



**CA INTER**

**VIGHNAHARTA**

**LIST FOR  
AUDIT AND  
ASSURANCE**

**MOST IMPORTANT  
QUESTIONS with  
ANSWERS**

**By: Vinit Mishra Sir**



ॐ गं गणपतये नमः



**सरस्वती महामाये दिव्य तेज स्वरूपिणी।  
हंस वाहिनी समायुक्ता विद्या दानं करोतु मे।**



**CA Dreamers the Avenger**

**Our Proud Moment**

*Congratulations!*



**AIR-4**

**ARUL KUMAR**

(STUDENT OF TOP-20)



**AIR-10**

**MEGHANA SAWAKAR**

(STUDENT OF TOP-20)

We are waiting for the  
NEXT RANK HOLDERS

**Is That You**



**AIR-?**

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# NATURE, OBJECTIVE AND SCOPE OF AUDIT

## Division A - Multiple Choice Questions

**Q.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

[ICAI Study Material]

**ANSWER:** (c)

**Q.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.

[ICAI Study Material]

**ANSWER:** (a)

**Q.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 ensures 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.

[ICAI Study Material]

**ANSWER:** (c)

**Q.4:** Consider following statements in relation to “Limited assurance engagement”: -

**Statement I** – It involves obtaining sufficient appropriate evidence to draw reasonable conclusion.

**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 Statement I and II are correct.
- (c) Both Statement I and II are incorrect.
- (d) Statement I is incorrect. Statement II is correct.

[ICAI Study Material]

**ANSWER:** (d)

**Q.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.

[ICAI Study Material]

**ANSWER: (b)**

**Q.6:** Which of the following is correct?

- (a) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.
- (b) The auditor is expected to and can reduce audit risk to zero and can therefore obtain absolute assurance.
- (c) The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain reasonable assurance that the financial statements are free from material misstatement due to fraud or error.
- (d) The auditor is expected to and can reduce audit risk to zero and can therefore obtain reasonable assurance that the financial statements are free from material misstatement due to fraud or error.

[MTP April 19]

**ANSWER: (c)**

**Q.7:** M/s KYC & Co. is a reputed Audit firm in Mumbai. They are appointed as Statutory Auditors of Blessed Ltd. Which of the below is the responsibility of M/s. KYC & Co.

- (a) Preparation of financial statements
- (b) Designing, implementation and maintenance of internal control system
- (c) Reporting on true and fair view of financial statements
- (d) Compliance with the applicable law and regulation

[RTP Nov. 20]

**ANSWER: (c)**

**Q.8:** Owing to the \_\_\_\_\_ limitations of an audit, there is \_\_\_\_\_ risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

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

[MTP March 22]

**ANSWER: (a)**

**Q.9:** Which of the following is the responsibility of the auditor:

- (a) Preparation and presentation of the financial statements in accordance with applicable financial reporting
- (b) Design, implementation and maintenance of internal controls
- (c) Express an opinion on the Financial Statements
- (d) To obtain limited assurance.

[MTP April 22]

**ANSWER: (c)**

**Q.10:** With respect to auditing, which of the following statement is correct:

- (a) Audited financial statements are absolutely free from all material misstatement due to fraud or error.
- (b) An audit is an official investigation into alleged wrongdoing and auditor has specific legal powers to conduct investigation.

- (c) The auditor can obtain only a reasonable assurance about whether the financial statement as a whole are free from material misstatement and report on it.
- (d) An auditor's opinion is an assurance as the future viability of the enterprise or the efficiency or effectiveness of the management.

[MTP April 23]

**ANSWER:** (c)

## **Division B - Descriptive Questions**

**Q.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? **[ICAI Study Material]**

**ANSWER:**

**Objectives of Audit:**

- An audit does not provide assurance to investor in shares regarding safety of his money. Shares 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.

**Conclusion:** Thinking of Lalji Bhai is not correct

**Q.2:** 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 (3 Marks)]**

**ANSWER:**

**Objectives of 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.

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.

**Q.3:** Goods 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?

[ICAI Study Material]

**ANSWER:**

**Scope of Audit:**

An Audit of Financial Statements include within its scope the following:

- (1) **Coverage of all aspects of entity:** Audit of F.S. should be organized adequately to cover all aspects of the entity relevant to the F.S.
- (2) **Reliability and sufficiency of financial information:** Auditor should be reasonably satisfied that information contained in accounting records and other source data (like bills, vouchers, documents etc.) is reliable and provide sufficient basis for preparation of F.S.
- (3) **Proper disclosure of financial information:** Auditor should decide whether relevant information is properly disclosed in F.S in compliance with applicable statutory requirements. For this purpose, auditor is required to study and assess accounting systems and internal controls.

**Conclusion:** Proper disclosure of financial information is well within scope of audit.

**Q.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 reasons for such a situation.

[ICAI Study Material]

**ANSWER:**

**Inherent Limitations of an Audit:**

- An Audit suffers from inherent limitations due to which auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the F.S. are free from material misstatement due to fraud or error.
- Circumstances as given in questions is an example of failure of internal controls of the firm. The internal control has not operated due to collusion between employees which is a limitation of internal control itself. The auditor has relied upon internal controls. It is very nature of financial reporting that management is responsible for devising suitable internal controls.

**Conclusion:** Partners of the firm are not correct. This is an inherent limitation of audit.

**Q.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.

[ICAI Study Material]

**ANSWER:**

**Inherent Limitations of an Audit - Nature of Audit procedures:**

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

- (1) Auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.
- (2) Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as requested. 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.

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.

**Q.6:** 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?** **[ICAI Study Material]**

**ANSWER:**

**Review Engagement:**

Raja & Co. can provide a review report in this case. Review is a limited assurance engagement and involves fewer procedures and gathers sufficient appropriate evidence on the basis of which limited conclusions can be drawn up.

Hence Raja & Co. can provide a report as requested by management of Exotic Tours and Travels Limited. Such report would be in nature of "Review".

Raja & Co. will be required to obtain sufficient appropriate evidence based on limited procedures performed.

**Q.7:** Assurance engagements are not restricted to audit of financial statements alone. Discuss.

**[ICAI Study Material]**

**ANSWER:**

**Assurance engagements:**

- Assurance Engagement is an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.
- Scope of Assurance Engagements is not restricted to audit of financial statements only; it also extends to examination of Prospective Financial Information (PFI) and examination of internal controls.
- Examples of various assurance engagements that can be rendered by a practitioner includes the following:
  - (1) **Audit of F.S.** – Reasonable assurance engagement
  - (2) **Review of F.S.** – Limited assurance engagement
  - (3) **Examination of PFI** – Provides assurance regarding reasonability of assumptions forming basis of projections and related matters.
  - (4) **Report on controls operating at an organization** – Provides assurance regarding design and operations of controls.

**Q.8:** An assurance engagement involves a three-party relationship. Discuss meaning of three parties in such an engagement. [ICAI Study Material]

**ANSWER:**

**Three Party relationship of assurance engagement:**

An assurance engagement involves three parties - a practitioner, a responsible party, and intended users.

- (1) **Practitioner:** Person who provides the assurance. Practitioner broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.
- (2) **Responsible party:** Party responsible for preparation of subject matter.
- (3) **Intended users:** Persons for whom an assurance report is prepared. These persons may use the report in making decisions.

**Q.9:** A Chartered Accountant is specifically asked to check accounts whether fraud exists. State with reasons whether it is an example of reasonable assurance engagement. [ICAI Study Material]

**ANSWER:**

**Examination of Accounts for determining existence of Fraud:**

- Assurance engagement is an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.
- Reasonable Assurance requires a high, but absolute assurance.
- In this case, a Chartered Accountant is specifically asked to check accounts whether fraud exists.

