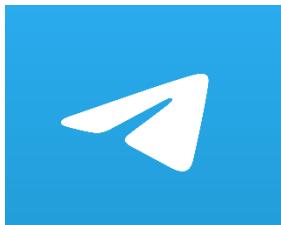
15. As per the Standard on Auditing (SA) 520 "Analytical Procedures", 3 what are the examples of analytical procedures having consideration of relationships? [Nov-22]

Analytical procedures also include consideration of relationships, for example:

- Among **elements of financial information** that would be expected to conform to a predictable pattern based on the entity's experience, such as **gross margin percentages**.
- Between **financial information and relevant non-financial information**, such as **payroll costs to number of employees**.

*"Basis my Analytical Procedures,  
you are on RIGHT TRACK to CLEAR the Exams"*

## CA NOTE HUB

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## 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:

- o 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.
- o 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.
- o 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 on above, answer 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:**

## Ch-12 Audit Report

- (a) Modified Opinion
- (b) Qualified Opinion
- (c) Disclaimer of Opinion
- (d) Unmodified Opinion

1. (b) 2. (c) 3. (c) 4. (b) 5. (d)

### MCQs based Questions

**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

1. (c) 2. (a) 3. (d) 4. (c) 5. (c)

### Test Your Understanding

.. 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?

The 18-digit alpha numeric number noticed by her at end of audit report is Unique Document Identification number (UDIN). It is a system generated unique number. Its basic objective is to curb the malpractices of non-CAs impersonating themselves as CAs. It helps in securing reports and documents issued by practising CAs. It is required to be stated in case of audit reports and certificates.

.. 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.

"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.

### Correct/Incorrect

.. In considering the qualitative aspects of the entity's accounting practices, the auditor may not become aware of possible bias in management's judgments. [RTP Nov-20]

incorrect: In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated.

2. The Location of the description of the auditor's responsibilities for the audit of the financial statements is always within the body of the auditor's report [July-21]

incorrect: The description of the auditor's responsibilities for the audit of the financial statement shall be always shown as below -

- Within the body of the auditor's report
- Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix or

By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so.

3. There is no need of addressee in the Auditor's report. [SM]

incorrect: The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed. The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

## Ch-12 Audit Report

4. Where the firm is appointed as an auditor of the entity the audit report is signed only in the name of audit firm, [May-19] or

Where a firm is appointed as the auditor of a company, the report is signed only in the personal name of the partner signing the report. [Nov-22]

**Incorrect:** Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India along-with registration number for the firm.

### Past Exams/RTPs/MTPs/SM Questions

1. The auditor evaluated, in respect of T Ltd., whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. Auditor's evaluation included consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. Advise the qualitative aspects of the entity's accounting practices. [MTP Mar-19]

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

### Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgments about the amounts and disclosures in the financial statements.

2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.

3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:

- (i) The selective correction of misstatements brought to management's attention during the audit
- (ii) Possible management bias in the making of accounting estimates.

4. SA 540 addresses possible management bias in making accounting estimates.

Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

2. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required. [RTP May-20]

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated.

Indicators of a lack of neutrality include the following:

## Ch-12 Audit Report

(i) The selective correction of misstatements brought to management's attention during the audit.

Example

- Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
- The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives.

(ii) Possible management bias in the making of accounting estimates.

3. While drafting auditor's report of LK Ltd., what are the matter to be included by auditor in Opinion Section paragraph? [RTP Nov-22]

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion".

Opinion Section of the Auditor's report shall also:

- (i) Identify the entity whose financial statements have been audited;
- (ii) State that the financial statements have been audited;
- (iii) Identify the title of each statement that comprises the financial statements;
- (iv) Refer to the summary of significant accounting policies and other explanatory information; and
- (v) Specify the date or period covered by each financial statement comprising the financial statements.

4. The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. Explain stating clearly specific evaluations made by the auditor. (RTP May-22 + MTP Oct-21/Mar-23)

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

In particular, the auditor shall evaluate whether:

- (a) The financial statements adequately disclose the significant accounting policies selected and applied;
- (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- (c) The accounting estimates made by management are reasonable;
- (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;
- (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
- (f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Further, when the financial statements are prepared in accordance with a fair presentation framework, the evaluation mentioned above shall also include an evaluation by the auditor as to whether the financial statements achieve fair presentation which shall include consideration of:

- (a) The overall presentation, structure and content of the financial statements; and
- (b) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

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The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

**5. M/s S & Associates are the Statutory Auditors of Real Ltd., a company engaged in the business of manufacturing of garments. The auditor has completed the audit and is in the process of forming an opinion on the financial statements for the F.Y. 2020-2021. CA K, the engagement partner, wants to conclude that whether the financial statements as a whole are free from material misstatements, whether due to fraud or error. What factors he should consider to reach that conclusion? [Dec-21]**

### Factors to be considered to form an opinion:

- ✓ The auditor shall form an **opinion** on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
- ✓ In order to form that opinion, the auditor shall **conclude** as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

### That conclusion shall take into account:

- (a) The auditor's conclusion, in accordance with SA 330, whether **sufficient appropriate audit evidence** has been obtained
- (b) The auditor's conclusion, in accordance with SA 450, whether **uncorrected misstatements are material**, individually or in aggregate.

#### (c) The evaluations required

- (i) The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.
- (ii) This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

**6. 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**

**[SM + MTP Apr-23]**

**Responsibilities for the Financial Statements:** The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted. This section of the auditor's report shall describe management's responsibility for:

**(a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;[because of the possible effects of fraud**

## Ch-12 Audit Report

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.

7. The Auditor is fully satisfied with the audit of an entity in respect of its systems and procedures and wants to issue a report without any hesitation. Discuss the type of opinion that can be given and state giving reasoning.

[RTP May-21]

### Unqualified Opinion:

1. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements.

2. An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.

3. An unqualified opinion also indicates that:

- (i) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;
- (ii) the financial statements comply with relevant statutory requirements and regulations; and
- (iii) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

8. The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally. Explain. [RTP May-21]

- ✓ The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users.
- ✓ This SA promotes consistency in the auditor's report but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions.
- ✓ Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards.
- ✓ It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

### SA 701 "Communicating Key Audit Matters in the Independent Auditor's Report"

#### Correct/Incorrect

**Communicating Key Audit Matters** is a substitute for the auditor expressing a **modified audit opinion** when required by the circumstances of a specific audit engagement in accordance with SA 705. [Jan-21]

**Incorrect:** Communicating key audit matters in the auditor's report is not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised)

#### Past Exams/RTPs/MTPs/SM Questions

**1. Communicating Key Audit Matter** is not a substitute for disclosure in the **Financial Statements** rather **Communicating key audit matters in the auditor's report** is in the context of the Auditor having formed an opinion on the financial statements as a whole. Analyse. [RTP May-18 + MTP May-22]

**Communicating key audit matters in the auditor's report is not:**

- (i) A substitute for **disclosures** in the financial statements that the applicable Financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
- (ii) A substitute for the auditor expressing a **modified** opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);
- (iii) A substitute for reporting in accordance with SA 570 when a **material uncertainty** exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
- (iv) A **separate opinion** on individual matters.

**2. As an auditor of listed company, what are the matters that the auditor should keep in mind while determining "Key Audit Matters".** [MTP Oct-21 + Nov-23]

**Determining Key Audit Matters:** As per SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report", the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

- (i) **Areas of higher assessed risk of material misstatement**, or significant risks identified in accordance with SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.
- (ii) **Significant auditor judgments** relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- (iii) The effect on the audit of **significant events or transactions** that occurred during the period.

The auditor shall determine which of the matters determined in accordance with above were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

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## SA 705, "Modifications to the Opinion in the Independent Auditor's Report"

### Correct/Incorrect

1. Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are detected by obtaining sufficient appropriate audit evidence. [May-22]

Incorrect: Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

2. When the auditor has to express an adverse opinion, he need not communicate with those charged with governance as this may have an impact on payment of his audit fees.

Incorrect: When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification

### Past Exams/RTPs/MTPs/SM Questions

1. While conducting audit of VED Ltd., you as an auditor are not only prevented in completing certain audit procedures but also are not able to obtain audit evidence even by performing alternative procedures. How you will deal with this situation? [MTP Apr-22]

As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", if, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

- (1) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
- (2) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
  - (i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or
  - (ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

If auditor withdraws, 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.

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2. Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2020- 21 the company transferred its accounts to computerised system (SAP) from manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such the statutory auditors of the company were not able to extract correct data and reports from the system. Such data was not available manually also. Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. The auditor believes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive. Explain the kind of audit report that the statutory auditor of the company should issue in this case.

[RTP Nov'21]

The auditor shall disclaim an opinion when the auditor is **unable to obtain sufficient appropriate audit evidence** on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be **both material and pervasive**.

The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

In the present case Delightful Ltd, the statutory auditor of the company is unable to extract correct data and reports from the SAP system for conduct of audit. Also, such data and reports are not available manually. Moreover, the auditor believes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive.

As such, the statutory auditor of Delightful Ltd. should give a **disclaimer of opinion**.

3. What an auditor should state in "Basis for opinion" section of auditor's report and when the auditor modifies the opinion on the financial statements, what amendments he should make in this section ?

[Jan-21 + RTP Nov'20]

An auditor should state in "Basis for Opinion" section of Auditor's Report as under:

### Basis for Opinion:

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

- (i) States that the audit was conducted in accordance with **Standards on Auditing**;
- (ii) Refers to the **section** of the auditor's report that describes the **auditor's responsibilities under the SAs**;
- (iii) Includes a **statement** that the auditor is independent of the entity in accordance with the **relevant ethical requirements** relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.
- (iv) States whether the auditor believes that the audit evidence the auditor has obtained is **sufficient and appropriate to provide a basis for the auditor's opinion**.

### Amendments an Auditor should make :

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

- (i) **Amend the heading "Basis for Opinion"** required by para of SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and
- (ii) Within this section, **include a description of the matter giving rise to the modification**.

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4. When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700. Explain. (RTP May-22 + July-21 Suggested)

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

- a. A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;
- b. A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- c. The statement about auditor independence and other ethical responsibilities required by SA 700 (Revised).

5. 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.

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers is likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

In the present case CA Daisy, the statutory auditor is unable to verify the cash in hand of Zebra Ltd. as on 31.03.2022. The same is due to a limitation imposed by the management of Zebra Ltd. which is due to the non availability of the cashier. In such situation, CA Daisy should perform alternate procedures to verify the cash on hand of the company. Further, CA Daisy should consider the impact on the auditor's report and may consider issuing a qualified opinion.

5. Distinguish between an adverse opinion and a qualified opinion. Also draft an opinion paragraph for both types of opinion. [SM]

An auditor shall express an adverse opinion, when the auditor having obtained sufficient and appropriate audit evidence, concludes that misstatements, individually or in aggregate are both material and pervasive. Whereas, when the auditor, having obtained sufficient and appropriate audit evidence, concludes that misstatements are material but not pervasive, shall express a qualified opinion.

SA705 – “Modifications To The Opinion In The Independent Auditor's Report” deals with the form and content of both types of report.

The following are the draft of the opinion paragraphs of the reports.

### (a) Adverse Opinion

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the “Holding Company”) and its subsidiaries (the Holding Company and its subsidiaries together referred to as “the Group”), its associates and jointly controlled entities, which comprise the consolidated balance

## Ch-12 Audit Report

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.

### *SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report"*

#### Correct/Incorrect

##### 1. The inclusion of an Emphasis of Matter paragraph in the Auditor's Report affects the auditor's opinion.

[MTP Mar-21]

**Incorrect:** When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall indicate that the auditor's opinion is not modified in respect of the matter emphasized. Such a paragraph shall refer only to information presented or disclosed in the financial statements.

The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion.

#### Past Exams/RTPs/MTPs/SM Questions

##### 1. State clearly the objective of the Auditor as per SA 706. Also define emphasis of matter paragraph and other matter paragraph. [MTP Oct-20]

As per **SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report"**, the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

- A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or
- As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

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**Emphasis of Matter paragraph** – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

**Other Matter paragraph** – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

### 2. Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report? [RTP Nov-20]

**Emphasis of Matter paragraph:** A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements. When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (i) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
- (ii) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
- (iii) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

3. D Ltd. is a company engaged in publishing business magazines. CA P is the statutory auditor of the company. The company takes property in the barter deal from its real estate customers against publication of their advertisements. The properties obtained during the year through such barter deals have been considered in the books of accounts on the basis of possession letter only and have been included in PPE in the financial statements. Considering this matter of such importance that is fundamental to the users understanding, CA P has decided to communicate the same in his report. CA P seeks your guidance in reporting this matter in his audit report.

[May-22]

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

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

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

**The draft of the same is as under:**

Emphasis of Matter – Effect of Properties obtained through barter deals by the company

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

### 4. Mention the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph. [RTP Nov-22 + MTP Oct-21]

**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.

### *SA 710 "Comparative Information – Corresponding Figures & Comparative Financial Statements"*

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. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. Explain clearly stating the essential audit reporting differences between the approaches. Also define comparative information and audit procedures regarding comparative information.

[RTP May-19 + Nov-23]

The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

The essential audit reporting differences between the approaches are:

- (a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
- (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

**Definition of Comparative Information** – The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

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### 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.

2. The senior member of the firm Kaur & Associates, Chartered Accountants, informed to its auditing staff that at the time of audit reporting regarding corresponding figures, when corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in specified circumstances. What are those exceptional circumstances? [May-22]

**Audit reporting Regarding Corresponding Figures:** When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:

1. If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements.

In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

- (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
- (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

2. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified.

3. **Prior Period Financial Statements Not Audited-** If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

3. NG Ltd. appointed CA N as the statutory auditor for the F.Y. 2021-2022. Previous year's auditor gave a qualified opinion on the Comparative Financial Statements for the year ended 31.03.2021. What will be the reporting responsibility casted on CA N when he forms an opinion and prepares audit report on the Comparative Financial Statements for the F.Y. 2021-2022?

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**Prior Period Financial Statements Audited by a Predecessor Auditor:** As per SA 710, if the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, CA. N, the auditor of NG Limited shall state in an Other Matter paragraph:

- a. That the financial statements of the prior period were **audited by a predecessor auditor**
- b. The **type of opinion** expressed by the predecessor auditor and, if the opinion was modified, the **reasons** therefor and
- c. The **date of that report**, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

### Branch Audit & SA 600

**1. 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.

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.

**2. 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. [SM]

Sub-section (8) of section 143 of the Companies Act, 2013, prescribes the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed.

It may be noted that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

Further as per rule 12 of the Companies (Audit and Auditors) Rules, 2014, the branch auditor shall submit his report to the company's auditor and reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

## SA 299 "Joint Audit of Financial Statements"

### Correct/Incorrect

1. Joint auditor is always bound by the views of majority of the joint auditors regarding matters to be covered in report. [May-19]

**Incorrect**- Where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s). Therefore, joint auditor is not bound by the views of the majority of the joint auditors regarding the matters to be covered in the audit report.

### Past Exams/RTPs/MTPs/SM Questions

1. Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard. [RTP May-20]

**Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:**

- (a) identify division of audit areas and common audit areas;
- (b) ascertain the reporting objectives of the engagement;
- (c) consider and communicate among all joint auditors the factors that are significant
- (d) in directing the engagement team's efforts;
- (e) consider the results of preliminary engagement activities, or similar engagements performed earlier.
- (f) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

2. In Joint Audit, "Each Joint Auditor is responsible only for the work allocated to him". Discuss. [SM]

It further states that, in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures.

On the other hand, all the joint auditors shall be jointly and severally responsible for:

- (i) the audit work which is **not divided** among the joint auditors and is carried out by all joint auditors;
- (ii) **decisions taken by all** the joint auditors under audit planning in respect of common audit areas;
- (iii) **matters which are brought to the notice** of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;
- (iv) examining that the **financial statements** of the entity comply with the requirements of the relevant statutes;
- (v) **presentation and disclosure of the financial statements** as required by the applicable financial reporting framework;
- (vi) ensuring that the **audit report** complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

In case a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.

## Ch-12 Audit Report

3. 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. [SM + MTP Apr-23]

**Joint Audit:** The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the advantages that flow may be the following:

- (i) Sharing of expertise.
- (ii) Advantage of mutual consultation.
- (iii) Lower workload.
- (iv) Better quality of performance.
- (v) Improved service to the client.
- (vi) Displacement of the auditor of the company taken over in a takeover often obviated.
- (vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- (viii) Lower staff development costs.
- (ix) Lower costs to carry out the work.
- (x) A sense of healthy competition towards a better performance

4. HMB Limited's business has grown from one state of India to various 4 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? [Nov-22]

**SA 299 Joint Audit of Financial Statements**, all joint auditors shall be jointly and severally responsible for:

- (i) the audit work which is **not divided** among the joint auditors and is carried out by all joint auditors;
- (ii) **decisions taken by all** the joint auditors under audit planning in respect of common audit areas;
- (iii) **matters which are brought to the notice** of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;
- (iv) examining that the **financial statements** of the entity comply with the requirements of the relevant statutes;
- (v) **presentation and disclosure of the financial statements** as required by the applicable financial reporting framework;
- (vi) ensuring that the **audit report** complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

*"Hard Work is like Gajar ka Halwa,  
May Take time,  
but Results are Sweet"*

1. According to CARO 2020, the company auditor is required to state that whether the title deeds of all immovable properties held in the name of the company are disclosed in its financial statements. [May-22]

**Incorrect:** According to CARO, 2020, the company auditor is required to state whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company.

2. G Pvt. Ltd. had fully paid up Capital and Reserves of ₹ 1.20 crore as at the end of F.Y. 2020-2021. During the F.Y 2021-2022, business was interrupted due to Covid restrictions and therefore the company incurred losses to the tune of ₹ 25 lacs. During the year, the company also borrowed ₹ 55 lakh each from a bank and a financial institution independently. It had a turnover of ₹ 850 lakh (other than revenue of ₹ 250 lakh from discontinuing operations). Ascertain whether CARO, 2020 is applicable to the company. [May-22]

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

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

Applying the above to the given case, G Pvt. Ltd., its paid-up capital and reserves are ₹ 95 Lakh (₹ 120 Lakh - ₹ 25 Lakh), borrowings from a Bank and financial institution are (₹ 55 Lakh + ₹ 55 Lakh) i.e., ₹ 1.10 Crore, turnover {including discontinuing operations (₹ 850 lakh + ₹ 250 Lakh)} ₹ 1100 Lakh i.e., ₹ 11 Crore.

Since its borrowings and turnover are exceeding the specified limit and therefore it is not exempt from the applicability of CARO, 2020.

3. State the auditor's reporting responsibilities under CARO 2020 when –

- (i) The company has raised money by public issue.
- (ii) The company has made private placement of shares. [Jan-21]

Auditor's reporting responsibilities under CARO 2020:

(i) **Clause (x) para 3 of CARO, 2020** states - whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans 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.

(ii) **Clause (x) para 3 of CARO, 2020** states - whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance.

**4. State the matters to be included in auditor's report as per CARO, 2020 regarding - Verification of inventory and working capital limits. [RTP May-22]**

**Matters to be included in Auditor's report as per CARO 2020:** Clause (ii) of Para 3 of CARO, 2020, requires the auditor to report

- (a) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;
- (b) whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

**5. TS Ltd. has raised funds by issuing fully convertible debentures. These funds were raised for the expansion and diversification of the business. However, the company utilised these funds for repayment of long-term loans and advances. What are the reporting requirements under CARO 2020 in this case?**

**[RTP Nov-20 + Nov-22]**

**Reporting Requirements under CARO 2020 for raising funds:** As per clause (x)(b) of Para 3 of CARO, 2020, the auditor of a company has to report whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance.

In the present case, TS Ltd. has raised funds by issuing fully convertible debentures for expansion and diversification of the business. However, the company used the funds for repayment of long-term loans and advances instead of utilisation of the same for the purpose for which the funds were raised i.e. expansion and diversification of business.

Here, the auditor should report the fact in his report that the funds were used for the purpose other than the purpose for which the funds were raised, as per clause (x)(b) of Para 3 of CARO, 2020.

**6. M Ltd. has given certain loans to related parties and also has accepted certain deposits. As an auditor, how will you include the above items in paragraph 3 of CARO, 2020? [Nov-19]**

**Clause (iii) of paragraph 3 of CARO, 2020 states**

whether during year Co. has made investments in, provided any guarantee or security or granted any loans or advances in nature of loans, secured or unsecured, companies, firms, LLPs or any other parties, if so,-

(a) whether during year Co. has provided loans or provided advances in nature of loans, or stood guarantee, or provided security to any other entity [not applicable to companies whose principal business is to give loans], if so, indicate-

(A) aggregate amt during year, and balance o/s at BS date w.r.t. such loans or advances and guarantees or security to subsidiaries, joint ventures and associates;

(B) Agg. amt during year, and balance outstanding at BS date w.r.t such LAGS to parties other than subsidiaries, joint ventures and associates;

- (b) whether investments made, guarantees provided, security given and T&Cs of grant of all loans and advances in nature of loans and guarantees provided are not prejudicial to the company's interest;
- (c) in respect of loans and advances in nature of loans, whether schedule of repayment of principal and payment of interest has been stipulated and whether repayments or receipts are regular;
- (d) if amount is overdue, state total amount overdue for more than 90 days, and whether reasonable steps have been taken by company for recovery of principal and interest;
- (e) whether any loan or advance in the nature of loan granted which has fallen due during the year, has been renewed or extended or fresh loans granted to settle the overdues of existing loans given to the same parties, if so, specify the aggregate amount of such dues renewed or extended or settled by fresh loans and percentage of aggregate to total loans or advances in the nature of loans granted during year [not applicable to companies whose principal business is to give loans];
- (f) whether company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so, specify the aggregate amount, percentage thereof to the total loans granted, aggregate amount of loans granted to Promoters, related parties as defined in Sec 2(76) of Companies Act, 2013;

2. Further, **Clause (v) of paragraph 3 of CARO, 2020** states in case the company has accepted deposits,

- (i) whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated;
- (ii) If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?

In the given situation, M Ltd. has given certain loans to related parties and also has accepted certain deposits. Thus, the auditor is required to report the same as per clause (iii) and (v) of Paragraph 3 of CARO, 2020.

**7. Mr. T, the director of A Ltd., has purchased an old car belonging to the company against the cooling equipment belonging to the director, which is given to the company as consideration for the car. The auditor is not required to include this in his CARO report. [Nov-22]**

**Incorrect:** The auditor is required to report the same as per clause (xv) of Paragraph 3 of CARO, 2020, "whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with".

1. The financial statements of a bank are prepared in a specified format. Discuss legal provisions in this regard as applicable to financial statements of a nationalized bank.

**Section 29(1) & (2) of the Banking Regulations Act, 1949** deal with the form and content of financial statements of a banking company and their authentication. These provisions are also applicable to nationalised banks.

- Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit.
- **Form A of the Third Schedule to the Banking Regulation Act, 1949**, contains the form of Balance Sheet and **Form B** contains the form of Profit and Loss Account.

2. Ranjana Ceramic Private Limited is sanctioned a cash credit facility of ₹100 lacs from a branch of LMO Bank. Besides, branch has also sanctioned a one-time bank guarantee of ₹ 10 lacs on behalf of the company in favour of a statutory authority. Discuss, what type of credit facilities have been sanctioned by branch of LMO bank to the company along with probable purpose for each of credit facility.

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.

3. During course of audit of branch of a nationalized bank, you find that system has generated a report marking ten term loan accounts as SMA. Discuss, meaning of SMA accounts and significance of such a classification.

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.

It means there are **overdues in accounts for a period of 0 to 90 days**. Since period of 90 days has not been exceeded as on the date, such accounts have not been classified as NPA as per RBI norms.

Such a classification is significant as **early recognition of such accounts** enables banks to initiate **timely remedial actions to prevent potential slippages of such accounts into NPAs**.

4. CA P is conducting stock audit of a borrower availing cash credit facility of ₹100 lacs from branch of a bank. The cash credit facility is against security of paid stocks and debtors up to 90 days. Margin stipulated is 25% for stocks and 40% for debtors. Following further information is available as on 31.12.22: -

	₹
Value of stocks	125 lacs
Value of stock (fully damaged) included in above	5
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?

The computation of Drawing power is as under: -

Value of stocks as on 31.12.22	₹ 125 lacs
Less: value of damaged stocks	₹ 5 lacs
	₹ 120 lacs
Less: creditors for goods as on 31.12.22	₹ 50 lacs
Value of Paid stocks	₹ 70.00 lacs
Less: Margin @ 25%	₹ 17.50 lacs
Drawing power (A)	₹ 52.50 lacs
Value of debtors as on 31.12.22	₹ 50 lacs
Less: debtors exceeding 90 days	₹ 10 lacs
	₹ 40 lacs
Less: Margin @ 40%	₹ 16 lacs
Drawing Power (B)	₹ 24 lacs
<b>Drawing Power (A+B)</b>	<b>₹ 76.50 lacs</b>

The drawing power calculated by CA P is not proper. Drawing Power comes to ₹ 76.50 lacs.

**5. You are verifying interest on deposits paid by branch of a nationalized bank. Discuss, any two "analytical procedures", to verify interest on deposits paid by branch. CA M is conducting statutory audit of branch of MMC Bank.**

The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.

The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

### Case Study

During the course of audit, it is noticed as under:-

- 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".
- 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.
- 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.

## Ch-14 Audit of Banks

(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 on above, answer 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 "NonPerforming 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.

1. c 2. c 3. b 4. b 5. a

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### MCQs based Questions

(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

### Correct/Incorrect

(1) RBI has been entrusted with the responsibility of regulating the activities of commercial banks only.

Incorrect. RBI has been entrusted with the responsibility of regulating the activities of commercial and other banks.

(2) In the computerised environment, the auditor need not be familiar with latest applicable RBI guidelines that have bearing on the classification/ provisions and income recognition.

Incorrect. In the Computerised environment, it is imperative that the auditor is familiar with, and is satisfied that, all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income recognition.

(3) The auditor can assume that the system generated information is correct and relied upon.

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**Incorrect.** The auditor should not go by the assumption that the system generated information is correct and can be relied upon without evidence that demonstrates that the system driven information is based on validation of the required parameters for the time being in force and applicable.

**(4) Collateral security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank.**

**Incorrect.** Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

**(5) Registered mortgage is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof**

**Incorrect.** Equitable mortgage, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

**(6) Any amount due to the bank under any credit facility is 'overdue' if it is not paid within 90 days of becoming due.**

**Incorrect.** Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

**(7) An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.**

**Correct.** An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power.

**(8) Banks recognize income on Non-Performing Assets on accrual basis.**

**Incorrect:** Income from non-performing assets (NPA) is not recognised on accrual basis due to its uncertainty but is booked as income only when it is actually received.

**(9) Auditor of a Nationalised bank is to be appointed at the annual general meeting of the shareholders.**

**Incorrect-** Auditor of a nationalized bank is to be appointed by the bank concerned acting through its Boards of Directors and approval of the Reserve bank is required before the appointment is made.

**(10) Classification as NPA should be based on the availability of security and asset classification would be facility wise and not borrower wise. [MTP Apr-23]**

**Incorrect:** Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Asset classification would be borrower-wise and not facility-wise.

## Ch-14 Audit of Banks

(11) Reporting of fraud of INR 150 Lakhs by auditor will be done within three days of the fraud coming to the knowledge of the auditor to the Board or the Audit Committee along with remedial action taken in case of audit of ABA Bank Ltd.

**Incorrect**- The auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days. The Banking Company is bound to disclose remedial action taken in Board's report.

(12) **Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets.**

**Correct:** Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.

### Past Exams/RTPs/MTPs/SM Questions

1. There are different types of banks prevailing in India. Explain giving examples of such banks.

[MTP Mar-21]

There are different types of banking institutions prevailing in India which are as follows:

1. **Commercial banks** are the most wide spread banking institutions in India, that provide a number of products and services to general public and other segments of economy. Two of its main functions are:-

- (a) accepting deposits and
- (b) granting advances.

2. **Regional Rural Banks** known as RRBs are the banks that have been set up in rural areas in different states of the country to cater to the basic banking and financial needs of the rural communities. Examples are :- Punjab Gramin Bank , Tripura Gramin Bank , Allahabad UP Gramin Bank , Andhra Pradesh Grameen Vikas Bank, etc.

3. **Co-operative Banks** function like Commercial Banks only but are set up on the basis of Cooperative Principles and registered under the Cooperative Societies Act of the respective state or the Multistate Cooperative Societies Act and usually cater to the needs of the agricultural and rural sectors. Examples are :- The Gujarat State Co-operative Bank Ltd. , Chhattisgarh Rajya Sahakari Bank Maryadit , etc.

4. **Payments Banks** are a new type of banks which have been recently introduced by RBI. They are allowed to accept restricted deposits but they cannot issue loans and credit cards.

However , customers can open Current & Savings accounts and also avail the facility of ATM cum Debit cards , Internet-banking & Mobilebanking. Examples are :- Airtel Payments Bank , India Post Payments Bank, Paytm Payments Bank , etc.

5. **Development Banks** had been conceptualized to provide funds for infrastructural facilities important for the economic growth of the country. Examples are:- Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI) , etc.

6. **Small Finance Banks** have been set up by RBI to make available basic financial and banking facilities to the unserved and unorganised sectors like small marginal farmers, small & micro business units, etc. Examples are:- Equitas Small Finance Bank , AU Small Finance Bank , etc.

## Ch-14 Audit of Banks

2. In the case of a nationalised bank, the auditor is required to make a report to the Central Government. The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank. Explain what would the auditor state in his report.

[MTP Oct-18]

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

- a. whether, in his opinion, the **balance sheet** is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;
- b. whether or not the **transactions** of the bank, which have come to his notice, have been within the powers of that bank;
- c. whether or not the **returns received from the offices and branches** of the bank have been found adequate for the purpose of his audit;
- d. whether the **profit and loss account** shows a true balance of profit or loss for the period covered by such account; and
- e. **any other matter** which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank.

3. "If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smells any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".

Analyse and explain the above RBI Circular regarding liability of accounting and auditing profession.

[MTP Aug-18]

The RBI issued a **Circular** relating to implementation of recommendations of **Committee on Legal Aspects of Bank Frauds** applicable to all scheduled commercial banks (excluding Regional Rural Banks). Regarding liability of accounting and auditing profession, the said circular provided as under:

"If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".

As per the above requirement, the member shall be required to report the kind of matters stated in the circular to RBI.

Auditor should also consider the provisions of **SA 250**, "Consideration of Laws and Regulations in an Audit of Financial Statements". The said Standard explains that the **duty of confidentiality is over-ridden by statute, law or by courts**.

**SA 240**, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" states that an auditor conducting an audit in accordance with SAs is responsible for obtaining **reasonable assurance** that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

## Ch-14 Audit of Banks

It must be noted that auditor is not expected to look into each and every transaction but to evaluate the system as a whole. Therefore, if the auditor while performing his normal duties comes across any instance, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.