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

**Q.10:** Explain qualities of Auditor. [Oct. 21]

**ANSWER:**

**Qualities of an Auditor:**

- Auditor is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent.
- The qualities required are tact, caution, firmness, good temper, integrity, discretion, industry knowledge, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor.
- In addition, auditor must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence.
- Auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education. He is called upon constantly to critically review F.S. and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert.
- An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of auditing. He must know thoroughly all accounting principles and techniques.

**Q.11:** 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? **[ICAI Study Material]**

**ANSWER:**

**Duties in relation to Engagement and Quality Control Standards:**

- It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them.
- However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement. In such a case, professional accountant is required to ensure the following:
  - (a) Document how alternative procedures performed to achieve the purpose of required procedure;
  - (b) Reason for departure has also to be documented;
  - (c) Report should draw attention to such departures.

**Conclusion:** CA P Babu is required to document how alternative procedures performed achieve the purpose of required procedure. Reason for departure has to be documented. His report should draw attention to such departure.

## **Division C - Case Study Based Questions**

### **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 doing 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.
  - (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.

#### ANSWER

|     |     |     |     |     |     |     |     |     |     |
|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|
| (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 P providing assurance regarding these projections to consider request of management.

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

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

**Based on above, answer following questions:**

- (1) The management of company has engaged CA P to issue a duly signed report for half year. Which of the following standards, if any, issued by ICAI are relevant for CA P?
  - (a) Standards on Review Engagements
  - (b) Standards on Auditing
  - (c) Standards on Related Services
  - (d) There are no standards for issuing report in such situation.
- (2) Which of the following statements is **MOST APPROPRIATE** in given case situation?
  - (a) CA P can assist management in preparation of financial statements of the company. However, issue of a report in such a case is outside the scope of work.
  - (b) CA P can assist management in preparation of financial statements of the company and he can issue an audit report.
  - (c) CA P can assist management in preparation of financial statements of the company and he can issue a compilation report in this respect.
  - (d) The responsibility of preparation of financial statement is of company's management. CA P cannot assist management in preparation of financial statements of the company. However, he can issue a review report.
- (3) In the above said scenario for issuance of signed financial statements for half year by CA P, as discussed in last para of Case Study, identify the **MOST APPROPRIATE** statement: -
  - (a) Standard on Quality control (SQC 1) is not applicable as CA P cannot issue audit report.
  - (b) Standard on Quality Control (SQC 1) is not applicable as CA P cannot issue review report.
  - (c) Standard on Quality Control (SQC 1) is applicable in such type of engagement.
  - (d) Standard on Quality Control (SQC 1) is not applicable as CA P is barred from issuing any report in such type of engagement.
- (4) The banker of company has also requested for projected financial statements for coming years along with a report from CA regarding these projections to consider request of management. Which of the following standards issued by ICAI are relevant for CA P in such a situation, if any?
  - (a) Standards on Review Engagements
  - (b) There are no standards for issuing such type of reports.
  - (c) Standards on Related Services

(d) Standards on Assurance Engagements

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

- (a) CA P has to satisfy himself regarding arithmetical accuracy of projected data.
- (b) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover and its consistency with actuals.
- (c) CA P has to satisfy himself regarding arithmetical accuracy of data along with its proper presentation to banker.
- (d) CA P has to satisfy himself regarding reasonableness of assumptions underlying projected turnover, its consistency with actuals, disclosure and presentation.

**ANSWER**

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



**CA DREAMERS**  
THE AVENGER

# AUDIT STRATEGY, AUDIT PLANNING AND AUDIT

## Division A - Multiple Choice Questions

**Q.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

[ICAI Study Material]

**ANSWER:** (c)

**Q.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.

[ICAI Study Material]

**ANSWER:** (d)

**Q.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

[ICAI Study Material]

**ANSWER:** (d)

**Q.4:** Which of the following is not an advantage of an audit programme?

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

[ICAI Study Material]

**ANSWER:** (c)

**Q.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

[ICAI Study Material]

**ANSWER:** (b)

**Q.6:** When planning the audit \_\_\_\_\_.

- (a) The auditor considers what would make the financial information materially misstated.
- (b) The auditor need not consider what would make the financial information materially misstated.
- (c) The auditor need not consider what would make the financial information materially misstated at planning state.
- (d) The auditor needs to consider that would make the financial information materially misstated while conducting audit only.

[MTP March 19]

**ANSWER:** (a)

**Q.7:** With reference to SA 300, the auditor shall document:

- (a) The overall audit strategy.
- (b) The audit plan.
- (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.
- (d) All of the above.

[MTP April 19]

**ANSWER:** (d)

**Q.8:** Planning an audit involves

- (a) Establishing the overall audit strategy for the engagement and developing an audit plan.
- (b) Establishing the overall audit plan for the engagement and developing an audit strategy.
- (c) Establishing the overall audit plan for the engagement.
- (d) Developing an audit strategy.

[MTP Oct. 19]

**ANSWER:** (a)

**Q.9:** As per SA 300 \_\_\_\_\_.

- (a) Planning is not a continual and iterative phase of an audit, but rather a discrete process.
- (b) Planning is not a discrete phase of an audit, but rather a continual and iterative process.
- (c) Planning is not continual and iterative process.
- (d) Planning is not a discrete phase of an audit.

[MTP Oct. 19]

**ANSWER:** (b)

**Q.10:** The auditor shall update and change \_\_\_\_\_ as necessary during the course of the audit.

- (a) Overall strategy.
- (b) The overall audit strategy and the audit plan.
- (c) Audit plan
- (d) Audit program.

[RTP May 20]

**ANSWER:** (b)

## **Division B - Descriptive Questions**

**Q.1:** 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. **[Nov. 18 (4 Marks)]**

### **ANSWER**

**Cases by which auditor can ascertain the reporting objectives of the engagement:**

As per SA 300 "Planning and 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, among other ascertain the reporting objectives of the engagement to plan the timing of the audit.

Various cases through which auditor can ascertain the reporting objectives of the engagement are:

- (i) Entity's timetable for reporting, such as at interim and final stages.
- (ii) Organization of meetings with management and TCWG to discuss the NTE of the audit work.
- (iii) Discussion with management regarding the expected type and timing of reports to be issued.
- (iv) Expected nature and timing of communications among ET members, including the nature and timing of team meetings and timing of the review of work performed.

**Q.2:** 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? **[ICAI Study Material]**

### **ANSWER**

**Development of Audit Plan:**

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

- (i) Nature, timing and extent of planned risk assessment procedures;
- (ii) Nature, timing and extent of planned further audit procedures at assertion level; an
- (iii) Other planned audit procedures that are required to be carried out so that the engagement complies with SAs.

In this case, auditor would like to inquire from inhouse legal counsel of the company as to status of pending litigation matters 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.

**Conclusion:** Planned risk assessment procedures are included in audit plan in accordance with SA-300.

**Q.3:** SA 300 states that auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. Discuss few factors affecting such supervision and review of work of engagement team members. **[ICAI Study Material]**

### **ANSWER**

**Planning the Direction and Supervision of Engagement Team:**

- As per SA 300 "Planning and Audit of Financial Statements" the auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.
- The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

- (a) The size and complexity of the entity.
- (b) The area of the audit.
- (c) The assessed risks of material misstatement
- (d) The capabilities and competence of the individual team members performing the audit work.

**Q.4:** An auditor of a company fails to document audit strategy and audit plan. Briefly outline consequences of such failure. **[ICAI Study Material]**

**ANSWER**

**Consequences of Failure to document audit Strategy and Audit Plan:**

- 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.
- 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.
- 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.

If auditor fails to document audit strategy and audit plan, he will not be able to carry out audit in an efficient and effective manner and will not be able to prove that audit was planned and performed in accordance with Standards on Auditing.

**Q.5:** The auditor shall document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. Explain **[Nov. 20]**

**ANSWER**

**Documentation of Audit Plan:**

- 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.
- 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.
- 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.
- 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.

**Q.6:** SA 300 states that auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. Discuss few factors affecting such supervision and review of work of engagement team members. **[ICAI Study Material]**

## **ANSWER**

### **Planning the Direction and Supervision of Engagement Team:**

- As per SA 300 "Planning and Audit of Financial Statements" the auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.
- The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:
  - (e) The size and complexity of the entity.
  - (f) The area of the audit.
  - (g) The assessed risks of material misstatement
  - (h) The capabilities and competence of the individual team members performing the audit work.

**Q.7:** 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? **[ICAI Study Material]**

## **ANSWER**

### **Assistants to keep an Open Mind:**

- Assistants engaged should be encouraged to keep an open mind beyond the programme given to him. They should be instructed to note and report significant matters coming to their notice, to seniors or partners or proprietor of the firm.
- In this case, Rohit 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.

**Conclusion:** Attitude of Rohit is not proper. Reasons for cancellation of many e-way bills in month of March need to be looked into. Matter should be informed to engagement partner.

**Q.8:** "Purported disadvantages of an audit programme can be overcome". Do you agree?

**[ICAI Study Material]**

## **ANSWER**

### **Elimination of disadvantages of audit programme:**

Disadvantages of audit programme may be eliminated by

- (a) imaginative supervision of the work carried on by the assistants;
- (b) receptive attitude of auditor as regards the assistants;
- (c) encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal.

**Q.9:** Evolving one audit programme applicable to all audit engagements under all circumstances is not practicable. Explain **[Nov. 20]**

## **ANSWER**

### **Uniform Audit Programme applicable to all audit assignments:**

Evolving one audit programme applicable to all audit engagements under all circumstances is not practicable due to following reasons:

- 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 differs 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 is an essential requirement that audit programme specify in details 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.

**Q.10:** 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 (4 Marks)]**

**ANSWER**

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

- To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme.
- As experience is gained by actually carrying out the work, the programme may be altered to take care of situations which were left out originally, but are found relevant for the particular concern.
- Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped.
- The assistant engaged in the job should be encouraged to keep an open mind beyond the programme given to him. He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.
- In the given case, the attitude of assistants of TP & Co. is not justified. They should keep an open mind and go beyond the programme to take care of newer areas of the business of KSR Ltd. into which the Company has diversified.

## **Division C - Case Study Based Questions**

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

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

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

**Based on above, answer following questions:**

- (1) Auditor is fact checking about promoters and key managerial persons. She is also considering competence of staff to perform engagement. What is she trying to do?**
  - (a) She is establishing audit strategy.
  - (b) She is conducting preliminary engagement activities.
  - (c) She is designing audit plan.
  - (d) She is checking her compliance of ethical requirements.
- (2) Consideration of number and location of branches, requirements of financial reporting framework and expected time of completion are relevant factors primarily for which of the following –**
  - (a) Developing audit plan
  - (b) Establishing overall audit strategy
  - (c) Designing audit programme
  - (d) Designing risk assessment procedures
- (3) Taking into account description of planned inquiry and visit, which of the following statements is TRUE?**
  - (a) Planned inquiry and visit fall in area of audit strategy.
  - (b) Planned inquiry and visit are planned risk assessment procedures and fall in field of audit plan.
  - (c) The said description is not related to audit planning.
  - (d) Planned inquiry and visit fall in scope of audit programme.
- (4) What is detailed set of instruction given to assistants in engagement team known as?**
  - (a) Audit guidelines
  - (b) Audit plan
  - (c) Audit Programme
  - (d) Audit Procedures
- (5) The issue of generation of scrap has been overlooked in detailed set of instructions given to engagement team. What should be proper course of action by CA Simran Kaur?**
  - (a) She should ignore this information as audit has already begun.
  - (b) She should modify earlier set of instructions.

- (c) She should leave the matter to wisdom of engagement team.
- (d) She should put the ball in court of management as she was not provided with complete information earlier.

**[ICAI Study Material]**

**ANSWER**

**(1)**

**(b)**

**(2)**

**(b)**

**(3)**

**(b)**

**(4)**

**(c)**

**(5)**

**(b)**



# RISK ASSESSMENT AND INTERNAL CONTROL

## Division A - Multiple Choice Questions

**Q.1:** Which of the following is true regarding materiality?

- (a) It is unaffected by nature of an item.
- (b) It is unaffected by requirements of law or regulations.
- (c) It is not a matter of professional judgment.
- (d) It is not always a matter of relative size.

[ICAI Study Material]

ANSWER: (d)

**Q.2:** The operations of a company are automated substantially. Which of the following statements is most appropriate in this respect?

- (a) It results in complex business environment.
- (b) It results in simple business environment and easier audit.
- (c) Automation has no relationship with complexity of business environment.
- (d) It results in simple business environment. However, it increases complexity of audit.

[ICAI Study Material]

ANSWER: (a)

**Q.3:** Who is responsible for maintaining effective internal financial controls?

- (a) Statutory auditor
- (b) Audit Committee
- (c) Management
- (d) Shareholders

[ICAI Study Material]

ANSWER: (c)

**Q.4:** Which of the following is not a risk to a company's internal control due to its IT environment?

- (a) Potential loss of data
- (b) Inability to access data when required
- (c) Unauthorized access to data
- (d) Processing of large volumes of data

[ICAI Study Material]

ANSWER: (d)

**Q.5:** Which of the following is not an example of "General IT controls"?

- (a) Controls pertaining to Disaster recovery plan
- (b) Controls pertaining to batch preparation
- (c) Controls pertaining to data security
- (d) Controls pertaining to validation of input data in an application

[ICAI Study Material]

**ANSWER: (d)**

**Q.6:** SA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement.

- (a) At the financial statement levels only.
- (b) At the assertion levels only.
- (c) At the financial statement and assertion levels.
- (d) At the financial statement or assertion levels.

**[MTP March 19; Oct 19]**

**ANSWER: (c)**

**Q.7:** The risks of material misstatement at the assertion level consist of two components:

- (a) Inherent risk and detection risk.
- (b) Control risk and detection risk.
- (c) Audit risk and detection risk.
- (d) Inherent risk and control risk.

**[MTP March 19]**

**ANSWER: (d)**

**Q.8:** Audit risk is a function of the \_\_\_\_\_.

- (a) Risks of material misstatement and detection risk.
- (b) Audit risk and detection risk.
- (c) Control risk and detection risk.
- (d) Inherent risk and detection risk.

**[MTP April 19, March 21, April 21]**

**ANSWER: (a)**

**Q.9:** Risk of material misstatement may be defined as the risk \_\_\_\_\_.

- (a) That the financial statements are materially misstated after audit.
- (b) That the financial statements are materially misstated during audit.
- (c) That the financial statements are materially misstated prior to audit.
- (d) All of the above.

**[MTP April 19, Oct. 19, March 21, Nov. 21]**

**ANSWER: (c)**

**Q.10:** The assessment of the risks of material misstatement may be expressed in.

- (a) Quantitative terms, such as in percentages, or in non-quantitative terms.
- (b) Quantitative terms, such as in percentages.
- (c) Non-quantitative terms.
- (e) None of the above.

**[MTP Oct. 19]**

**ANSWER: (a)**

## **Division B - Descriptive Questions**

**Q.1:** 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.

[ICAI Study Material]

### **ANSWER**

- **Inherent Risk:** Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate.
- **Control Risk:** There is a security tag on each item displayed. Moreover, inventory records are physically verified on monthly basis.

Despite various controls being implemented at the stores, still collusion among employees may be there and risk to auditor would again be that inventory records would be inaccurate.

- **Detection Risk:** Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, enquiry, etc. In addition to these, the auditor would also employ sampling techniques to check few sales transactions from beginning to end.

However, despite all these procedures, the auditor may not detect the items which have been stolen or misappropriated.

**Q.2:** 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 2023-24. 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.

[ICAI Study Material]

### **ANSWER**

#### **Audit Risk:**

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.