**Duty to report on Frauds under the Companies Act, 2013** - As per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

4. Mr. Piyush, the Bank Manager develops controls to aid in managing key business and financial risks. Discuss the various requirements for an effective risk management system in a bank. [May-19]

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 (BOD/Chief Executive Officer) 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 manage 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 of limits, reporting and approval of exceptions, physical security and contingency planning.
- (iv) **Monitoring activities:** Risk management models, methodologies and assumptions used to measure and manage 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.

5. The engagement team discussion ordinarily includes a discussion of the matters such as - Errors that may be more likely to occur; Errors which have been identified in prior years; Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures; etc.

In the above context, explain the advantages of such a discussion. [RTP Nov-21 + July-21 Suggested]

Advantages of such a discussion :-

- ✓ Specific emphasis should be provided to the **susceptibility of the bank's financial statements to material misstatement due to fraud**, that enables the engagement team to consider an appropriate response to fraud risks, including those related to engagement risk, pervasive risks, and specific risks.
- ✓ It further enables the audit engagement partner to **delegate the work to the experienced engagement team members**, and to determine the procedures to be followed when fraud is identified.
- ✓ Further, audit engagement partner may review the need to **involve specialists** to address the issues relating to fraud.

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6. The discussion between members of the engagement team members and the audit engagement partner should be done on the susceptibility of the bank's financial statements to material misstatements. Briefly discuss the points ordinarily included in discussion of the engagement team. [Nov-19]

The engagement team discussion ordinarily includes a discussion of the following matters:

- (i) Errors that may be more likely to occur;
- (ii) Errors which have been identified in prior years;
- (iii) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and / or disclosure;
- (iv) Audit responses to engagement risk, pervasive risks and specific risks;
- (v) Need to maintain professional skepticism throughout the audit engagement;
- (vi) Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g. the bank's application of accounting policies in the given facts and circumstances).

7. Your firm of auditors, SRG & Co., has been appointed as Statutory Central Auditors of Reliable Bank. Explain the reporting requirements of the Statutory Central Auditors (SCAs) in addition to their main audit report. [RTP May-21]

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

- a. Report on adequacy and operating effectiveness of **Internal Controls over Financial Reporting** in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
- b. Long Form Audit Report. (LFAR)
- c. Report on compliance with **SLR** requirements.
- d. Report on whether the **treasury operations** of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
- e. Report on whether the **income recognition**, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
- f. Report on whether any **serious irregularity** was noticed in the working of the bank which requires immediate attention.
- g. Report on status of the compliance by the bank with regard to the implementation of **recommendations of the Ghosh Committee** relating to frauds and malpractices and of the recommendations of **Jilani Committee** on internal control and inspection/credit system.
- h. Report on instances of **adverse credit-deposit ratio** in the rural areas.

8. Explain the categories of Agricultural Advances in case of Banks and related NPA norms. (MTP Apr-22)

As per the guidelines, Agricultural Advances are of two types:

- (1) Agricultural Advances for "long duration" crops; and
- (2) Agricultural Advances for "short duration" crops.

The "long duration" crops would be crops with **crop season longer than one year** and crops, which are not "long duration" crops would be treated as "short duration" crops. The **crop season** for each crop, which means the period up to harvesting of the crops raised, would be as determined by the **State Level Bankers' Committee** in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for **short duration crops** will be treated as NPA, if the instalment of principal or interest thereon remains **overdue for two crop seasons**; and
- A loan granted for **long duration crops** will be treated as NPA, if the instalment of principal or interest thereon remains **overdue for one crop season**.

9. "Ramjilal & Co. had been allotted the branch audit of a nationalized bank for the year ended 31st March, 2018. In the audit planning, the partner of Ramjilal & Co., observed that the allotted branches are predominantly based in rural areas and major portion of the advances were for agricultural purpose."

Now he needs your assistance on the following points so as to incorporate them in the audit plan:

- (i) for determination of NPA norms for agricultural advances
- (ii) for accounts where there is erosion in the value of security/frauds committed by the borrowers.

[Nov-18]

(i) Answer 9

(ii) Accounts where there is erosion in the value of security / frauds committed by borrowers

Not prudent to follow stages of asset classification. It should be straightaway classified as doubtful or loss asset as appropriate.

(i) Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.

(ii) If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowing accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset. It may be either written off or fully provided for by the bank.

10. After becoming Chartered Accountant, you have got your first assignment as an auditor of a bank branch dealing in various types of advances. What are the areas which you will be looking for obtaining sufficient appropriate evidence (for advances) besides studying and evaluating internal controls?

[May-22]

**Audit Procedure in Audit of Advances in case of Bank Audit:** The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- (i) examining the **validity** of the recorded amounts;
- (ii) examining **loan documentation**;
- (iii) reviewing the **operation** of the accounts;
- (iv) examining the **existence, enforceability** and **valuation** of the **security**;
- (v) checking compliance with **RBI norms** including appropriate **classification and provisioning**; and
- (vi) carrying out appropriate **analytical procedures**.

11. The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. Explain this statement. (MTP Apr-22)

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The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, inter alia, the following:

- The bank should make an advance only after satisfying itself as to the **credit worthiness of the borrower** and after obtaining sanction from the appropriate authorities of the bank.
- All the **necessary documents** (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The **compliance with the terms of sanction and end use of funds** should be ensured.
- **Sufficient margin** as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- If the securities taken are in the nature of shares, debentures, etc., the **ownership of the same should be transferred in the name of the bank** and the effective control of such securities be retained as a part of documentation.
- All securities requiring **registration** should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- In the case of **goods in the possession of the bank**, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- **Drawing Power Register** should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- The accounts should be kept within both the **drawing power and the sanctioned limit**.
- All the **accounts which exceed the sanctioned limit or drawing power or are otherwise irregular** should be brought to the notice of the controlling authority regularly.
- The **operation of each advance account** should be reviewed at least once a year and at more frequent intervals in the case of large advances.

**12. In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about amounts included in balance sheet in respect of advances which are outstanding. Explain stating clearly all the considerations in this context. [RTP Nov-22 + RTP May-21]**

Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

**In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:**

- a. Amounts included in balance sheet in respect of advances 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 recognized **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**.

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13. "There is no difference in provisioning of NPA as regards to categories of NPA, whether the debt is secured or unsecured." Critically evaluate the statement on the basis of provisioning norms of NPA of nationalised bank stating clearly the provision percent required. [MTP Oct-21 + Nov-22]

Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Further, asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA. There are different provisioning requirements as regards to categories of NPA such as Substandard assets, Doubtful assets and loss assets which are given below:

Categories of NPA	Provision Required
Sub std assets (NPAs upto 12 months)	15%
Doubtful Assets (Sub std for period of 12 Months)	
<u>Sub Categories</u>	<u>Secured/Unsecured</u>
Doubtful upto 1 year	25%/100%
Doubtful 1-3 years	40%/100%
Doubtful > 3 years	100%/100%
<u>Loss Assets:</u> Loss identified by bank/internal/external auditors or RBI but amt not w/off wholly.	100%

14. In case of a Bank, explain the meaning of Funded loans. Also give examples. [MTP Oct-21]

Funded loans are those loans where there is an actual transfer of funds from the bank to the borrower.

Advances comprise of funded amounts by way of:

- Term loans :-
- Cash credits, Overdrafts, Demand Loans
- Bills Discounted and Purchased
- Participation on Risk Sharing basis
- Interest-bearing Staff Loans

15. Distinguish between Primary Security and Collateral Security with reference to audit of Banks. Also give examples of most common types of securities accepted by the Banks. [RTP Nov-20]

A. **Primary security** refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.

B. **Collateral security** is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following:

- Personal Security of Guarantor
- Goods/Stocks/Debtors/Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property

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- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Banker's General Lien
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments

**16. Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien. Explain with specific reference to Audit of Banks.**

[RTP Nov-20 + MTP Mar-23]

Depending on the nature of the item concerned, creation of security may take the form of a mortgage, pledge, hypothecation, assignment, set-off or lien.

**(i) Mortgage:** Mortgage are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage.

- **Registered Mortgage** can be effected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security.
- **Equitable mortgage**, on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

**(ii) Pledge:** A pledge thus involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge.

**(iii) Hypothecation:** The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favour of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank.

The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

**(iv) Assignment:** Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favour of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

An assignment gives the assignee absolute right over the moneys/debts assigned to him.

**(v) Set-off** is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same). For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

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(vi) **Lien:** Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

17. Explain "Advances under Consortium" in the context of Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances. [MTP Nov-21 + Jan-21]

**Advances under Consortium:** Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances.

- ✓ Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.
- ✓ The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

18. 1. N Ltd. has been sanctioned a Cash Credit Facility by XYZ Bank Ltd. for INR 1 crore and drawing power as per the stock statements furnished for the last quarter is INR 80 Lakh. Outstanding balance in the account is INR 75 lakh. Interest charged to the account is INR 3.5 Lakh and total credit into the account for the quarter is INR 2.5 Lakh. As an auditor how will you report this account in your report. [July-21]

**Out of Order:** An account should be treated as 'out of order' if:

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- Credits are there but are not enough to cover the interest debited during the same period, these accounts should be treated as 'out of order'.

Applying the above to the given case of N Ltd, its Drawing power is ₹ 80 Lakhs, although outstanding balance in the account is ₹ 75 Lakhs, but still the account would be reported as out of order because credits in the account are not sufficient to cover the interest debited during the same period.

19. In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also. Analyse and Explain.

[RTP May-20]

**Reversal of Income:**

If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not 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.

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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).

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.

**20. In a bank, all accounts should be kept within the drawing power and the sanctioned limit. The accounts which exceed the sanctioned limit or drawing power should be brought to the notice of the management regularly. Analyse the following points to be considered in the computation of drawing power in case of bank audit. (i) Bank's Duties (ii) Auditor's concern (iii) Computation of DP (iv) Stock audit [MTP Apr-23]**

### Computation of Drawing Power:

#### (i) Bank's Duties:

- ✓ Banks should ensure that drawings in the working capital account are **covered by the adequacy of the current assets.**
- ✓ Drawing power is required to be arrived at based on **current stock statement**. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should **not be older than three months**.
- ✓ The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as **irregular**.

#### (ii) Auditor's Concern:

- ✓ The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail.
- ✓ The audited Annual Report submitted by the borrower should be scrutinized properly.
- ✓ The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.

**(iii) Computation of DP:** It needs to be ensured that the drawing power is calculated as per the **extant guidelines formulated by the Board of Directors** of the respective bank and **agreed upon by the concerned statutory auditors**. **Special consideration** should be given to proper **reporting of sundry creditors** for the purposes of calculating drawing power.

#### (iv) Stock Audit:

- ✓ The stock audit should be carried out by the bank for all accounts having **funded exposure of more than 5 crores**. Auditors can also advise for stock audit in other cases if the situation warrants the same.
- ✓ Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital.
- ✓ The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

**21. In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense. Analyse and explain stating the audit approach and procedure in regard to interest expense. [RTP Nov-21]**

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In carrying out an audit of interest expense, the auditor is primarily concerned with **assessing the overall reasonableness of the amount of interest expense by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year**. In modern day banking, the entries for interest expenses are automatically generated through a batch process in the **CBS system**.

The auditor should obtain from the bank an **analysis of various types of deposits outstanding at the end of each quarter**. From such information, the auditor may **work out a weighted average interest rate**. The auditor may then **compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts** and enquire into the difference, if material.

The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

The auditor should **obtain general ledger break-up for the interest expense incurred on deposits (savings and term deposits) and borrowing each month/quarter**. The auditor should **analyse month on month (or quarter on quarter) cost analysis** and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger. The auditor should understand the **process of computation of the average balance and re-compute the same on sample basis**.

The auditor should, on a **test check basis**, verify the calculation of interest and ensure that:

- Interest has been provided on all deposits upto the date of the balance sheet;
- Interest rates are in accordance with the **bank's internal regulations**, the **RBI directives** and agreements with the respective deposit holder;
- Interest on savings accounts** are in accordance with the rules framed by the bank/RBI in this behalf.
- Interest on inter-branch balances** has been provided at the rates prescribed by the head office/RBI.

The auditor should ascertain whether there are any **changes in interest rate** on saving accounts and term deposits during the period. The auditor should obtain the interest rate card for various types of deposits and analyse the interest cost for the period accordingly.

The auditor should **examine the completeness that interest has been accrued on the entire borrowing portfolio** and the same should agree with the general ledgers.

The auditor should **re-compute the interest accrual** i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc. from the term sheet, deal ticket, agreements, etc. and ensure that the recomputed amount is tallying with the amount as per books of accounts without any significant difference.

**22. Explain the following in the context of Bank audit:**

- For audit of operating expenses**, the auditor should study and evaluate the system of internal control relating to expenses.
- For audit of Provisions and contingencies**, the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.

[RTP May-22 + MTP Mar-23]

(a) **For audit of operating expenses**,

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- Auditor should study and evaluate the system of **internal control** relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures.
- The auditor should examine whether there are any **divergent trends** in respect of major items of expenses.
- The auditor should **perform substantive analytical procedures** in respect of these expenses. e.g. assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.
- The auditor should also verify expenses with **reference to supporting documents** and check the calculations wherever required.

**(b) For audit of Provisions and contingencies**, the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.

- The auditor should obtain an understanding as to how the bank **computes provision on standard assets and non-performing assets**.
  - ✓ It will primarily include checking the **basis of classification** of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets.
  - ✓ The auditor may verify the **loan classification on a sample basis**. The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.
- The auditor should obtain the **tax provision computation** from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation.
- The **other provisions for expenses** should be examined vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

**23. When are following considered as non performing as per the RBI guidelines?**

(i) **Government guaranteed advances** (ii) **Advances to staff [MTP Mar-23]**

### **Government Guaranteed advances:**

- Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose.
- The situation would be different if the advance is guaranteed by State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

### **Advances to Staff**

- **Interest-bearing staff advances** as a banker should be included as part of advances portfolio of the bank.
- In the case of **housing loan or similar advances** granted to staff members where **interest is payable after recovery of principal**, interest need not be considered as overdue from the first quarter onwards. Such loans/advances should be classified as NPA only when there is a default in repayment of installment of principal or payment of interest on the respective due dates.
- The staff advances by a bank as **an employer and not as a banker** are required to be included under the sub-head '**Others**' under the schedule of **Other Assets**.

**24. CA X is acting as concurrent auditor of a branch of KLT Bank (a nationalized bank) located in Delhi during the year 2022-23. The assignment started from 1st October 2022 and is for a period of one year. By virtue of this assignment, he is required to issue monthly reports on different aspects of the functioning of branch including deposits, advances and housekeeping to controlling authorities of Bank. At the end of March, 2023, he has got an**

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offer to conduct statutory audit of two branches of KLT Bank located in the State of Rajasthan for the year 2022-23. Can he accept the above offer? Discuss. [MTP Nov-23]

In the given situation, CA X has undertaken concurrent audit assignment of KLT Bank which is in the nature of internal assignments. In accordance with RBI guidelines, statutory audit assignments should not be undertaken by auditors while being associated with internal assignments in bank during the same year like concurrent audits (internal audits of banks conducted monthly during the year).

As CA X is associated with KLT Bank as concurrent auditor, he should not accept statutory audit assignment of same bank even though it relates to different branches of the bank.

25. 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?

RBI norms stipulate that if any advance account becomes NPA as at close of any year, the entire interest accrued or credited to income account in past periods should be reversed or provided for, if the same is not realized.

Further, in respect of NPAs, fees, commission and other similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

In the given case, account has turned Sub-standard asset which is a type of NPA. Therefore, auditor should make compliance of above norms relating to income recognition.