**Q.3:** 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?

[ICAI Study Material]

### **ANSWER**

#### **Component of Risk of Material Misstatement:**

- Facts given in the question highlights 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.

**Conclusion:** Component of risks of material misstatement involved is “inherent risk.”

**Q.4:** 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.

[ICAI Study Material]

## **ANSWER**

### **Component of Risk of Material Misstatement:**

- Facts given in the question highlights that 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.

**Conclusion:** Component of risks of material misstatement is “control risk”.

**Q.5:** 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? **[ICAI Study Material]**

## **ANSWER**

### **Detection Risk:**

Facts given in the question highlights that there is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition.

**Conclusion:** The risk alluded to it is “detection risk”.

**Q.6:** 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. **[ICAI Study Material]**

## **ANSWER**

### **Reason of increased audit risk due to listing:**

- Based on the facts given in the question, 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.

**Conclusion:** There is increased audit risk i.e., risk of expressing inappropriate opinion by the auditor when financial statements are materially misstated.

**Q.7:** 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? **[ICAI Study Material]**

## **ANSWER**

### **Risk Assessment Procedure:**

- Facts given in the question highlights 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.

**Conclusion:** Auditor is using “analytical procedures”.

**Q.8:** Discuss how “analytical procedures” performed as “assessment procedures” can be useful to an auditor.

[ICAI Study Material]

**ANSWER**

**Use of Analytical Procedures as Risk Assessment procedures:**

- Analytical 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 may include both financial and non-financial information.
- 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.

**Q.9:** “Risk of material misstatement consists of two components” Explain clearly defining risk of material misstatement.

[ICAI Study Material]

**ANSWER**

**Components of risk of material misstatement**

The risk of material misstatement at assertion level comprises of two components i.e., inherent risk and control risk.

Both inherent risk and control risk are the entity’s risks and they exist independently of the audit of financial statements. Inherent risk and control risk are influenced by the client.

These are entity’s risks and are not influenced by the auditor.

- (a) **Inherent Risk:** Susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, assuming that there were no related internal controls.
- (b) **Control Risk:** Risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control.

**Q.10:** “The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement” Explain.

[ICAI Study Material]

**ANSWER**

**Combined Assessment of the Risk of Material Misstatement**

- SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”.
- However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.
- Assessment of the risks of material misstatement may expressed in quantitative terms, such as in percentages, or in non-quantitative terms.

Audit risk = Risks of material misstatement X Detection risk

Audit risk = Inherent risk X Control risk X Detection risk

**Q.11:** 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 (3 Marks)]

## **ANSWER**

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

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 include observation or inspection of the following:

- (1) Entity's operations.
- (2) Documents (such as business plans and strategies), records, and internal control manuals.
- (3) Reports prepared by management (quarterly management reports and interim financial statements) and those charged with governance (minutes of board meetings)
- (4) The entity's premises and plant facilities.

**Q.12:** You are appointed as an auditor of Gama Ltd. Your audit assistant wants to understand the meaning of Audit Risk. Explain him the meaning of Audit Risk with example. Also guide him as to what is not included in Audit Risk. **[May 23 (4 Marks)]**

## **ANSWER**

### **Audit Risk:**

- Risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.
- It is the possibility that auditor expresses an unmodified opinion even when F.S. are materially misstated.
- Auditor is required to plan and perform audit in such a way that audit risk is reduced to an acceptably low level.
- SA 200 states that auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusion on which to base the auditor's opinion.
- Audit risk is a function of the risks of material misstatement and detection risk.

**Risks not forming part of Audit Risk:** Refer Answer of Q. No. 12.

**Q.13:** 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. **[ICAI Study Material]**

## **ANSWER**

### **Consideration of Materiality and Audit Risk:**

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.

**Q.14:** 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. **[ICAI Study Material]**

## **ANSWER**

### **Consideration of Materiality:**

- 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.

**Q.15:** Is materiality required to be documented by the auditor? What factors have to be considered in regard? **[ICAI Study Material]**

**ANSWER**

**Documentation of Materiality:**

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

**Q.16:** With reference to SA 320 “Materiality in planning and performing an audit” Indicate the factors which may effect the identification of an appropriate benchmark while determining materiality for the financial statements as a whole. **[Nov. 20 (4 Marks)]**

Or

An auditor has to exercise professional judgement in determining materiality. Explain the factors that may affect the identification of an appropriate benchmark in determining materiality for the financial statements as whole. **[May 23 (3 Marks)]**

**ANSWER**

**Factors affecting Identification of appropriate benchmark as per SA 320:**

Determining materiality involves the exercise of professional judgment.

A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

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

- (1) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- (2) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance, users may tend to focus on profit, revenue or net assets);
- (3) 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.
- (4) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- (5) The relative volatility of the benchmark.

**Q.17:** 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. **[ICAI Study Material]**

**ANSWER**

**Understanding of the Entity:**

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 auditor should proceed accordingly.

**Q.18:** While auditing the books of accounts of Heavy Material Limited for the financial year 2023-24, 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. [\[ICAI Study Material\]](#)

**ANSWER**

**Understanding of the Entity:**

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.

**Q.19:** 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. [\[ICAI Study Material\]](#)

**ANSWER**

**Understanding of the Entity:**

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.

**Q.20:** 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. [\[ICAI Study Material\]](#)

**ANSWER**

**Understanding Internal Controls:**

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.

**Q.21:** 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. [\[ICAI Study Material\]](#)

**ANSWER**

**Understanding Internal Controls:**

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.

**Q.22:** 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? [\[ICAI Study Material\]](#)

**ANSWER**

**Understanding Internal Controls:**

- 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.

**Q.23:** 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. **[ICAI Study Material]**

**ANSWER**

**Understanding Internal Controls:**

- 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.

**Q.24:** The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting” Explain. **[ICAI Study Material]**

**ANSWER**

Auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting.

Following point merit consideration in this regard:

- Monitoring of controls is a process to assess the effectiveness of internal control performance over time.
- It involves assessing the effectiveness of controls on a timely basis and taking necessary corrective actions.
- Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
- Management’s monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

**Q.25:** “The auditor shall obtain an understanding of the control environment”. Explain stating what is included in control environment. **[ICAI Study Material]**

Or

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:

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

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

**[May 20, March 19]**

## ANSWER

### Elements of Control Environment:

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.

Control environment includes the following elements:

- (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** – It includes attributes of those charged with governance such as their independence from management, their experience, the extent of their involvement and the information they receive and the scrutiny of activities.
- (d) **Management's philosophy and operating style** – It comprises of management characteristics such as:
  - 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.

**Q.26:** Briefly discuss the limitations of internal control.

**[May 18 (6 Marks)]**

## ANSWER

### Inherent Limitations of Internal Control:

- (a) **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.
- (b) **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.
- (c) **Lack of understanding the purpose:** Operation of a control may not be effective, such as where information produced for the purposes of internal control is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.
- (d) **Collusion among People:** 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.
- (e) **Judgements by Management:** 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.

- (f) **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 able to override controls because the system of internal control is less structured.

**Q.27:** 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. **[Oct. 21, March 23]**

**ANSWER**

**Components of Internal Control:**

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.

**Q.28:** The auditor shall obtain an understanding of major activities that the entity uses to monitor internal control over financial reporting.

Discuss "Monitoring of control" as a component of Internal control.

**[Nov. 20 (4 Marks)]**

**ANSWER**

**Monitoring of Controls:**

Auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting. Following point merit consideration in this regard:

- (a) Monitoring of controls is a process to assess the effectiveness of internal control performance over time.
- (b) It involves assessing the effectiveness of controls on a timely basis and taking necessary corrective actions.
- (c) 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.
- (d) 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.
- (e) Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations.

**Q.29:** Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as materiality, the significance of the related risk etc. Explain in detail. **[March 22]**

**ANSWER**

**Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit:**

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

**Q.30:** Z Ltd. is a manufacturer of ready-made garments. During the year 2021-23, they have opened two new branches and there is a substantial increase in their sales. The management has appointed CA R to review the internal control system of the company as they feel that there are lapses in the control environment of the company. What is included in the control environment and what will the auditor evaluate in order obtain an understanding of the control environment? **[Nov. 22 (4 Marks)]**

**ANSWER**

**Elements of Control Environment:** Refer answer of Q. No. 40.

**Evaluation of Control environment by auditor:** The Auditor shall obtain an understanding of the control environment.

As part of obtaining this understanding, the auditor shall evaluate whether:

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

**Q.31:** ABC Ltd. has many divisions and branches across the country. They have an internal control system which is well established maintained by the management on a regular basis. Explain the meaning of internal control as per SA-315 and also state the benefits of understanding the internal controls of a company. **[Nov. 22 (3 Marks)]**

**ANSWER**

**Meaning of Internal Control:**

As per SA-315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", 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:

- (1) Reliability of financial reporting,
- (2) Effectiveness and efficiency of operations,
- (3) Safeguarding of assets, and
- (4) Compliance with applicable laws and regulations.

**Benefits of understanding the internal controls:** Refer answer of Q. No. 46.

**Q.32:** What is understood by “non-routine” transactions? Briefly outline why risks of material misstatement is greater for such transactions. [ICAI Study Material]

**ANSWER**

**Non-routine transactions:**

Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.

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

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

**Q.33:** 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 (3 Marks)]

**ANSWER**

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

Significant risks often relate to significant non-routine transactions or judgmental matters.

Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Risks of Material Misstatement– Greater for Significant Non-Routine Transactions Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- (a) Greater management intervention to specify the accounting treatment.
- (b) Greater manual intervention for data collection and processing.
- (c) Complex calculations or accounting principles.
- (d) The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.
- (e) Keeping in view above stated aspects, view of Auditor of Sunshine Ltd is correct.

**Q.34:** 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. [ICAI Study Material]

**ANSWER**

**Review of Internal Controls:**

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

**Q.35:** 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 [ICAI Study Material]

**ANSWER**

### Review of Internal Controls:

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

**Q.36:** 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. [ICAI Study Material]

#### ANSWER

##### Method of Evaluation of Internal Control:

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.

**Q.37:** 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. [ICAI Study Material]

#### ANSWER

##### Method of Evaluation of Internal Control:

- 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.

**Q.38:** 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? [ICAI Study Material]

#### ANSWER

##### Method of Evaluation of Internal Control:

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

**Q.39:** After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. For this, he resorts to actual testing of the system in operation.

Explain what can be included in Tests of Controls. [ICAI Study Material]

#### ANSWER

##### Elements of ToCs:

Tests of control may include:

- Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.

- Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

**Q.40:** Discuss relationship between “General IT controls” and “application controls” in an automated environment. **[ICAI Study Material]**

**ANSWER**

**General IT Controls and 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.

**Q.41:** Which are specific risks to the company's internal control having IT environment? **[May 19 (4 Marks)]**

**ANSWER**

**Risk to internal control imposed by IT:**

Auditor is required to consider the following risk that may arise due to use of IT Systems:

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

**Q.42:** Analyse how risks in the IT system, if not mitigated, could have an impact on the audit.

**[Nov. 20 (3 Marks); March 23]**

**ANSWER**

**Impact of IT Related Risks:**

When risks in IT systems are not mitigated, the audit impact could be as follows:

- (i) Auditor may not be able rely on the reports, data obtained, automated controls, calculations and accounting procedures in the IT system.
- (ii) Auditor has to perform additional audit work by spending more time and efforts.
- (iii) Auditor may have to issue a modified opinion, if necessary.

**Q.43:** Discuss the common methods applied by the auditor when testing in an automated environment is done by him. **[Jan. 21 (3 Marks)]**

**ANSWER**

**Commonly used methods for testing in an automated environment:**

- (i) 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.
- (ii) Observe how a user processes transactions under different scenarios.
- (iii) Inspect the configuration defined in an application.
- (iv) Inspect the system logs to determine any changes made since last audit testing.
- (v) Inspect technical manual / user manual of systems and applications.
- (vi) Carry out a test check and observe the error message displayed by the application.
- (vii) Conduct reperformance using raw source data and independently applying formulae, business rules or validations on the source data using CAATs.

**Q.44:** When the company is working in an automated environment, it is not necessary for its auditor to understand its automated environment and depends upon the professional judgement of the auditor as to whether gaining knowledge of company's IT systems is required or not. Do you agree with this statement? **[May 22 (3 Marks)]**

**ANSWER**

**Understanding and Documenting Automated Environment:**

Statement given is incorrect.

When the company is working in an automated environment, it is necessary for its auditor to understand its automated environment.

Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.

**Matters of which understanding is required:** Refer answer of Q. No. 69.

**Q.45:** 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 (3 Marks)]**

**ANSWER**

**Objectives of Access Security:**

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

**Activities:**

- (i) Security Organization & Management
- (ii) Security Policies & Procedures
- (iii) Application Security
- (iv) Data Security
- (v) Operating System Security
- (vi) Network Security, and
- (vii) Physical Security.

**Q.46:** While carrying out audit in automated environment, what should be the audit approach.

[ICAI Study Material]

**ANSWER**

**Audit Approach in an Automated Environment:**

- (a) Risk Assessment;
- (b) Understand and evaluate:
- (c) Test for Operating Effectiveness; and
- (d) Reporting.

**Q.47:** While it is true that companies can benefit immensely from the use of data analysis in terms of increased profitability, better customer service, etc., analyse various functions that can be performed even by the auditor also using Data Analytics tools and techniques in the audit process to obtain good results.

[Nov. 20 (4 Marks)]

**ANSWER**

**Concept of Data Analytics:**

- Data analytics is an analytical process by which meaning information is generated and prepared from raw system data using processes, tools, and techniques.
- In an automated environment, various insights can be extracted from operational, financial, and other forms of electronic data internal or external to the organization.
- The data so extracted is useful for preparation of management Information System (MIS) reports and electronic dashboards that give a high-level snapshot of business performance.
- The data analytics methods used in an audit are known as Computer Assisted Auditing Techniques or CAATs,
- Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL.

**Application of Data Analytics:**

In an automated environment, auditors can apply the concept of data analytics for several aspects of an audit including the following:

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

**Q.48:** Briefly Explain use of Digital Technologies in carrying out an audit of financial statements.

[ICAI Study Material]

**ANSWER**

**Use of Digital Technologies in carrying out an audit of financial statements:**

- Entities are embracing digitization as part of their operations to keep pace with changing times.

- New technologies are helping companies revamp their operations and rethink the way business is conducted.
- Companies are restructuring their business models driven by technology. Automation is key to digitization.
- In such a business environment, use of digital technology is being made by auditors right from planning to expression of final opinion.
- Auditors are making use of artificial intelligence, data analytics and other latest technologies to help understand business processes in a better way.
- By using such tools, auditors can conduct audit in a better way and devote more attention to areas requiring greater focus.
- Digital audit is helping auditors to better identify risks making use of technology.

**Q.49:** Foreceful Limited is a company dealing in mobile spare parts and having its showrooms in almost all the states in the country. For FY 2022-23, 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 (3 Marks)]**

Or

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 (3 Marks)]**

### **ANSWER**

#### **Assess and report Audit Findings in audit in Automated Environment:**

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:

- (1) Are there any weaknesses in IT controls?
- (2) What is the impact of these weaknesses on overall audit?
- (3) Report deficiencies to management – Internal Controls Memo or Management Letter.
- (4) 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.

**Q.50:** 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. **[ICAI Study Material]**

### **ANSWER**

#### **Control Deficiency:**

- Facts of the question highlights 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.