26. While verifying provisions of advances of a branch of MCO Bank as part of statutory branch audit, CA Z notices that credit facilities consisting of term loan to KRT Enterprises have been classified under doubtful asset (D1) category. The outstanding balance in above term loan account as on 31.3.2023 is ₹ 50 lakhs. Value of security held in account is ₹ 40 lakhs. The branch has made provision of ₹ 7.50 lakhs. Is provision made by branch proper? Discuss. [MTP Nov-23]

The provision for advances falling in D1 category is required @ 25% of secured portion and 100% of unsecured portion.

Therefore, provision in above case is arrived as under:-

Outstanding balance as on 31.3.23	₹ 50 lakhs
Less: Value of security	₹ 40 lakhs
Unsecured portion	₹ 10 lakhs

Therefore, outstanding balance of ₹50 lakhs is secured to the tune of ₹40 lakhs and balance ₹ 10 lakhs is unsecured.

**Provision calculation**

25% of secured part i.e., 25% of ₹40 lakhs	₹ 10 lakhs
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100% of unsecured part i.e., 100% of ₹10 lakhs	₹ 10 lakhs
Required provision	₹ 20 lakhs

Therefore, provision made by branch is not proper. It should have made provision of ₹20 lakhs instead of ₹7.50 lakhs.

*"If you can THINK about it, you can ACHIEVE it,*

*Think about what you WANT in LIFE"*

## CASE STUDY

Consider the following five descriptions:-

(A) Audit of "Implementation of Nagpur Metro Rail Project" was conducted by the Comptroller and Auditor General of India.

Following is extract of few audit findings placed on website cag.gov.in.

"The location of New Airport station was not ideal from the viewpoint of ridership due to sparse population in and around the station and also from the accessibility point of view.

Cotton Market station, the second additional station was projected to have high peak hour peak direction trips but the work was kept on hold midway citing fund crunch due to non-release of pending contribution from stakeholders. However, the situation could have been managed through prioritization of works."

(B) Another set of audit findings in respect of audit of Haryana Power Generation Corporation Limited, a wholly owned government company responsible for operation of power generation plants in state of Haryana is as under: "The main reason for low generation was higher variable cost of thermal power stations which resulted in backing down of plants."

(C) A report was tabled in Parliament highlighting main features of direct taxes administration of country as mandated in Constitution of India. This report primarily discussed compliance to the provisions of the Income Tax Act, 1961 and the associated rules and procedures etc. as applied to administration of direct taxes including irregularities noticed in finalizing assessments etc.

(D) Radial finance corporation Limited is a government company. The audit of the company is conducted by statutory auditors appointed by Comptroller and Auditor General of India.

(E) Bharat Insurance Company Limited is a general insurance government owned company. The statutory auditor is appointed by Comptroller and Auditor General of India.

The annual report for a particular year also contains comments of statutory auditors on matters such as whether company has carried out reconciliations in respect of its inter-company balances with other government owned insurance companies.

Based on above, answer 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

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(3) Which of the following is the most appropriate statement in context of report tabled in Parliament regarding administration of direct taxes?

- a. It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Comptroller and Auditor General of India.
- b. It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by an independent task force of experts.
- c. It is likely to be a report prepared for submission to the President under Article 151 of the Constitution of India by Central Board of Direct Taxes.
- d. It is likely to be a report prepared for submission to the Prime Minister under Article 151 of the Constitution of India by Central Board of Direct Taxes.

(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

1. c 2. d 3. a 4. c 5. b

### MCQ

1. 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

Ans D

### Test Your Understanding

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

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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?

Consolidated Fund of India consists of all the revenue received from direct and indirect taxes, all the loans taken by the Govt. of India and all the amount of repayment of loans received by the Govt. of India. Its importance lies in the fact that all government expenditure is incurred from this fund. No moneys out of the Consolidated Fund of India shall be appropriated except in accordance with law and for the purposes and in the manner provided in the Constitution.

### Correct/Incorrect

1. The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971.

[RTP May-22]

**Incorrect:** The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013

2. The Constitution of India contains no specific provisions regarding the appointment, salary and duties and powers of the C&AG. Moreover, the constitution does not guarantee the independence of the C&AG of India [MTP May-22/RTP Nov-20]

**Incorrect:** The Constitution of India contains specific provisions regarding the appointment, salary and duties and powers of the C&AG. The constitution guarantees the independence of the C&AG of India by prescribing that he shall be appointed by the President of India and shall not be removed from office except on the ground of proven mis-behaviour or incapacity.

3. Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the Finance Minister may on the advice of the C&AG prescribe.

**Incorrect.** Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.

4. According to 'Audit of sanctions', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.

**Incorrect.** According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. According to 'Audit of sanctions', the auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority.

### Past Exams/RTPs/MTPs/SM Questions

1. Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession. Explain stating clearly the definition of Government auditing as discussed in U.N. Handbook on Govt Auditing and Developing Countries and also state Objectives of Govt audit.

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession.

The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:-

Government auditing is

- the objective, systematic, professional and independent examination
- of financial, administrative and other operations of a public entity
- made subsequently to their execution
- for the purpose of evaluating and verifying them,
- presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions
- by the responsible officials
- and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

**Objectives :-**

- a. **Accounting for Public Funds**:- Government audit serves as a mechanism or process for public accounting of government funds.
- b. **Appraisal of Government policies**:- It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.
- c. **Base for Corrective actions**:- Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.
- d. **Administrative Accountability** :- The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration

2. **C&AG's (Duties, Powers and Conditions of Service) Act, 1971** provides certain powers to the C & AG in connection with performance of his duties. Discuss. [MTP Nov-21/Apr-23]

**Powers of C & AG in performance of his duties:** C&AG's (Duties, Powers and Condition of Service) Act, 1971 gives the following powers to the C&AG in connection with the performance of his duties:

- (i) To inspect any an office accounts under the control of the union or a State Government including office responsible for creation of initial or subsidiary accounts.
- (ii) To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, **be sent to specified places**.
- (iii) To put such **questions or make such observations** as he may consider necessary to the person- in charge of the office and to call for such information as he may require for preparation of any account or report, which is his duty to prepare.

In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transaction as he may determine.

## Ch-15 Government Audit

### 3. Explain the duties of C&AG of India. [RTP May/Nov-19]

#### Duties of the C&AG:

**(i) Compile and submit Accounts of Union and States** – C&AG shall be responsible for compiling accounts of the Union and of each State from initial and subsidiary accounts rendered to audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. C&AG shall, from the accounts compiled by him or [by the Government or any other person responsible in that behalf] prepare in each accounts (including, in the case of accounts compiled by him, appropriation accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each UT having a Legislative Assembly, and shall submit those accounts to President or Governor of State or Administrator of UT having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

**(ii) General Provisions Relating to Audit** - It shall be the duty of the C&AG to audit & report on—

- (a) all expenditure from the Consolidated Fund of India and of each State and of each UT 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) all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;
- (c) to audit and report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

**(iii) Audit of Receipts and Expenditure** - Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any UT having a Legislative Assembly, the C&AG shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

Where the grant or loan to a body or authority from the Consolidated Fund of India or of any State or of any UT having a Legislative Assembly in a financial year is not less than rupees twenty-five lakhs and the amount of such grant or loan is not less than seventy-five per cent of the total expenditure of that body or authority, such body or authority shall be deemed, for this purpose to be substantially financed by such grants or loans as the case may be.

**(iv) Audit of Grants or Loans** - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any UT having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the C&AG shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

**(v) Audit of Receipts of Union or States** - It shall be the duty of the C&AG to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit and report thereon.

**(vi) Audit of Accounts of Stores and Inventory** - The C&AG shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

**(vii) Audit of Government Companies and Corporations** –

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The duties and powers of the C&AG in relation to the audit of the accounts of government companies shall be performed and exercised by him as per provisions of Companies Act, 2013. C&AG shall appoint auditor under section 139(5) or (7) (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to C&AG which, among other things, include the directions, if any, issued by C&AG, the action taken thereon and its impact on the accounts and financial statement of the company.

**4. Audit of government expenditure is one of the major components of government audit conducted by the office of C & AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Explain those standards. [MTP Apr-22]**

**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 funds authorised by competent authority fixing the limits within which expenditure can be incurred. These standards are—

- (i) 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'**.
- (ii) that there is sanction, either special or general, accorded by competent authority authorizing the expenditure. Such an audit is called as the **audit of sanctions**.
- (iii) 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**.
- (iv) 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**.

**5. "Public moneys should not be utilised for the benefit of a particular person or section of the community". List out the exceptions to this rule while audit against propriety. [MTP Oct-21]**

### **Exceptions to the rule – Audit Against Propriety:**

Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

- (i) the amount of expenditure involved is **insignificant**; or
- (ii) a claim for the amount could be **enforced in a Court of law**; or
- (iii) the expenditure is in pursuance of a **recognised policy or custom**; and
- (iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type **should be so regulated** that the allowances are not, on the whole, sources of profit to the recipients.

**6. PQR Ltd., a government company, constructed a building in conformity with rules and regulations for installing a telephone exchange but not used for the same purpose resulting in the infructuous expenditure. Considering the above case, explain the type of expenditure audit to be performed to curb the situation. [MTP Nov-21]**

**Propriety audit:** According to 'propriety audit', the auditors try to bring out cases of **improper, avoidable, or infructuous expenditure** even though the expenditure has been incurred in **conformity with the existing rules and**

## Ch-15 Government Audit

regulations. Further, it may so happen that a transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned but may still be highly wasteful.

In the given situation, PQR Ltd. being a government company, constructed a building in conformity with rules and regulations for installing a telephone exchange but not used for the same purpose resulting in an infructuous expenditure.

Thus, propriety audit should be done for PQR Ltd. to bring out improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations to the notice of the proper authorities of wastefulness in public administration.

**7. C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. Explain. [MTP Oct-20]**

**Compile and submit Accounts of Union and States –** C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.

C&AG shall, from accounts compiled by him or [by Government or any other person responsible in that behalf] prepare in each accounts (including, in case of accounts compiled by him, appropriation accounts) showing **under the respective heads the annual receipts and disbursements** for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of UT having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

C&AG Act of 1971 has provisions for relieving him of this responsibility to give information and render assistance to Union and States. C&AG shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

**8. 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. [RTP Nov-20 +MTP Oct-21]**

**Audit against Rules & Orders -** Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder.

It also seeks to satisfy that the expenditure is in accordance with the **financial rules, regulations and orders issued by a competent authority**.

These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

- (i) Rules and orders regulating the powers to **incur and sanction expenditure** from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);

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- (ii) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and
- (iii) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, 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 the orders of, or rules made by, any higher authority; and
- d. in case they have **not been separately approved by competent authority**, the issuing authority possesses the **necessary rule-making power**.

Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C&AG.

**9. The auditor of a Govt Company has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. Explain [RTP Nov-20]**

**Audit of sanctions** - The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. The audit of sanctions is directed both in respect of ensuring that the expenditure is properly covered by a sanction, and also to satisfy that the authority sanctioning it is competent for the purpose by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made thereunder, or by the rules of delegation of financial powers made by an authority competent to do so.

**10. The audit of receipts of government is not as old as audit of expenditure but with the rapid growth of public enterprises audit of receipts tax or non-tax has come to stay. Discuss audit of receipts with respect to Government Audit. [Nov-20]**

Government auditing in India as elsewhere was primarily expenditure- oriented. Gradually, audit of receipts-tax and non-tax was taken up.

The audit of receipts is neither all pervasive nor as old as audit of expenditure but has come to stay in some countries. Such an audit provides for checking;

- (i) whether all revenues or other debts due to government have been **correctly assessed, realised and credited to government account** by the designated authorities;
- (ii) whether **adequate regulations and procedures have been framed** by the department/agency concerned to secure an effective check on assessment, collection and proper allocation of cases;

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- (iii) whether such regulations and procedures are actually being carried out;
- (iv) whether adequate checks are imposed to ensure prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or wilful omission or negligence to levy or collect taxes or to issue refunds; and
- (v) review of systems and procedures to see that the internal procedures adequately secure correct and regular accounting of demands collection and refunds and pursuant of dues up to final settlement and to suggest improvement. The basic principle of audit of receipts is that it is more important to look at the general than on the particular, though individual cases of assessment, demand, collection, refund, etc. are important within the area of test check. A review of the judicial decisions taken by tax authorities is done to judge the effectiveness of the assessment procedure.
- (vi) The extent and quantum of audit required to be done under each category of audit are determined by the C&AG. These are neither negotiable nor questioned. The prescribed extent and quantum of audit are structured in accordance with the design of test check, random sampling, general review, in-depth study of specified areas, etc. as may be warranted by the nature of transactions, its importance in the scheme of activities of a department and the totality of its transactions, the frequency of check and total plan of audit to be executed during a period.
- (vii) Institutional mechanism provides for primary check by the auditor, test check by the supervisor and control and direction by the group leader. Planning, executing and reporting of work is directed and monitored at middle and top levels of the audit hierarchy. There are built-in arrangements within the C&AG to ensure that the work assigned to each employee is carried out as prescribed.
- (viii) The audit is conducted both centrally where accounts and original vouchers are kept and locally where the drawing and disbursing functions are performed depending on the organisational and institutional arrangements obtaining.

**11. Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. Explain [RTP May-21]**

- ✓ Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end.
- ✓ The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration.
- ✓ In India, the function of Government Audit is discharged by the independent statutory authority of the Comptroller and Auditor General through the agency of the Indian Audit and Accounts Department.
- ✓ Audit is a necessary function to ensure accountability of the executive to Parliament, and within the executives of the spending agencies to the sanctioning or controlling authorities. The purpose or objectives of audit need to be tested at the touchstone of public accountability.
- ✓ The Comptroller and Auditor General (C&AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.

**12. 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. [Dec-21]**

**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:-

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- (i) to ascertain whether the **Regulations** governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.
- (ii) to bring to the notice of the government any **deficiencies** in quantities of stores held or any defects in the system of control.
- (iii) to verify that the **purchases are properly sanctioned**, made economical and in accordance with the Rules for purchase laid down by the competent authority.
- (iv) to ensure that the **prices paid are reasonable and are in agreement** with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.
- (v) to **check the accounts** of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding.

Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

## Ch-16 Audit of Co-operative Societies

### Test Your Understanding

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.

The society is in nature of Multi-state cooperative society as it serves interests of members in more than one state. It accepts small savings from its members and grants loan to members. As per Multi-State Co-operative Society Rules 2002, every Multi-State Co-operative society shall keep books of account with respect to:-

- all sum of money received and expended and matters in respect of which the receipt and expenditure take place
- the assets and liabilities

### MCQ

The appointment of first auditor of a multi-state cooperative society is made by:-

- Central Registrar
- Board of society
- Members of society
- Central Government

### Past Exams/RTPs/MTPs/SM Questions

1. You are appointed as an auditor of co-operative society. State the special features of the co-operative audit to be borne in mind by the auditor, concerning:

- Audit classification of society.
- Discussion of draft audit report with the management committee.

[Nov-20]

(1) Audit classification of society - After a judgement of an overall performance of the society, the auditor has to award a class to the society. This judgement is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.

(2) Discussion of draft audit report with managing committee – On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit draft report. The audit report should never be finalised without discussion with the managing committee. Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

2. Central Govt. hold 55% of the paid up share Capital in Kisan Credit Co-operative Society, which is incurring huge losses. Advise when the Central Government can direct Special Audit under Section 77 of the Multi State Co-operative Society Act. [May-19 + MTP Apr-23]

Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi-State co-operative society. Under section 77 of the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:

- 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
- 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
- that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

## Ch-16 Audit of Co-operative Societies

Thus, in the given case since Central Govt is holding 55% shares and financial position of Kisan Credit co-operative society is in danger, Central government can direct for special audit.