- 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”

**Q.51:** “A multinational co. wants to appoint you to carry the statutory audit.” Discuss with reference to SA 330 the substantive procedures to be performed. **[Nov. 18 (6 Marks)]**

**ANSWER**

**Substantive Procedure to be performed to assess the risk of material misstatement:**

Substantive procedures are audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

- (i) Tests of details (of classes of transactions, account balances, and disclosures); and
- (ii) Substantive analytical procedures.

SA 330 “Responses to Assessed Risks” deals with the auditor’s responsibility to design and implement responses to the risks of material misstatements identified and assessed by the auditor in accordance with SA 315. Accordingly.

- Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.
- Depending on the circumstances, the auditor may determine that:
  - (i) Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor’s assessment of risk is supported by audit evidence from tests of controls.
  - (ii) Only tests of details are appropriate.
  - (iii) A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.
- Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.
- Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from test of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.
- In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size.

**Q.52:** XYZ & Associates, Chartered Accountants, while evaluating the operating effectiveness of internal controls, detects deviation from controls. In such a situation, state the specific inquiries to be made by an auditor to understand these matters and their potential consequences. **[May 18 (5 Marks)]**

**ANSWER**

**Specific inquiries by auditor when deviations from controls are detected:**

As per SA 330 “Responses to Assessed Risks”, when deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

- (a) The test of controls that have been performed provide an appropriate basis for reliance on the controls
- (b) Additional test of controls is necessary or
- (c) The potential risks of misstatement need to be addressed using substantive procedures.

**Q.53:** 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 elapsed before retesting. **[Nov. 19 (4 Marks)]**

## **ANSWER**

### **Consideration in determining appropriateness of using audit evidence about operating effectiveness of controls obtained in previous audit:**

As per SA 330 "Responses to Assessed Risks" In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, auditor shall consider the following:

- (a) Effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process
- (b) Risks arising from the characteristics of the control, including whether it is manual or automated
- (c) Effectiveness of general IT-controls
- (d) Effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control
- (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances and
- (f) Risks of material misstatement and the extent of reliance on the control

## **Division C - Case Study Based Questions**

### **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 following questions:**

- (1) Regarding drastic fall in revenue of the company, which of the following is an audit risk?
  - (a) Fall in revenue would result in fall of profits for the company.
  - (b) Drastic fall in revenue may imply that company is not able to carry out its operations in foreseeable future due to lack of demand in the market for company's products. There is a risk that going concern disclosure is omitted to be made in financial statements.
  - (c) The company can explore some new line of activity, if demand of its products is falling.
  - (d) Fall in revenue would mean lower tax liabilities for the company.
- (2) The company's products are getting outdated in the market. Which of the following is an audit risk?
  - (a) The company should devise strategies to sell products in the market.
  - (b) Inventories may be understated in such a scenario.
  - (c) Inventories may be overstated in such a scenario.

- (d) The company should launch a 1 + 1 free offer for its customers.
- (3) A large customer has failed to pay to the company. Identify audit risk from below:**
- (a) Receivables may be misstated if irrecoverable debt is not written off.
  - (b) Receivables may be overstated if irrecoverable debt is not written off.
  - (c) Writing off irrecoverable debt would impact profits of company adversely.
  - (d) Failure to recover outstanding debt would impact cash flows of company adversely.
- (4) Identify audit risk involved when inventory holding period has increased from 30 days to 90 days.**
- (a) There is a risk of overstatement of inventories.
  - (b) There is a risk relating to existence of inventories.
  - (c) There is a risk that slow movement of stocks would increase tax liability when GST rates are increased.
  - (d) There is a risk relating to holding and storage cost of inventories.
- (5) Part of inventories are lying with third parties. Identify audit risk involved.**
- (a) There is a risk that third parties do not manufacture according to specifications of the company.
  - (b) There is a risk that by getting job work done from third parties, company is increasing its costs.
  - (c) There is a risk that sufficient and appropriate evidence would not be available in respect of quantity and condition of inventories lying with third parties.
  - (d) There is a risk that sufficient and appropriate evidence would not be available for quality control in respect of inventories lying with third parties.

**[ICAI Study Material]**

**ANSWER**

|     |     |     |     |     |     |     |     |     |     |
|-----|-----|-----|-----|-----|-----|-----|-----|-----|-----|
| (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 following questions:**

- (1) Which of the following most appropriately describes test of control regarding inventory Counts?**
- (a) Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. The sum insured and period of validity of policy are not relevant.

- (b) Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure adequacy of sum insured by comparing it with value of inventories. Also ensure policy period has not expired.
- (c) Inspect insurance policies to verify that inventories at each location are comprehensively insured. Ensure policy period has not expired.
- (d) Inspect insurance policies to verify that inventories at each location are insured for fire and burglary. Ensure policy period has not expired.
- (2) Which of the following most appropriately describes test of control regarding inventory counts?**
- (a) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure.
- (b) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count.
- (c) Obtain detail of inventory counting procedure and ensure that inventory count is carried out according to laid down procedure. Attend inventory count and perform test count.
- (d) Attend inventory count and perform test count.
- (3) While testing control over bank reconciliations, it has been noticed that bank reconciliations are not being performed at regular intervals. Identify the most appropriate description of “control deficiency” in this regard: -**
- (a) Bank reconciliations are not being performed regularly as concerned staff is overburdened.
- (b) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors.
- (c) Bank reconciliations are not being performed regularly as concerned staff is overburdened. It could result in errors. It may result in misstatement of cash and bank balance in financial statements.
- (d) Bank reconciliations are not being performed regularly as concerned staff is overburdened. These should be performed monthly and reviewed by senior accountant.
- (4) Since the company is a new client, which of the following statements is most appropriate?**
- (a) There is reduced detection risk.
- (b) There is increased detection risk.
- (c) There is no effect on detection risk.
- (d) Detection risk should be increased to lower audit risk.
- (5) Which of the following statements is most appropriate regarding auditor’s response to assessed risk of a new client?**
- (a) More substantive procedures would require to be performed.
- (b) Less substantive procedures would require to be performed.
- (c) There is no effect on substantive procedures.
- (d) There is no effect on substantive procedures as audit risk is low.

**[ICAI Study Material]**

**ANSWER**

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

# AUDIT EVIDENCE

## Division A - Multiple Choice Questions

**Q.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

[ICAI Study Material]

ANSWER: (d)

**Q.2:** An auditor finds during course of an audit that the entity has entered into many related party transactions. Which of the following statements is true?

- (a) The risk that management may override controls in respect of related party transactions is lower.
- (b) The risk that management may override controls in respect of related party transactions is higher.
- (c) There is no effect on the risk that management may override controls in respect of related party transactions.
- (d) Risk of overriding of controls by management has no relationship at all with related party transactions.

[ICAI Study Material]

ANSWER: (b)

**Q.3:** Which of the following is not an objective of a company's policies for ensuring "internal financial controls"?

- (a) Efficient conduct of business
- (b) Safeguarding of assets
- (c) Prevention and detection of frauds and errors
- (d) Assessing audit risk

[ICAI Study Material]

ANSWER: (d)

**Q.4:** Which of the following is not an advantage of statistical sampling?

- (a) Sample size does not increase in proportion to size of area tested.
- (b) Sample selection is more objective.
- (c) It provides a means of deriving a calculated risk and corresponding precision.
- (d) In case of verifying compliance with specific legal requirements, it is suitable.

[ICAI Study Material]

ANSWER: (d)

**Q.5:** A company auditor receives external confirmation from an entity to whom company has sold goods. The said amount is properly classified in financial statements of company. Which of the following statements is not true in this regard?

- (a) It shows that said trade receivable exists.

- (b) It shows that said trade receivable is properly valued.
- (c) It shows that company has a right to said trade receivable.
- (d) It shows that amount of said trade receivable has been recorded in proper account.

[ICAI Study Material]

**ANSWER: (b)**

**Q.6: Which of the following is incorrect?**

- (a) Inquiry consists of seeking information of unknown persons, both financial and non- financial, within the entity or outside the entity.
- (b) Inquiry is used extensively throughout the audit in addition to other audit procedures.
- (c) Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.
- (d) Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence.

[MTP March 19]

**ANSWER: (a)**

**Q.7: In the case of tests of details**

- (a) the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population.
- (b) the projected misstatement is the auditor's best estimate of misstatement in the population.
- (c) the anomalous misstatement is the auditor's best estimate of misstatement in the population.
- (d) the projected misstatement plus anomalous misstatement, if any, cannot be the auditor's best estimate of misstatement in the population.

[MTP March 19]

**ANSWER: (a)**

**Q.8: Which of the following is correct :**

- (a) When the projected misstatement exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.
- (b) When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.
- (c) When the anomalous misstatement exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested.
- (d) When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample provides a reasonable basis for conclusions about the population that has been tested.

[MTP March 19]

**ANSWER: (b)**

**Q.9: Which of the following is correct:**

- (a) As per the Standard on Auditing (SA) 520 "Analytical Procedure" 'the term "analytical procedures" means evaluations of financial information through analysis of financial data.
- (b) As per the Standard on Auditing (SA) 520 "Analytical Procedure" 'the term "analytical procedures" means evaluations of financial information through analysis of non-financial data.

- (c) As per the Standard on Auditing (SA) 520 "Analytical Procedure" 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.
- (d) As per the Standard on Auditing (SA) 520 "Analytical Procedure" 'the term "analytical procedures" means evaluations of financial information through ratio analysis.

[MTP March 19]

**ANSWER:** (c)

**Q.10:** Audit evidence includes.

- (a) Information contained in the accounting records underlying the financial statements
- (b) Both information contained in the accounting records underlying the financial statements and other information.
- (c) Other information.
- (d) Information contained in the accounting records underlying the financial statements or other information.

[MTP April 19, Oct. 19, March 21, April 21, Nov. 21, March 23]

**ANSWER:** (b)

## **Division B - Descriptive Questions**

**Q.1:** The auditor of JPJ Limited explained to the audit team members about the relationship between Audit Evidence and Opinion of Auditor. Explain what relationship exists between Audit Evidence and Opinion of Auditor.

[ICAI Study Material]

**ANSWER**

**Relationship between Audit Evidence and Opinion of Auditor:**

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

**Q.2:** An audit team member of the auditors of Genuine Limited was of the view that audit evidence obtained internally from within the company under audit are more appropriate from the reliability point of view as compared to audit evidence obtained externally as evidence obtained internally are obtained from the company whose audit is being conducted.

Give your views as auditor of Genuine Limited.

[ICAI Study Material]

**ANSWER**

**Reliability of Internal and External Evidences:**

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

**Q.3:** There was a Partnership Firm of Chartered Accountants VM and Associates. Mr. M, one of the partners of VM and Associates, while explaining to his audit team members about importance of audit evidence informed them about sufficiency and appropriateness of audit evidence. Mr. A, one of the members of audit team of VM and Associates was of the view that sufficiency of audit evidence means simplicity of audit

evidence and appropriateness of audit evidence means ease of obtaining audit evidence. Explain whether sufficiency and appropriateness of audit evidence mean simplicity and ease of obtaining audit evidence.

[ICAI Study Material]

#### **ANSWER**

##### **Sufficiency and Appropriateness of audit evidence:**

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

**Q.4:** While auditing the books of accounts of AB Limited for the financial year 2022-23, the auditor of the company used an audit procedure according to which complete documents and records of the company were checked in detail in order to obtain audit evidence. Explain the audit procedure used by the auditor of Extremely Distinct Limited.

[ICAI Study Material]

#### **ANSWER**

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

**Q.5:** 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.

[ICAI Study Material]

#### **ANSWER**

##### **Identifying Nature of Audit Procedure**

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

**Q.6:** CA Soory 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 him that controls in respect of preparing bank reconciliations statements have operated effectively.

[ICAI Study Material]

#### **ANSWER**

##### **Procedures w.r.t. evaluating controls in preparing BRS:**

- 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 Soorya should verify whether proper bank reconciliations have been carried out monthly as stipulated by management. Only then, he can be satisfied about operating effectiveness of controls in this regard.

**Q.7:** 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.

[ICAI Study Material]

#### **ANSWER**

### Reliability of Internal Evidences:

- 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.

**Q.8:** State the assertions in respect of an item in the balance sheet under current assets reading as “cash in hand - ₹ 10,000”. **[ICAI Study Material]**

### ANSWER

**Assertions w.r.t. Cash in hand - ₹ 10,000:**

- (a) The firm concerned had ₹ 10,000 in hand in valid notes and coins on the balance sheet day;
- (b) That the cash was free and available for expenditure to the firm; and
- (c) That the books of account show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.

**Q.9:** Discuss what is understood by “appropriateness” of audit evidence. **[ICAI Study Material]**

### ANSWER

**Appropriateness of audit evidence:**

- Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.
- Reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

**Q.10:** Maintaining accounts using accounting software having a feature of recording audit trail can be useful for an auditor. Discuss some of the advantages for such a feature in accounting software for auditors. **[ICAI Study Material]**

### ANSWER

**Advantages of Using Audit Trail feature in Accounting Software:**

- An audit trail is a documented flow of a transaction. It is used to investigate how a source document was translated into an account entry and from there it was inserted into financial statement.
- It is used as audit evidence to establish authentication and integrity of a transaction.
- Audit trails help in maintaining record of system and user activity. Like, in case of banks, there is an audit trail keeping track of log-on activity detailing record of log-on attempts and device used.
- It is a step-by-step record by which accounting, trade details, or other financial data can be traced to their source.
- Audit trails (or audit logs) act as record-keepers that document evidence of certain events, procedures or operations, because their purpose is to reduce fraud, material errors, and unauthorized use.
- Audit trails involve costs.
- The cost is not only in terms of system expenditure but also in terms of time involved in analysing data made available by audit trails.
- Systems which have a feature of audit trail inspires confidence in auditors.

- Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.

**Q.11:** Give your assertions for the following items appearing in Balance Sheet of a Limited Company:

|       |                      | ₹         |  | ₹         |
|-------|----------------------|-----------|--|-----------|
| (i)   | Cash in hand         |           |  | 10,000    |
| (ii)  | Investments          |           |  | 1,00,000  |
| (iii) | Secured Loans        |           |  | 10,00,000 |
| (iv)  | Machinery:           |           |  |           |
|       | Opening cost         | 13,00,000 |  |           |
|       | Less: Depreciation   |           |  |           |
|       | Current Depreciation | 1,30,000  |  | 11,70,000 |

[ICAI Study Material]

#### ANSWER

**(i) Cash in Hand:**

- Cash in hand is an item of current assets and it implies the following:
- That the company has ₹ 10,000 in hand in the form of currency notes and coins on the Balance Sheet date.
- That the cash is free and available for expenditure to the company.
- That the books of account show a cash balance of ₹ 10,000 as on balance sheet date.

**(ii) Investments:**

Investments is an item appearing in Balance sheet either as non-current or as current investments and it implies as follows:

- That the company has made invested its surplus funds in the investments, i.e. its existence and ownership.
- That the investments are non-current or current investments i.e. its classification.
- That the value of investments as on Balance Sheet date was ₹ 1,00,000, i.e. its valuation.

**(iii) Secured Loan:**

Secured loan is an item appearing in the Balance sheet either as long-term borrowing or as short-term borrowings and it implies as follows:

- That the company has borrowed, i.e. its existence.
- That the borrowing is secured one. i.e. its nature.
- That the borrowing as on Balance sheet date was ₹ 10,00,000, i.e. its valuation.

**(iv) Machinery:**

Machinery is an item appearing in the balance sheet as fixed asset under the heading non-current assets and it implies as follows:

- That the Company has certain plant and Machinery as on balance sheet date, i.e. its existence and ownership.
- Opening WDV is ₹ 13,00,000 and year end WDV was ₹ 11,70,000 after charging current year depreciation, i.e. its valuation and allocation of current year depreciation.