### 3. Briefly explain the provisions for qualification and appointment of Auditors under the Multi- State Co-operative Societies Act, 2002. [Nov-18 + MTP Apr-21]

**Qualification of Auditors** - Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of Multi-State co-operative society.

However, the following persons are not eligible for appointment as auditors of a Multi-State co-operative society-

- 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 the 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.

If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be deemed to have vacated his office as such.

**Appointment of Auditors** - Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this sub-section, the Multi- State co-operative society in the general meeting may appoint the first auditor or auditors.

The subsequent auditor or auditors are appointed by Multi-State co-operative society, at each annual general meeting. The auditor or auditors so appointed shall hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

### 4. As per Multi-state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account. Explain [RTP May-20]

As per sub-section (3) & (4) of section 73 of Multi- state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co- operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

- (a) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and
- (b) In the case of the profit and loss account, of the profit or loss for its financial year.

## Ch-16 Audit of Co-operative Societies

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.

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.

### 5. Explain the powers and duties of auditors under the Multi-State Co-operative Societies Act, 2002.

[RTP May-20]

Section 73 of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors. According to this, every auditor of a Multi-State co-operative society shall have a right of access at all times to the books accounts and vouchers of the Multi-State co-operative society, whether kept at the head office of the Multi-State co-operative society or elsewhere, and shall be entitled to require from the officers or other employees of the Multi-State co-operative society such information and explanation as the auditor may think necessary for the performance of his duties as an auditor.

As per section 73(2), the auditor shall make following inquiries:

- (a) Whether loans and advances made by the Multi-State co-operative society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State co-operative society or its members,
- (b) Whether transactions of the Multi-State co-operative society which are represented merely by book entries are not prejudicial to the interests of the Multi-State co-operative society,
- (c) Whether personal expenses have been charged to revenue account, and
- (d) Where it is stated in the books and papers of the Multi-State co-operative society that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct regular and not misleading.

### 6. No inspection under Section 79 of Multi-State Co-operative Societies Act, 2002 shall be made unless a notice has been given to the multi-state co-operative society. Explain stating clearly when and how such inspection can be made. Also state the powers available with the Central Registrar in this regard along with provisions relating to communication of the inspection report under the said section. [RTP May-22]

## Ch-16 Audit of Co-operative Societies

### Inspection of Multi-State Co-operative societies under Section 79

**1. When:** The Central Registrar may, on a request from

- (i) federal co-operative to which a Multi-State Co-operative society is affiliated or a creditor or
- (ii) not less than one-third of the members of the board or
- (iii) not less than one-fifth of the total number of members of a Multi-State co-operative society

**2. How:** By general or special order in writing in this behalf inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into the constitution, working and financial condition of a Multi-State co-operative society.

**3. Opportunity of Being heard:** No inspection shall be made unless a notice of not less than fifteen days has been given to the multi-state co-operative society.

**4. Powers available:** The Central Registrar or the person authorized by him shall have the following powers:

- (a) He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, take them into custody and shall have power to verify the cash balance of the society and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary.
- (b) Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.

**5. Inspection Report:** A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection.

**7. Before holding inquiry by the Central Registrar thirty days' notice must be given to the Multi-State co-operative society. [RTP May-22]**

**Incorrect:** Before holding inquiry by the Central Registrar fifteen days' notice must be given to the Multi-State co-operative society.

**8. The first auditor of a Multi-State co-operative Society will be appointed in Annual General Meeting. [July-21]**

**Incorrect:** Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this sub-section, the Multi-State Co-operative Society in the general meeting may appoint the first auditor or auditors.

## Ch-17 Other Special Audits

### Audit of Local Bodies

#### 1. Draft an Audit Programme for conducting Audit of Local Bodies. [MTP Nov-23]

##### Audit Programme for Local Bodies

(i) **APPOINTMENT**:- The Local Fund Audit Wing of the State Govt. is generally incharge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure his appointment.

(ii) **AUDITOR'S CONCERNS**:- The auditor while auditing the local bodies should report on the

- fairness of the contents and presentation of financial statements,
- the strengths and weaknesses of system of financial control,
- the adherence to legal and/or administrative requirements;
- whether value is being fully received on money spent.

His objective should be to detect errors and fraud and misuse of resources.

(iii) **RULES & REGULATIONS** :- The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.

(iv) **AUTHORISATIONS** :- He should ensure that all types of sanctions, either special or general, accorded by the competent authority.

(v) **PROVISIONING** :- He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.

(vi) **PERFORMANCE** :- The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

2. It would be imminent on the part of the auditor to understand financial administration of local bodies before embarking upon the audit. Explain.

##### Financial Administration

It would be imminent on the part of the auditor to understand financial administration of local bodies before embarking upon the audit. Some of the aspects are as under:

(a) **Budgetary Procedure**: This is geared to subserve the twin considerations of financial accountability and control of expenditure. The main objective is to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the legislature or council. Budget preparation is usually the occasion for determining the levels of taxation and rates and the ceilings on expenditure. Municipal budget formats and heads of accounts vary from state to state. There are variations between the corporation and municipalities. One important feature of the municipal budgets is that there is no strict separation between revenue and capital items; usually there is a 'head' called extraordinary items which cover most of the capital transactions. There are, however, a number of special funds (e.g. roads) or in some cases separate budgets for specific municipal functions (e.g. education) or enterprise activities (e.g., water supply and sanitation, transport, electricity, etc.)

## Ch-17 Other Special Audits

**(b) Expenditure Control:** The system of financial control existing in the state and central government level is conditioned by the fact that there is a clear demarcation between the legislature and executive. The integration of legislation and executive powers in the municipal council makes it difficult for its executive to function as its inquisitorial body as well. Moreover the separation of executive powers and functions in municipal government cannot accommodate the existence of an independent finance officer responsible to the municipal council or its executive committee. This leaves the system of external audit by state government as the only instrument of controlling municipal expenditure.

**(c) Accounting System:** Municipal accounting and budget format have been criticised as neither simple nor comprehensible, sometimes providing inadequate information and at other times a surfeit of information. Both these situations are not conducive to a proper system of management information.

### 3. List out the types of Revenue Grants received by local bodies from the State. [MTP Nov-21 + Nov-20]

Local bodies may receive different types of grants from the state administration. Broadly the revenue grants are of three types:

1. **General purpose grants:** These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.
2. **Specific purpose grants:** These grants which are tied to the provision of certain services or performance of certain tasks.
3. **Statutory and compensatory grants:** These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

### 4. The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. Explain stating important objectives of audit of such bodies. [RTP Nov-21] OR

Local Fund Audit Wing of a State of a State Government has appointed you to audit the accounts of one of the Local body governed by it. As an auditor, what will be your reporting areas? [Dec-21]

The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. However, the municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit.

The important objectives of audit are:

- (a) reporting on the **fairness of the content and presentation** of financial statements;
- (b) reporting upon the **strengths and weaknesses** of systems of financial control;
- (c) reporting on the **adherence to legal and/or administrative requirements**;
- (d) reporting upon whether **value** is being fully received on money spent; and
- (e) detection and prevention of **error, fraud and misuse of resources**.

### 5. CA Sevak is appointed as an auditor of a Municipal Corporation of a big smart city. He wants to verify various expenditures of the Municipality. Define the term "Municipality" and state what are the heads under which expenditures incurred by the Municipalities and Corporations can be broadly classified? [Nov-22]

## Ch-17 Other Special Audits

A Municipality can be defined as a unit of local self-government in an urban area. By the term 'local self-government' is ordinarily understood the administration of a locality – a village, a town, a city or any other area smaller than a state – by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.

Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads:

- (a) general administration and revenue collection,
- (b) public health,
- (c) public safety,
- (d) education,
- (e) public works, and
- (f) others such as interest payments.

7. The external control of municipal expenditure is exercised by the Central Government through the appointment of auditors to examine municipal accounts.

**Incorrect.** The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts.

8. The audit of municipal corporation of a large metro city is in progress. Which of the following is not likely an objective of such as audit?

- (a) To report on the adherence to legal and administrative requirements
- (b) To report on whether value is being fully received for money spent
- (c) To report on the weakness of systems of financial control
- (d) To provide better civic amenities to residents of metro city

Ans (d)

### *Audit of NGOs*

1. As an Auditor of NGO, how do you check/verify atleast four receipts of income during the year?

[Jan-21 + MTP Apr-23]

The receipt of income of NGO may be checked on the following lines:

(i) **Contributions and Grants for projects and programmes:** Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.

(ii) **Receipts from fund raising programmes:** Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

(iii) **Membership Fees:** Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.

## Ch-17 Other Special Audits

(iv) **Subscriptions:** Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine/ circulars/periodicals. Check the receipts with subscription rate schedule.

(v) **Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.

2. While planning the audit of an NGO, the auditor may focus on Knowledge of the NGO's work, its mission and vision, Updating knowledge of relevant statutes especially with regard to recent amendments, circulars etc. Explain the other relevant points the auditor needs to focus while planning the audit of NGO. [RTP Nov-21]

While planning the audit, the auditor may concentrate on the following:

- (i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operates.
- (ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 1976, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.
- (iii) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.
- (iv) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
- (v) Examination of minutes of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.
- (vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
- (vii) Setting of materiality levels for audit purposes.
- (viii) The nature and timing of reports or other communications.
- (ix) The involvement of experts and their reports.
- (x) Review the previous year's Audit Report.

3. 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 two points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations. [MTP Mar-19]

### Receipt of Donations:

- (i) **Internal Control System:** Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.
- (ii) **Custody of Receipt Books:** Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.
- (iii) **Receipt of Cheques:** Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.
- (iv) **Bank Reconciliation:** Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.

## Ch-17 Other Special Audits

- (v) **Cash Receipts:** Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.
- (vi) **Foreign Contributions,** if any, to receive special attention to compliance with applicable laws and regulations.

### Remittance of Donations to Different NGOs:

- (i) **Mode of Sending Remittance:** All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.
- (ii) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.
- (iii) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.
- (iv) **Direct Confirmation Procedure:** Send confirmation letters to entities to whom donations have been paid.
- (v) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.
- (vi) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.

4. The audit programme of NGO should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted. Explain. [MTP Mar-21]

- (i) **Corpus Fund:** The contributions / grants received towards corpus be vouched with special reference to the letters from the donor(s). The interest income be checked with Investment Register and Physical Investments in hand.
- (ii) **Reserves:** Vouch transfers from projects / programmes with donors letters and board resolutions of NGO. Also check transfer of gross value of asset sold from capital reserve to general reserve and adjustments during the year.
- (iii) **Ear-marked Funds:** Check requirements of donors institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.
- (iv) **Project / Agency Balances:** Vouch disbursements and expenditure as per agreements with donors for each of the balances.
- (v) **Loans:** Vouch loans with loan agreements, counterfoil of receipt issued.
- (vi) **Fixed Assets:** Vouch all acquisitions / sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/ agreements for the grant. In the case of immovable property check title, etc.
- (vii) **Investments:** Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis - investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.
- (viii) **Cash in Hand:** Physically verify the cash in hand and imprest balances, at the close of the year and whether it tallies with the books of account.
- (ix) **Bank Balance:** Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.
- (x) **Inventory:** Verify inventory in hand and obtain certificate from the management for the quantities and valuation of the same.
- (xi) **Programme and Project Expenses:** Verify agreement with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.

## Ch-17 Other Special Audits

(xii) **Establishment Expenses:** Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

**5. Non-Governmental Organisations (NGOs) registered under the Companies Act, 2013 are allowed to maintain accounts either on accrual basis or cash basis. [MTP Oct-21]**

**Incorrect:** NGOs registered under the Companies Act, 2013 must maintain their books of account under the accrual basis as required by the provisions of section 128 of the said Act. If the accounts are not maintained on accrual basis, it would amount to non-compliance of the provision of the Companies Act, 2013. The NGOs which are not registered under the Companies Act, 2013 are allowed to maintain accounts either an accrual basis or cash basis.

**6. NGOs may be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives.**

**Correct.** NGOs can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, managing disasters and emergent situations

**7. "Save Democracy" is an NGO working in cause of promoting democracy and democratic institutions in many countries including India. Its Indian counterpart has received funds from a renowned "Flower Trust" of US. As auditor of NGO, which of the following laws/orders would be relevant to you in context of above information?**

- (a) Income Tax Act, 1961
- (b) Foreign Contribution Regulation Act, 2010
- (c) Companies Act, 2013
- (d) Orders issued by Ministry of Social Justice and Empowerment

### *Audit of Partnership Firm*

**1. Discuss the matters which should be specially considered in the audit of accounts of a partnership.**

[RTP May-19]

**Matters which should be specially considered in the audit of accounts of a partnership:**

- (i) Confirming that the **letter of appointment**, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.
- (ii) Studying the **minute book**, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans; purchase of assets, extraordinary contracts entered into and other such matters as are not of a routine nature.
- (iii) Verifying that the **business in which the partnership is engaged is authorised** by the partnership agreement; or by any extension or modification thereof agreed to subsequently.
- (iv) Examining whether **books of account appear to be reasonable** and are considered adequate in relation to the nature of the business of the partnership.
- (v) Verifying generally that the **interest of no partner has suffered prejudicially** by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.
- (vi) Confirming that a **provision for the firm's tax payable** by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.

## Ch-17 Other Special Audits

(vii) Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

### 2. State six important advantages of audit of accounts of a Partnership firm. [MTP Apr-19 + RTP Nov-23]

On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows:

1. Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated. On this consideration, it is usually provided in and accepted by the partners, shall be binding upon them, unless some manifest error is brought to light within a specified period subsequent to the accounts having been signed.
2. On the **retirement or death of a partner**, audited accounts, which have been accepted by the partners, constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.
3. The accounts of a partnership, which have been audited, are **generally accepted by the Income Tax Department** as the basis for computing the assessable income of the partners.
4. Audited statement of accounts are **relied upon by the banks** when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.
5. Audited statements of account can be **helpful in the negotiations** to admit a person as a partner, especially when they are available for a number of past years.
6. An audit is an **effective safeguard** against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

### 3. CA Akash Virmani is auditor of a partnership firm consisting of 4 partners. During the year, one of the partners has retired and another partner has joined the next day. Discuss, any one point, which shall be considered by you to ensure that financial statements of firm are not misstated due to change of constitution of firm.

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.

## Audit of LLP

### 1. Tomo Construction Engineering LLP approached CA K to understand various returns to be maintained and filed by them. Guide/Discuss the various returns to be maintained and filed by them. [July-21]

#### Returns to be maintained and filed by an LLP:

- Every LLP would be required to file **annual return in Form 11** with ROC within 60 days of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.
- Every LLP is also required to submit **Statement of Account and Solvency in Form 8** which shall be filed within a period of thirty days from the end of six months or the financial year to which the Statement of Account and Solvency relates.

### 2. The accounts of every LLP shall be audited in accordance with rule 24 of LLP Rules 2009. [May-19]

**Incorrect-** Rule 24 of LLP Rules 2009 provides that any LLP, whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty five lakh rupees, is not required to get its accounts audited. However if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rules.

## Ch-17 Other Special Audits

3. Ban LLP is formed during the year 2021-22. They are not sure about 4 the type of books of accounts to be maintained. What are the books of accounts that the LLP is required to maintain? [Nov-22]

LLP's are required to maintain books of accounts which shall contain

1. Particulars of all sums of money received and expended by the LLP and the matters in respect of which the receipt and expenditure takes place,
2. A record of the assets and liabilities of the LLP,
3. Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,
4. Any other particulars which the partners may decide.

4. The auditor of an LLP may be appointed by the Designated Partners or other Partners whosoever is available at the time of appointment. [SM]

**Incorrect-** The auditor is to be appointed by the designated partners of the LLP. However, the Partners may appoint the auditors only if the Designated Partners have failed to appoint them.

5. An LLP files compliance returns with: -

- (a) Registrar of firms & societies
- (b) Central Registrar
- (c) Registrar of Companies
- (d) Local fund audit wing

Ans (c)

### *Audit of Charitable Institutions*

1. 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. [Dec-21]

**Audit Procedure in audit of Subscriptions & donations:**

Audit Procedure to be undertaken by CA A in respect of Subscriptions and donations received by a Charitable Institution is:

- (i) Ascertaining, if any, the changes made in amount of **annual or life membership subscription** during the year.
- (ii) Whether **official receipts** are issued;
  - (a) confirming that adequate control is imposed over **unused receipt books**;
  - (b) obtaining all receipt books covering the **period under review**;
  - (c) test checking the counterfoils with the cash book; any **cancelled receipts** being specially looked into;
- (d) obtaining the **printed list of subscriptions and donations** and agreeing them with the total collections shown in the accounts;
- (e) examining the **system of internal check** regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and
- (f) verifying the total subscriptions and donations received with any **figures published in reports**, etc. issued by the charity.

2. In the case of audit of a charitable institution, what attentions should be paid by the auditor regarding audit of expenditure items? [RTP Nov-20 + May-23]

## Ch-17 Other Special Audits

### Audit of Expenditure of Charitable Institution:

- (i) Vouching payment of grants also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and that no trustee, director or member of the management committee has benefited there from either directly or indirectly.
- (ii) Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test basis.
- (iii) Check payment along with supporting documents in regard to salary and other expenses. Verify that all payments are made after proper sanction by appropriate authority.
- (iv) Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.
- (v) Verifying the cash and bank balances/payments.

### *Audit of Educational Institutions*

*(SCHOOL, COLLEGE OR UNIVERSITY)*

1. What are the special steps involved in conducting the audit of an Educational Institution? (Write any 12 points)  
[RTP Nov-19]

The Special Steps Involved in the Audit of an Educational Institution are the following:

- (i) Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.
- (ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

### Tuition Fees [MTP Mar-21]

- (iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.
- (iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
- (v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
- (vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.
- (vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.
- (viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.
- (ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.
- (x) Verify rental income from landed property with the rent rolls, etc.
- (xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

## Ch-17 Other Special Audits

(xii) Verify any **Government or local authority grant** with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.

**2. 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. [July-21]**

### Verification of Assets & Liabilities of VJM Schools:

1. Report any **old heavy arrears** on account of fees, dormitory rents, etc. to the Managing Committee.
2. Confirm that **caution money and other deposits paid by students on admission**, have been shown as **liability** in the balance sheet and not transferred to revenue, unless they are not refundable.
3. See that the **investments representing endowment funds for prizes** are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.
4. Ascertain that the **system of ordering & inspection** on receipt and issue of provisions, food stuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
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.

**3. You are auditor of a school operating in your city. During audit of a year, it is noticed that fees concessions to students have been provided in substantial number of cases. Discuss, how, you as an auditor, would proceed to verify the same?**

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.

## *Audit of Hospital*

**1. M/s T & Co. Chartered Accountants**, a partnership firm, is appointed as an auditor of Treatment Hospital run by Smile Foundation, a charitable trust. Over and above the receipts of treatment of patients, during the year trust has received donations from various donors to treat COVID-19 patients and also incurred some capital expenditure for further development of the hospital. On some of the investment income, income tax has been deducted. What are the special points to be considered by M/s T & Co. while auditing such transactions of Treatment Hospital? [May-22]

### Audit of a Hospital:

#### (A) Receipts from treatment of patients

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

**(B) Donations from donors to treat the patients:** Ascertain those legacies and donation received for a specific purpose have been applied in the manner agreed upon.

**(C) Capital Expenditure Incurred:** Verify the Capital Expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee.

(D) Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax. This involves:

- (i) vouching the Income-tax refund with the correspondence with the Income-tax Department; and
- (ii) checking the calculation of the repayment of claims/refund claim.

2. You have been appointed auditor of M/s. BLK Hospital. Discuss important points that would attract your attention while audit. [MTP Apr-22]

## AUDIT OF HOSPITAL

The important points involved in such an audit are stated below-

- (i) **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.
- (ii) **Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence. For eg. copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills etc.
- (iii) **Income from Investments, Rent etc.:** See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends and interest on securities have been collected.
- (iv) **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
- (v) **Reconciliation of Subscriptions:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).
- (vi) **Authorisation and sanctions:** Vouch all purchases and expenses and verify that the capital expenditure incurred only with the prior sanction of the trustees of the Managing Committee and that appointments and increments to staff have been duly authorised.
- (vii) **Grants and TDS:** Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.
- (viii) **Budgets:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.
- (ix) **Internal Check:** Examine the internal check as regards the receipt and issue of stores, medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.
- (x) **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.
- (xi) **Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.
- (xii) **Inventories:** Obtain inventories, especially of stocks and stores as at the end of the year and check the percentage of the items physically, also compare their total values with respective ledger balances.
- (xiii) **Management Representation and Certificate:** Get proper Management Representation and Certificate with respect to various aspects covered during audit.

## Ch-17 Other Special Audits

### *Audit of Club*

You have been appointed as internal auditor of 'City Club' in Delhi. The receipts of the club were 50 lakhs during the previous year ending 2019-20. You are required to mention special points of consideration while auditing such receipts of the club. [Jan-21]

The special steps involved, to be considered by the Internal Auditor of City Club in conducting the audit of receipts of the club are stated below:-

- a. 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.
- b. 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.
- c. 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.
- d. Check totals of various columns of the Register of members and tally them across.
- e. 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.
- f. 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.

### *Audit of Cinema*

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?

[RTP Nov-22 + Nov-22]

**Audit of Cinema:** The special steps involved in the audit of receipts from sale of tickets are stated below-

- (i) Verify that entrance to the cinema-hall during show is only through printed tickets;
- (ii) Verify that they are serially numbered and bound into books
- (iii) Verify that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially
- (iv) Verify that for advance booking a separate series of tickets is issued;
- (v) Verify that the inventory of tickets is kept in the custody of a responsible official.
- (vi) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.
- (vii) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.
- (viii) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class.
- (ix) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

## Ch-17 Other Special Audits

### *Audit of Hire Purchase & Leasing Companies*

#### 1. Define the different types of lease agreements as per Accounting Standard/Ind-AS. [May-19]

AS-19/ Ind-AS 17 defines that lease arrangements could be of 2 types i.e.

- (i) Finance Lease and
- (ii) Operating Lease.

##### **Finance Lease:**

An arrangement with the following attributes qualifies as a Finance Lease:

The lease arrangement transfers ownership of the asset to the lessee at the end of the lease term;

- Lessee has **option to purchase asset at a price that is expected to be sufficiently lower than fair value at the date option becomes exercisable** for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- The **lease term is for the major part of the economic life** of the asset even if title is not transferred;
- At the inception of the lease, the **present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset**; and
- the leased assets are of such a **specialized nature** that only the lessee can use them without major modifications

Operating Lease.

An arrangement that does not transfer substantially all the risks and rewards incidental to ownership qualifies as an Operating Lease.

In other words, an operating lease is a lease arrangement "Other than finance lease".

#### 2. An Operating Lease is a kind of Financing arrangement. [SM]

**Incorrect-** A Finance Lease is a Financing arrangement. An Operating lease, on the other hand, is a simple arrangement where, in return for rent, the lessor allows the lessee to use the asset for a certain period.

#### 3. ABC Ltd. wants to buy some equipment on lease and hence is required to sign lease agreement with the supplier of the equipment. What are the important points to be considered in the lease agreement?

The important points to be examined in the lease agreement are:

- (i) the **description of the lessor, the lessee, the equipment** and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).
- (ii) the amount of **tenure of lease, dates of payment, late charges, deposits or advances etc.** should be noted.
- (iii) whether the **equipment shall be returned to the lessor** on termination of the agreement and the cost shall be borne by the lessee.
- (iv) whether the **agreement prohibits the lessee from assigning the subletting the equipment** and authorises the lessor to do so.

1. You have been appointed as an auditor of ABC Hotel, a three star hotel, for Financial Year 2021-22. As an auditor what are the special points that need to be considered in verifying the Inventories in the nature of food and beverages? [RTP Nov-22 + MTP Mar/Nov-23]

**Verification of inventories in the nature of food and beverages:** Inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores' areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed.

Therefore, following points may be noted in this regard:

- a. All movement and transfer of inventories must be properly documented.
- b. Areas where inventories are kept must be kept locked and the key retained by the departmental manager.
- c. The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.
- d. Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.
- e. 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.

2. Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. Explain. [RTP May-22 + MTP Nov-23]

Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will minimise the leakage as far as possible. Evidence of their success 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. The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.

The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order.

The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities. If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts. As a result, the scope of his audit tests will necessarily be increased and, in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.

## Ch-17 Other Special Audits

3. An auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts in the case of audit of a Hotel. [SM]

**Correct-** The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts for proper recording of closing and opening entries and maintenance of accounts on Accrual basis as per the Matching concept.

4. Explain and also state the role of auditor with respect to the following in case of a hotel:

Travel agents & shops [MTP Mar-23]

- (i) For ledgers coming through travel agents or other booking agencies the bills are usually made on the travel agents or booking agencies. The auditor should ensure that money are recovered from the travel agents or booking agencies as per the terms of credit allowed.
- (ii) Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.

5. As an auditor, explain the areas of consideration while auditing the element of ROOM SALES during the audit of a 5-Star Hotel. [MTP Apr-23]

Following points merit consideration while auditing the element of ROOM SALES during the audit of a Hotel:-

- (1) The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor.
- (2) The source of these entries is the guest register and audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period.
- (3) Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.
- (4) In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room. This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill.
- (5) Ensure compliance with the provisions of FEMA and RBI if receipts are in foreign currency. Ensure application of proper Conversion rate.
- (6) Special emphasis to be laid on receipts through Credit Cards.
- (7) The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.

### Test Your Understanding

1. A company is engaged in manufacturing of fabrics from yarn purchased from different suppliers. Occasionally, it also manufactures fabrics tailor made in accordance with requirements of certain mills from yarn received from these mills. The company raises bill of its labour charges only on mills for converting yarn into fabrics. The auditor of company tries to ensure that stocks of the company as at year end do not include stocks pertaining to these mills. Which assertion auditor tries to verify in above situation? How he can ensure that?

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**.

2. A company has availed cash credit facility of ₹ 2 crore (O/s balance ₹ 2 crore as at year end) from a bank for meeting its working capital requirements against security of stocks and debtors and guaranteed by directors of the company. Discuss, how the above cash credit facility, would be classified and disclosed in financial statements of company.

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.

3. Various ratios of current year and preceding year are disclosed in financial statements of a company in accordance with requirements of Schedule III of Companies Act, 2013. Discuss requirements of law in this regard (Do not list out names of ratios)

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**.

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

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.

5. While verifying depreciation charged to statement of profit and loss account of a company, it is noticed by auditor that one new machinery was purchased and installed in month of April. The necessary trials were carried out and machinery was ready for use in April itself. However, owing to lack of orders in the market, the said machinery was put into actual operation from 1st October. The company has, accordingly, provided depreciation

## Ch-18 Audit of Items of FS

in its books on this machinery w.e.f. 1st October. Is above recording of depreciation by company proper in its books?

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.

### 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:

- Current maturities to long term borrowings
- Long term maturities of finance lease obligations
- Interest accrued but not due on borrowings

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- Interest accrued and due on borrowings

Based on the above facts, 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

1. c 2. d 3. c 4. b 5. a

### MCQs based Questions

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

1. a 2. c 3. c 4. c 5. b

**Correct/Incorrect**

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

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

**Incorrect:** Employee benefits expenses, commonly called payroll expenses, represent the aggregate sum an entity pays to its employees for their labour/ efforts, as well as associated expenses such as perquisites/ benefits, postemployment benefits like gratuity, superannuation, leave encashment, provident fund contribution etc. as well as towards their hiring, their welfare and training.

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

**Incorrect:** Dividends are recognised in the statement of profit and loss only when:

- (i) the entity's right to receive payment of the dividend is established;
- (ii) it is probable that the economic benefits associated with the dividend will flow to the entity; and
- (iii) the amount of the dividend can be measured reliably

3. "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a premium or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

**Incorrect:** "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called

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

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

5. A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised.

**Correct:** A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But the amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.

6. If Company X's balance sheet shows building with carrying amount of ₹ 100 lakh, the auditor shall assume only one point that the management has only asserted that the building recognized in the balance sheet exists as at the period-end.

**Incorrect:** If Company X's balance sheet shows building with carrying amount of ₹ 100 lakh, the auditor shall assume that the management has claimed/ asserted that:

- The building recognized in the balance sheet exists as at the periodend (existence assertion);
- Company X owns and controls such building (Rights and obligations assertion);
- The building has been valued accurately in accordance with the measurement principles (Valuation assertion);

All buildings owned and controlled by Company X are included within the carrying amount of ₹ 100 lakh (Completeness assertion).

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

**Incorrect:** Material and Wages incurred on construction of building qualify to be capital expenditure as per AS 10 "Plant, Property and Equipment". Therefore, these have to be added to the cost of the asset i.e building and shall not be expensed off to Statement of Profit and Loss.

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

**Incorrect:** Depreciation is a fall in value of asset due to obsolescence, usage and effluxion of time, Therefore, depreciation is charged when the asset is ready for use . Active use of asset is not a mandatory criteria for charge of depreciation.

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

**Incorrect:** Increase in Authorised capital requires alteration of capital clause of memorandum of Association. Therefore, ordinary resolution is passed for increase in authorised capital of the company as per the Companies Act, 2013.

### 10. Capital redemption reserve can be used for distribution of dividends.

**Incorrect:** Capital Redemption reserve is not a free reserve. It is a restrictive reserve and can be used only for purposes given in the Act. Since it is not a free reserve, it cannot be utilised for payment of dividends. CRR can be used only for the purpose of issuing fully paid up bonus shares.

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

**Correct:** The dividends are recommended by the Board of Directors by passing a resolution at the board meeting. The Shareholders declare the dividends at the AGM by passing an ordinary resolution. Declaration of dividend is an item of ordinary business. However, the shareholders can decrease the amount of dividends recommended by the board but cannot increase it.

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

**Correct:** While auditing trade receivable balance, direct confirmations as per SA 505, is considered to be the most important audit activity. Direct confirmation can be sought from the debtors directly confirming their balance due. The replies to the confirmation can be then matched with the records maintained by the client. Any discrepancies so revealed, can be investigated and checked in detail for possibility of any risk of material misstatement. Auditor selects few debtors' balances and ask the client to prepare the confirmations properly addressed to the debtors. Auditor maintains strict control over this process.

#### SM Questions

##### 1. How will you vouch and/or verify the following:

- (a) Goods sent out on Sale or Return Basis.
- (b) Borrowing from Banks.

(a) The audit procedure generally required to be undertaken by the auditor while auditing Goods sent out on Sale or Return Basis is as under:

- (i) Check whether a **separate memoranda record** of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
- (ii) Verify that **price of such goods is unloaded** from the sales account and the trade receivables record. Check the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

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- (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.

### 2. How will you vouch/verify the following:

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

#### **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.

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- (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.

### 3. Explain how you will verify the items given while conducting an audit of an entity :

- (a) Payment of Taxes
- (b) Sale proceeds of scrap material
- (c) Advertisement Expenses.

#### Payment of Taxes:

- (i) Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the received challan.
- (ii) Payments or advance payments of income-tax should also be verified with the notice of demand and the received challan acknowledging the amount paid.
- (iii) The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.

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- (iv) Nowadays, **electronic payment of taxes** is also in trend. Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards.
- (v) The entity can make electronic payment of taxes also from the account of any other person. However, the **challan for making such payment must clearly indicate the Permanent Account Number (PAN)** of the assessee on whose behalf the payment is made. This should be checked by the auditor.
- (vi) It is not necessary for the entity to make payment of taxes from his own account in an authorized bank. While vouching such e-payment, the auditor should **cross verify the payments of taxes through the received challan along with PAN No /TAN No. etc.**

### Sale Proceeds of Scrap Material:

- (i) Review the **internal control** on scrap materials, as regards its generation, storage and disposal and see whether it was properly followed at every stage.
- (ii) Ascertain whether the organisation is maintaining **reasonable records** for the sale and disposal of scrap materials.
- (iii) Review the **production and cost records** for determination of the extent of scrap materials that may arise in a given period.
- (iv) Compare the **income from the sale of scrap materials** with the corresponding figures of the preceding three years.
- (v) Check the **rates** at which different types of scrap materials have been sold and compare the same with the rates that prevailed in the preceding year.
- (vi) See that scrap materials sold have been **billed and check the calculations on the invoices**.
- (vii) Ensure that there exists a **proper procedure to identify the scrap material** and good quality material is not mixed up with it and sold as scrap
- (viii) Make an **overall assessment of the value of the realisation from the sale of scrap materials** as to its reasonableness

### 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.

4. 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.

**Shares Issued at Premium:** In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the means in which the amount in the account can be applied. As per the section, where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account" and the provisions of this Act relating to

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reduction of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.

**Application of securities premium account:** The securities premium account may be applied by the Company:

- towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
- in writing off the preliminary expenses of the Company;
- in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
- in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
- 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

**5. The auditor has to ensure whether PPE has been valued appropriately and as per generally accepted accounting policies and practices and also the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements . Explain how the auditor will verify the same.**

[MTP Nov-22 + Dec'21] **OR**

CA Mehta is statutory auditor of ABC Ltd. While performing testing of additions during the year, he wanted to verify that:

- All PPE (property, plant and equipment) are in the name of the entity he is auditing.
- For all additions to land and building in particular, auditor desires to have concrete about the ownership.
- The auditor wants to know whether entity has valid legal ownership rights over PPE, where it is kept as security for any borrowings.

Advise auditor on audit procedure to be undertaken by him to establish Rights and Obligations of entity over the PPE. (3M) [MTP Apr-23]

The auditor has to ensure whether PPE has been valued appropriately and as per generally accepted accounting policies and practices.

The value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of PPE would be shown at higher amounts.

**The auditor should:**

- Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non- depreciable like freehold land;
- Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 - Impairment of Assets.

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To verify whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements

- In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity.
- For all additions to land and building in particular, the auditor should check the conveyance deed/ sale deed to verify whether the entity is the legal and valid owner or not.
- The auditor should insist and verify the original title deeds for all immovable properties held as at the balance sheet date.
- In case the entity has given such immovable 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 immovable property as security.
- In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

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

For Verification of Existence of Trade Receivables, the auditor should check the following :

- i. Check whether there are controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice. Ask for a period-end accounts receivable aging report and trace the balance as per the report to the general ledger.
- ii. Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoice-wise and on FIFO basis i.e. previous bill is adjusted first.
- iii. If any large balance is due for a long time, auditor should ask for reasons and justification for the same.
- iv. A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed.
- v. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.
- vi. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample.
- vii. Where no reply is received, the auditor should perform alternate procedures regarding the balances. This could include:
- viii. Agreeing the balance to cash received subsequently;
- xi. Check that receivables for other than sales or services are not included in the list.

### 7. 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?

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

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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		

8. How is "Cash and cash equivalents" disclosed in the Financial Statements as required under Schedule III (part I) to Companies Act, 2013? [Dec'21 + MTP Mar-23]

**Disclosure of Cash & Cash Equivalent in the Financial Statements:** Regarding Cash and cash equivalents- Ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made:

(i) Cash and cash equivalents shall be classified as:

- (a) Balances with banks;
- (b) Cheques, drafts on hand;
- (c) Cash on hand;
- (d) Others (specify nature)

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as **margin money or security** against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months' maturity shall be disclosed separately

9. Studymate Limited is a company engaged in the manufacture of stationery items. The company sells its goods on credit. The debtors as on 31.03.2024, amounted to ₹ 10 crores. What is the disclosure requirement for the company with respect to the ageing schedule of the trade receivables in terms of Schedule III (Part I) to the Companies Act, 2013?

Trade Receivables ageing schedule

Particulars	O/s for following periods from due date of payment #	Amt (in ₹)					
		Less than 6 months	6 Months- year	1-2 years	2-3 years	More than 3 years	Total
(i) Undisputed Trade receivables –considered good							
(ii) Undisputed Trade Receivables – Considered doubtful							
(iii) Disputed Trade Receivables Considered good							
(iv) Disputed Trade Receivables Considered doubtful							

# similar information shall be given where no due date of payment is specified, in that case disclosure shall be from the date of transaction.

*Unbilled dues shall be disclosed separately.*

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10. 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?

### Capital-Work-in Progress (CWIP)

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

#### CWIP ageing schedule

CWIP	< 1 Year	1-2 years	2-3 years	> 3 years	Total
Projects in Progress					
Projects temporarily suspended					

(b) For CWIP, whose completion is overdue or exceeded its cost compared to original plan, following CWIP completion schedule shall be given:

CWIP	To be completed in:				Total
	< 1 year	1-2 years	2-3 years	> 3 years	
Project 1					
Project 2					

(Details of projects where activity has been suspended to be given separately)

11. 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?

The statutory auditor of Saturn Ltd. should perform the following audit procedures to verify if the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2023. The auditor should:

- vouch recorded purchases to **underlying documentation** (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file).
- evaluate the **consigned goods**.
- examine **client correspondence, sales and receivables records, purchase documents**.
- determine existence of **collateral agreements**.
- review **consignment agreements**.
- review **material purchase commitment agreements**.
- examine **invoices for evidence of ownership** i.e. the invoices shall be in the name of the client.
- obtain confirmation for significant items of inventory.

For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.

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1. What audit points are to be borne in mind in case of issue of "Sweat Equity Shares" by a limited company?  
[MTP Oct-19] OR

S& Co., Chartered Accountants, are appointed as the auditors of ABC Ltd. CA S, the engagement partner, has come across the following while verifying equity share capital of the company:

- (i) He noticed that some of the equity shares are held by promoters.
- (ii) Some shares are issued as sweat equity shares to the employees.

What is the meaning of sweat equity shares? What are the disclosure requirements of such promoter's shareholding? [Nov-22]

**Issue of Sweat Equity Shares:** As per section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares'.

"Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. The auditor may see that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions are fulfilled-

- (a) The issue is authorized by a **special resolution** passed by the company;
- (b) The **resolution specifies the number of shares**, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;
- (c) **Not less than one year** has, at the date of such issue, elapsed since the date on which the company had commenced business; and
- (d) Where the equity shares of the company are listed on a recognized stock exchange, the sweat equity shares are issued in accordance with the **regulations made by the Securities and Exchange Board** in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

The rights, limitations, restrictions and provisions as are for the time being applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank paripassu with other equity shareholders.

Shares held by promoters at the end of the year				% Change during the year***
S No.	Promoter Name	No. of shares	% of total shares**	

\* Promoter here means promoter as defined in the Companies Act, 2013.

\*\* Details shall be given separately for each class of shares.

\*\*\* percentage change shall be computed with respect to the number at the beginning of the year or if issued during the year for the first time then with respect to the date of issue.]

2. BNP Ltd has reduced its Share Capital to a greater extent in the year for which you are conducting the audit. State how will you proceed for verifying the reduction of Capital. [MTP Oct-20]

### Reduction of Capital

For verifying reduction of capital, the auditor needs to undertake the following procedures:

- (i) Verify that meeting of shareholders held to pass **special resolution** was properly convened and that proposal was circularized in advance to all the shareholders;
- (ii) Verify that the **Articles of Association** authorises reduction of capital;

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- (iii) Examine the **order of the Tribunal** confirming the reduction and verify that a copy of the order and the minutes have been registered and filed with the Registrar of Companies;
- (iv) Check the **Registrar's Certificate** as regards to reduction of capital;
- (v) Vouch the **accounting entries** recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also check whether the requirements of Schedule III, Part I, have been complied with in relation to presentation;
- (vi) Confirm that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet.
- (vii) Verify that the **Memorandum of Association** of the company has been suitably amended.

**3. Reserves are a vital source of financing by internal means. Explain and also discuss the meaning of reserves along with revenue reserve and capital reserve. [MTP Oct-22]**

**Reserves are the amounts appropriated out of profits that are not intended**

- to meet any liability,
- contingency,
- commitment or
- diminution in the value of assets known to exist as at the date of the Balance Sheet.

Reserves are a vital source of financing by internal means. They are held for the purpose of distribution of dividend or financing the expansion of the company or strengthening the company financially. The company utilizes the reserves according to the nature and type of such reserve.

The reserves can be segregated as revenue or capital reserves.

Revenue reserves represent profits that are available for distribution to shareholders or below purposes such as: To supplement divisible profits in lean years, to finance an extension of business, to augment the working capital of the business or to generally strengthen the company's financial position.

**Capital Reserve** represents a reserve which does not include any amount regarded as free for distribution. They can be utilized only for certain limited purposes.

**Example**

Securities premium, capital redemption reserve.

It may be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve shall also be in the nature of a capital reserve.

**4. Discuss the audit procedure to be considered by an auditor while performing analytical procedure to obtain audit evidence as to overall reasonableness of purchase quantity and price. [RTP May-23]**

Auditor needs to perform analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price which may include:

- (i) **Consumption Analysis:** Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from management if any significant variations found.

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- (ii) **Stock Composition Analysis:** Auditor to collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with previous years and ask for the reasons from management if any significant variations found.
- (iii) **Ratios:** Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years.
- (iv) Auditor should review **quantitative reconciliation** of closing stocks with opening stock, purchases and consumption.

5. PK Pvt Ltd, based in Moradabad, is engaged in export of brassware goods. The company has huge export receivables as on 31st March 2022. It is also analysed from Export Sales account of the company that large number of small shipments were almost despatched daily during month of March 2022. List out few audit procedures you would adopt as an auditor to verify completeness assertion of export trade receivables. [RTP Nov-22 + Nov-22]

Completeness assertion in respect of account balances means that all balances which should have been recorded have been recorded. The auditor needs to satisfy himself about cut off so that there is no understatement or overstatement in account balances of export receivables.

In this context, while verifying completeness assertion of export trade receivables, following audit procedures are required: -

1. Check that in respect of invoices raised in last few days nearing the cut off date, goods have been actually dispatched and not lying with the company.
2. Check stock records, e-way bill, and transporter receipt regarding actual movement of goods. It would provide assurance that export invoices in respect of which revenue was booked have been actually moved out of company's premises.
3. Ensure that all goods invoiced prior to cut off date/year end have been included in export receivables on test check basis.
4. Ensure that no goods despatched after year end have been included in export receivables by tracing entries in export sales, stock records of next year. The same can be verified from e-way bills also.
5. Match invoices to despatch/shipping details. Further match invoices dates to despatch dates to see if sales are being recorded in correct accounting period.
6. Test invoices in receivable report. Select invoices from ageing report of export receivables and compare them with supporting documentation to ensure that these are billed with correct names, dates and amounts.

6. A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, etc. as at the end of the reporting period under audit. Explain the audit procedure in this context. [RTP Nov-20]

### Direct confirmation procedure

- A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, restrictive use accounts like dividend, escrow accounts as of the end of the reporting period under audit. This should necessarily be done for all account balances as at the period-end.
- The Company should be asked to investigate and reconcile the discrepancies, if any, including seeking written explanations/ clarifications from the banks/ financial institutions on any unresolved queries.
- The auditor should emphasize for confirmation of 100% of bank account balances.

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In remote situations, where no reply is received, the auditor should perform additional testing regarding the balances.

This testing could include:

- ✓ Agreeing the balance to **bank statement** received by the Company or internet/ online login to account in auditor's personal presence;
- ✓ Sending the audit team member to the **bank branch** along with the entity's personal to obtain balance confirmation from the bank directly.

**7. Write the audit procedures to be performed as an auditor for valuation (assertion) of Finished goods and goods for resale. [MTP May-20]**

### Audit procedure for valuation of finished goods and goods for resale

- Enquire into **what costs are included**, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the draft financial statements.
- Ensure that **inventories are valued at net realizable value if they are likely to fetch a value lower than their cost**. For any such items, also verify if the relevant semi/ partly processed inventories (work in progress) and raw materials have also been written down.
- **Follow up for items that are obsolete, damaged, slow moving** and ascertain the possible realizable value of such items. For the purpose, request the client to provide inventory ageing split between less than 30 days, 30-60 days old, 60-90 days old, 90-180 days old, 180-385 days old and more than 365 days old (refer screenshot below).
- Follow up any inventories which at **time of observance of physical counting were noted as being damaged or obsolete**.
- **Compare recorded costs with replacement costs**. Examine vendor price lists to determine if recorded cost is less than current prices.
- Calculate **inventory turnover ratio**. Obsolete inventory may be revealed if ratio is significantly lower.
- In manufacturing environments, **test overhead allocation rates** and ensure that only direct labor, direct material and overhead have been included.
- Verify the **correct application** of lower-of-cost-or-net realizable value principles.

**8. ABC Limited has a closing balance of work in progress of inventories aggregating ₹ 850 lakhs in their balance sheet as at March 31, 2020. As Statutory Auditor of ABC Limited, explain various audit procedures which need to be performed to confirm Work-in-progress of inventories have been valued appropriately and as per generally accepted accounting policies and practices. [Jan-21]**

Audit procedure which needs to be performed to confirm work in progress worth Rs.850 lakhs has been valued appropriately and as per generally accepted accounting policies and practices is given hereunder :

- (i) Ascertain how the **various stages of production/ value addition are measured** and in case estimates are made, understand the basis for such estimates.
- (ii) 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.
- (iii) Ensure that material costs **exclude any abnormal wastage factors**.

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9. XYZ Ltd made huge additions to Intangible assets during the period 01-04-2021 to 31-03-2022 i.e period under audit. You have been appointed as an auditor and you want to verify the additions made to intangible assets during the period. Suggest the audit procedure to verify the additions to intangible assets. [MTP Sep-22]

1. Verify the movement in the intangible assets schedule (asset class wise like software, designs/ drawings, goodwill etc.) compiled by the management i.e. Opening balances + Additions – Deletions = Closing balances. Tally the closing balances to the entity's books of account.

2. Check the arithmetical accuracy of the movement in intangible assets schedule.

**For additions during the period under audit, obtain a listing of all additions from the management and undertake the following procedures:**

(i) For all **material additions**, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26.

(ii) Ensure that **no cost related to research** (or from the research phase of an internal project) gets recognized as intangible asset.

(iii) Check the **certificate or report or other similar documentation** maintained by the entity to verify the date of use of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit.

(iv) Verify whether the additions (acquisitions) have been **approved by appropriate entity's personnel**.

(v) Verify whether **proper internal processes and procedures** like inviting competitive quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis.

(vi) In relation to **deletions** of intangible assets, understand from the management the reason and rationale for deletion and the manner of disposal. Obtain the management approval and disposal note authoring disposal of the asset from its active use. Verify the process followed for sale of discarded asset, example inviting competitive quotes, tenders and the basis of calculation of sales proceeds. Verify that the management has accurately recorded the deletion of intangible asset (original cost and accumulated amortization up to the date of disposal) and the resultant gain/ loss on disposal in the entity's books of account.

10. The value of intangible assets may diminish due to efflux of time, use and/ or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period. Discuss the audit procedures to be applied by the auditor to ensure that Intangible assets have been valued appropriately and as per generally accepted accounting policies and practices. [July-21]

The value of intangible assets may diminish due to efflux of time, use and/ or obsolescence. The diminution of the value represents cost to the entity for earning revenue during a given period. Unless this cost in the form of amortization is charged to the accounts, the profit or loss would not be correctly ascertained and the values of intangible asset would be shown at higher amounts.

The auditor should:

- ✓ Verify that the entity has charged amortization on all intangible assets;
- ✓ Verify that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

The auditor should also verify whether the management has done an impairment assessment to determine whether an intangible asset is impaired. For this purpose, the auditor needs to verify whether the entity has applied AS 28 -

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Impairment of Assets for determining the manner of reviewing the carrying amount of its intangible asset, determining the recoverable amount of the asset to determine impairment loss, if any.

**11. You are an auditor of PQR Ltd. which has spent ₹ 50 lakhs on Research activities of the product during period under audit, Board of Directors want to recognize it as an internally generated intangible assets. Advise and discuss the conditions necessary to be fulfilled to recognize the intangible assets in the financial statements.**

[MTP Nov-20/Apr-23]

No Intangible asset arising from research (or from the research phase of an internal project) shall be recognised. **Expenditure on research shall be recognised as an expense** when it is incurred since in the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Thus, board of directors of PQR Ltd cannot recognize the expense as internally generated intangible asset.

An intangible asset shall be recognised if, and only if:

- (i) the said asset is **identifiable**;
- (ii) the **entity controls the asset** i.e. the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits;
- (iii) it is **probable that future economic benefits** associated with the asset will flow to the entity;
- (iv) the **cost of the item can be measured reliably**.

**12. While auditing the accounts of ABC Ltd, a member of audit team is not clear about :**

- (i) the criteria regarding classification of liability into current liability and non-current liability.
- (ii) **Classification of Reserves and Surplus**

You being the senior member of audit team guide the member of the audit team about such criteria and classification as per general instructions for preparation of balance sheet as per Schedule III.

[MTP May-22]

**(i) A liability shall be classified as current when it satisfies any of the following criteria:**

- (a) it is expected to be settled in the company's normal operating cycle;
- (b) it is held primarily for the purpose of being traded;
- (c) it is due to be settled within twelve months after the reporting date; or
- (d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

**(ii) Reserves and Surplus shall be classified as:**

- (a) Capital Reserves;
- (b) Capital Redemption Reserve;
- (c) Securities Premium;
- (d) Debenture Redemption Reserve;
- (e) Revaluation Reserve;
- (f) Share Options Outstanding Account;
- (g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);
- (h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

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Note: A reserve specifically represented by earmarked investments shall be termed as a 'fund'.

Note: Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

**13. Write the audit procedures to be performed as an auditor for valuation (assertion) of Loans and Advances and other current assets. [MTP May-20]**

### **Audit procedure for valuation of Loans and Advances and other current assets**

- **Assess the allowance for doubtful accounts.** Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.
- **Obtain the ageing report of loans and advances,** split between not currently due, 30 days old, 30-60 days old, 60-180 days old, 180-365 days old and more than 365 days old. Also, obtain the list of loans and advances under litigation and compare with previous year.
- **Scrutinize the analysis and identify those loans and advances that appear doubtful;** Discuss with management their reasons, if any of these loans/ advances are not included in the provision for bad recoverable; Perform further testing where any disputes exist; Reach a final conclusion regarding the adequacy of the bad and doubtful loans/ advances provision.
- **Assess bad loans/ advances write-offs.** Prepare schedule of movements on Bad loans/ advances – Provision Accounts and loans/ advances written off.
- Check that write-offs or other reductions in the recoverable balances have been **approved** by an appropriate and authorised member of senior management, for example the financial controller or finance director.
- Check that the **restatement of foreign currency loans and advances/ other current assets** has been done properly.

**14. From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statements as required by AS 29. What type of disclosures should be made for each class of contingent liability as at the balance sheet date? [MTP Mar-21]**

**Disclosure for each class of Contingent Liability:** From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. As per, AS 29 an enterprise should disclose for each class of contingent liability at the balance sheet date.

- (i) A brief description of the nature of the contingent liability and where practicable.
- (ii) An estimate of the amount as per measurement principle as prescribed for provision in AS 29.
- (iii) Indication of the uncertainty relating to outflow.
- (iv) The possibility of any reimbursement.

Where any of the information as required above is not disclosed because it is not practicable to do so, that fact should be stated.

**15. Auditor of ABC Ltd while auditing its financial statements wants to ensure whether the disclosures regarding sales has been made as required under Schedule III (Part 1) to Companies Act, 2013. Explain such disclosure requirements. [MTP Mar-21]**

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With respect to sales of the client entity, the auditor is required to ensure whether the following disclosures as required under Schedule III (Part 1) to Companies Act, 2013 have been made:

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

**16. ABC limited appointed XYZ & Company, Chartered Accountants, as a Statutory Auditor of the Company for the year 2019-20. CA X, partner of XYZ & Company, was looking after the audit of other income of the company which consists of interest income on fixed deposits. As a Statutory Auditor how would CA X verify interest income on fixed deposits for the year 2019-20? [Nov-20]**

CA X, partner of XYZ & Company, would carry out the following audit procedure for verifying interest income on fixed deposits of ABC Limited:

1. Obtain a **listing of fixed deposits opened during the period under audit** along with the applicable interest rate and the number of days for which the deposit was outstanding during the period. Verify the arithmetical accuracy of the interest calculation made by the entity by recomputing i.e. multiplying the deposit amount with the applicable rate and number of days during the period under audit.
2. For deposits still outstanding as at the period- end, trace the same to the **direct confirmations obtained from the respective bank/ financial institution**.
3. Obtain a **confirmation of interest income from the bank** and verify that the interest income as per bank reconciles to the calculation shared by the entity.
4. Also, obtain a **copy of Form 26AS (TDS withholding by the bank/ financial institution)** and reconcile the interest reflected therein to the calculation shared by client.

**17. CA "X" while conducting an audit of Joyful Ltd. found a considerable increase in sales as compared to the previous year, he doubts that few fictitious sales have been recorded by the company to overstate its revenues. Discuss any four audit procedures to be undertaken by the auditor to ensure revenue from sales of goods and services performed during the period is not overstated? [July-21]**

CA X, having doubts about fictitious sales being recorded by Joyful Ltd would ensure that revenue is not overstated by performing following audit procedures:

- Check whether a **single sales invoice is recorded twice or a cancelled sales invoice could also be recorded**.
- **Test check few invoices with their relevant entries in sales journal.**
- **Obtain confirmation from few customers to ensure genuineness of sales transaction**
- Whether any **fictitious customers** and sales have been recorded.
- Whether any **shipments were done without the consent and agreement of the customer**, especially at the year end to inflate the sales figure
- Whether **unearned revenue recorded as earned**.
- Whether any **substantial uncertainty exists about collectability**
- Whether **customer obligations are contingent on other actions (financing, resale etc.)**

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

- i. Interest income from fixed deposit
- ii. Dividend income
- iii. Gain/(loss) on sale of investment in mutual funds. [Jan-21]

Statutory auditor would perform the following audit procedure for recognition of different items given in the question:

(1) **Interest income on fixed deposits** is recognized on a time proportion basis taking into account the amount outstanding and the applicable interest rate.

(2) **Dividends are recognised in the statement of profit and loss only when:**

- (i) the entity's right to receive payment of the dividend is established;
- (ii) it is probable that the economic benefits associated with the dividend will flow to the entity; and
- (iii) the amount of the dividend can be measured reliably.

(3) **Gain/(loss) on sale of investment in mutual funds** is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

19. Explain how you would verify Employee Benefit Expense incurred by a Company. [MTP Oct-22]

**The auditor shall verify that:**

- (i) Employee benefit expense has been incurred during the period in respect of the personnel employed by the entity. Employee benefit expense does not include the cost of any unauthorized personnel.
- (ii) Employee benefit expenses in respect of all personnel have been fully accounted for.
- (iii) Employee benefit expenses recognized during the period relates to the **current accounting period only**.
- (iv) Employee benefit expense has been **measured/ calculated accurately**. Any adjustments such as tax deduction at source have been correctly reconciled and accounted for.

20. Name the assertions for the following audit procedures: [RTP May-22]

- (i) **Year end inventory verification:** Existence
- (ii) **Depreciation has been properly charged on all assets:** Valuation
- (iii) **The title deeds of the lands disclosed in the Balance Sheet are held in the name of the company:** Rights & Obligations
- (iv) **All liabilities are properly recorded in the financial statements:** Completeness
- (v) **Related party transactions are shown properly:** Presentation & Disclosure

21. Depreciation and amortisation expense generally constitute an entity's significant part of overall expenses and have direct impact on the profit/loss of the entity. What are the attributes, the Auditor needs to consider while verifying Depreciation and amortisation expense. [Jan-21]

**Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses:**

- Obtain the **understanding of entity's accounting policy** related to depreciation and amortisation.
- Ensure the Company policy for charging depreciation and amortisation is **as per the relevant provisions of Companies Act/ applicable accounting standards**.
- Whether the depreciation has been calculated after making **adjustment of residual value from the cost of the assets**.

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- Whether depreciation and amortisation **charges are valid**.
- Whether depreciation and amortisation charges are **accurately calculated and recorded**.
- Whether all depreciation and amortisation charges are recorded in the **appropriate period**.
- Ensure the parts (**components**) of each item of property, plant and equipment that are to be depreciated separately have been properly identified.
- Whether the **most appropriate depreciation method** for each separately depreciable component has been used.

**22. While checking sales of the client, the auditor has to ensure that all sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted. Explain the audit procedures to ensure the same. [MTP Nov-22]**

While checking sales of the client, the auditor has to ensure that all sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted. The auditor can perform the following procedures to ensure the same.

- **Trace a few transactions** from inception to completion. (Examination in depth)  
E.g: Take few sales transaction, and check from the receipt of sales order to the payment of receivable balance, every underlying document to ensure if it is properly recorded at every stage and measured accurately taking into consideration all the incentives, discounts, if any. The recognition shall be according to the revenue recognition policy of the entity.
- If the client is engaged in **export sales**, then compliance with AS 11 shall be ensured.
- Auditor must **understand client's operations and related GAAP issues** e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.
- Compare the **rate of sales affected with related parties and review them for collectability**, as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

**23. Profit and Loss account of an organization shows various types of expenses like rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc., that are essential and incidental to running of business operations. What are the attributes that an auditor generally prefers for vouching these types of expenses? [Dec-21 +MTP Oct-21 + Nov-22]**

### **Attributes to be preferred for vouching other expenses:**

While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify following attributes:

- Whether the expenditure pertained to **current period** under audit;
- Whether the expenditure **qualified as a revenue** and not capital expenditure;
- Whether the expenditure had a **valid supporting documents** like travel tickets, insurance policy, third party invoice etc.;
- Whether the expenditure has been **classified under the correct expense head**;
- Whether the expenditure was **authorised** as per the delegation of authority matrix;
- Whether the expenditure was in **relation to the entity's business** and not a personal expenditure.

**24. The auditor may choose to analyse the monthly trend for Power & Fuel expense. Explain how this analysis will be performed by the auditor [MTP Nov-21]**

### **Power and fuel expense -**

- Obtain a **month wise expense schedule** along with the power bills.

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- Verify if expense has been recorded for all 12 months.
- Also, compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis.
- In relation to the units consumed, analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends.

25. Explain how you would verify rent expense incurred by a Company. [MTP Nov-22]

**Rent expense can be verified by:**

- Obtaining a month wise expense schedule along with the rent agreements.
- Verifying if expense has been recorded for all 12 months and whether the rent amount is as per the underlying agreement.
- Giving specific consideration to the escalation clause in the agreement to verify if the rent was required to be recorded on a straightline basis during the period under audit.
- Also, verifying if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity

26. B Ltd. is covered u/s 135 of the Companies Act, 2013 i.e. Corporate Social Responsibility (CSR). What matters (other than the amount spent, amount not spent, amount required to be spent etc.) shall be disclosed by the company with regard to CSR activities done by the company? [May-22 + MTP Apr-23]

**Corporate Social Responsibility (CSR):** Since B Ltd is covered under section 135 of the Companies Act, the following matters shall be disclosed by the B Ltd with regard to CSR activities:

- (a) total of previous years shortfall,
- (b) reason for shortfall,
- (c) nature of CSR activities,
- (d) 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,
- (e) 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.

27. Proceedings have been initiated against False Limited for holding benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, but such property is not recorded in books of accounts. As a consultant to the company, what will you advise to the company as far as disclosure requirements are concerned in relation to said proceedings? [May-22 + MTP May-22]

**Disclosure in case of Benami Properties held by the Company:** Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, the company shall disclose the following:

- (a) Details of such property, including year of acquisition,
- (b) Amount thereof,
- (c) Details of Beneficiaries,
- (d) If property is not in the books, then the fact shall be stated with reasons,
- (e) Where there are proceedings against the company under this law as an abetter of the transaction or as the transferor, then the details shall be provided,
- (f) Nature of proceedings, status of same and company's view on same.

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28. A Ltd. has traded for ₹ 50.00 Lacs in "TETRA", a virtual currency, during the F.Y. 2021-2022 and earned a profit of ₹ 20.00 Lacs on it. What disclosure requirements are prescribed for such type of transactions done by the company? [Nov-22]

### Details of Crypto Currency or Virtual Currency

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:-

- (a) profit or loss on transactions involving Crypto currency or Virtual Currency
- (b) amount of currency held as at the reporting date,
- (c) deposits or advances from any person for the purpose of trading or investing in Crypto Currency/ virtual currency

29. While verifying the legal and professional expenses of the client company, what audit procedures should the auditor perform? (MTP Mar-23)

While verifying legal and professional expenses of client company, auditor should perform following audit procedures

- Obtain a month-wise and consultant-wise summary.
- In case of monthly retainership agreements, verify whether the expenditure for all 12 months has been recorded correctly.
- For non-recurring expenses, select a sample and vouch for the attributes discussed above.
- Auditor should be cautious while vouching for legal expenses as the same may highlight a dispute for which entity may not have made any provision and matter may also not have been discussed/ highlighted to auditor for his specific consideration

30. While auditing books of accounts of SOLAR Ltd., you observed that an amount due from a debtor for invoice issued on 31.03.2022 has not been recognized in the books of accounts. As an auditor, you want to ensure that all trade receivable balances that are supposed to be recorded have been recognized in the financial statements. How will you achieve the stated objective? [Nov-22]

### Audit of Trade Receivable:

All Trade receivable balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS): The auditor needs to satisfy himself of the cut-offs. Without a cut-off, sales could be understated or overstated, hence there is a need to perform the following cut off procedure:

- (a) For the invoices issued during the last few days (last 5 days of the reporting year) i.e. cut-off date and which have been included in the debtors; check that the goods should have been dispatched and not lying with the Company;
- (b) Ensure that all goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis;
- (c) Ensure that no goods dispatched after the year- end have been invoiced and included in debtors for the period under audit.

*"Be a Warrior not a Worrier"*

### Test your Understanding

1. 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?

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**.

2. 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.

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.

### MCQs

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

### Descriptive Question

1. Discuss some of circumstances when work of the internal auditor cannot be used by external auditor. [SM]

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.

*All Questions DDD!!*

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