**Q.12:** Name the assertions for the following audit procedures:

- (1) Year-end inventory verification.
- (2) Depreciation has been properly charged on all assets.
- (3) The title deeds of that lands disclosed in the balance sheet are held in the name of the company.
- (4) All liabilities are properly recorded in the financial statements.
- (5) Related partly transactions are shown properly.

[May 18 (5 Marks), RTP Nov. 22]

#### ANSWER

#### Assertions for Audit Procedures:

|       | Audit Procedures                                                                       | Assertion                 |
|-------|----------------------------------------------------------------------------------------|---------------------------|
| (i)   | Year-end inventory verification                                                        | Existence                 |
| (ii)  | Depreciation has been properly charged on all assets                                   | Valuation                 |
| (iii) | Title deed of 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 |

**Q.13:** CA K audited the books of accounts of E Ltd. for the financial year 2023-2024. 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 (3 Marks)]

#### ANSWER

#### Audit Procedure:

- In the given case, 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. The procedure so performed by the auditor is known as inspection.
- Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.
- Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.
- 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.

**Q.14:** 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 (4 Marks)]

## **ANSWER**

### **Audit Procedures:**

As per SA 500 “Audit Evidence” audit procedures performed to collect audit evidences include the following:

- (a) Risk assessment Procedures
- (b) Further Audit procedures: It comprises of:
  - (1) Test of Controls, and
  - (2) Substantive Procedures: consists of:
    - Tests of Details, and
    - Substantive Analytical Procedures.

### **Types of Audit Procedures:**

Audit procedures to obtain audit evidence can include:

- (i) Inspection
- (ii) Observation
- (iii) External Confirmation
- (iv) Recalculation
- (v) Repperformance
- (vi) Analytical Procedures
- (vii) Inquiry

**Q.15:** 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?

[ICAI Study Material]

## **ANSWER**

### **Scope 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.

**Q.16:** 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. [ICAI Study Material]

## **ANSWER**

### **Relying upon work of Internal Auditors:**

- 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 Suresh, both the above factors suggest that he should not rely upon work of internal auditor extensively.

**Q.17:** Discuss some of circumstances when work of the internal auditor cannot be used by external auditor. [ICAI Study Material]

**ANSWER**

**Circumstances when work of the internal audit function cannot be used:**

External auditor shall not use the work of the internal audit function if he determines that:

- The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
- The function lacks sufficient competence; or
- The function does not apply a systematic and disciplined approach, including quality control.

**Q.18:** Moon Ltd. of which you are the statutory auditor, have an internal audit being conducted by an outside agency. State the factors that weigh consideration in opting to make use of direct assistance of the internal auditors for the purpose of statutory audit. [ICAI Study Material]

**ANSWER**

**Using direct assistance of internal auditor:**

As per SA 610 "Using the Work of Internal Auditor" statutory auditor can take direct assistance of internal auditor subject to following conditions:

- The external auditor is not prohibited by law or regulation from obtaining direct assistance from internal auditors.
- There are no significant threats to the objectivity of the internal auditor.
- The internal auditor is sufficient competent to perform the proposed work.

**Precautions to be taken while using direct assistance:**

- External auditor shall not use internal auditors to provide direct assistance to perform procedures that:
  - Involve making significant judgements in the audit;
  - Relate to higher assessed risks of material misstatements;
  - Relate to work with which the internal auditors have been involved; or
  - Relate to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.
- Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:
  - Obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and
  - Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.
- The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with SA 220.

**Q.19:** CA X, a practicing CA has been appointed as an internal auditor of Textile Ltd. He conducted the physical verification of the inventory at the year-end and handed over the report of such verification to CA Y, the statutory auditor of the Company, for his view and reporting, Can CA Y rely on such report?

[ICAI Study Material]

**ANSWER**

**Evaluation of Internal Audit function so as to replay on work of Internal Auditor:**

SA 610 “Using the work of Internal Auditors” deals with the external auditor’s responsibilities regarding the work of internal auditors when the external auditor has determined, in accordance with SA 315 that the internal audit function is likely to be relevant to the audit.

For this purpose, external auditor is required to evaluate the following:

- A. Objectively of Internal Auditor:** Objectively refer to the ability to perform without allowing bias to override professional judgment. Factors that may affect the external auditor’s evaluation include the following:
1. Organisational status of the internal audit function.
  2. Conflicting responsibilities.
  3. Oversight functions of TCWG w.r.t. employment decisions related to the internal audit function.
  4. Constraints or restrictions placed on the Internal audit function by management or TCWG.
- B. Level of Competency:** Competence of the internal audit function refers to the attainment of knowledge and skills to enable assigned tasks to be performed diligently. Factors that may affect the external auditor’s determination include the following:
1. Policies for hiring, training and assigning internal auditors to internal audit engagements.
  2. Adequate to technical training and proficiency in auditing internal auditors of internal auditors.
  3. Knowledge of internal auditors w.r.t. entity’s financial reporting and the applicable FRF.
  4. Membership of relevant professional bodies that oblige internal auditors to comply with the relevant professional standards.
- C. Systematic and Disciplined Approach:** Factors that may affect the external auditor’s determination of whether the internal audit function applies a systematic and disciplined approach include the following:
1. Existence, adequacy and use of documented internal audit procedures.
  2. Existence of appropriate quality control policies and procedures for internal function.

**Conclusion:** In the present case, if the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise.

The ultimate responsibility to express opinion on the financial statement is that of the statutory auditor.

**Q.20:** 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? [ICAI Study Material]

**ANSWER**

**Auditor’s responsibility in relation to audit sampling:**

- 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.

**Q.21:** What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 “Audit Sampling”. **[ICAI Study Material]**

**ANSWER**

**Meaning of Audit Sampling:**

“Audit Sampling” means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

**Samples Selection methods:**

1. **Random Selection:** This method of sampling ensures that all items within a population stand an equal chance of section by the use of random number tables or random number generators. The sampling units could be physical items, such as sales invoices or monetary units.
2. **Systematic Selection:** The number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.
3. **Monetary unit sampling:** It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
4. **Haphazard selection:** Samples are selected without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability. Haphazard selection is not appropriate when using statistical sampling.
5. **Block selection:** It involves section 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.

**Q.22:** Write short notes on the following “Stratified sampling”

**[ICAI Study Material]**

**ANSWER**

**Stratified Sampling:**

This method involves dividing the whole population in few separate groups called strata and taking a sample from each of them.

Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum.

The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

**Example:** Trade receivables balances may be divided as:

- balances in excess of ₹ 10,00,000;
- balances in the range of ₹ 5,00,001 to ₹ 10,00,000;
- balances in the range of ₹ 1,00,001 to ₹ 5,00,000; and
- balances ₹ 1,00,000 and below.

From these above groups the auditor may pick up different percentage of items from each of the group. From the top group i.e. balances in excess of ₹ 10,00,000, the auditor may examine all the items; from the second group 25% of the items; from the third group 10% of the items; and from the lowest group 2% of the items may be selected.

**Q.23:** Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk leads to erroneous conclusions. Explain in detail distinguishing it from non-sampling risk with examples. [RTP Nov. 20]

Or

In the context of SA 530 'Audit Sampling', explain the terms 'Sampling Risk' and 'Non-Sampling risk'.

[Jan. 21 (4 Marks)]

Or

While designing an audit sample, the auditor shall determine a sample size sufficient to reduce the sampling risk to an acceptably low level. In this context, explain sampling risk and non-sampling risk. [May 23 (4 Marks)]

**ANSWER**

**Sampling and Non-sampling Risk:**

**Sampling Risk:** Refer Q. No. 42

**Non-Sampling Risk:** The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Non-sampling risk can never be mathematically measured.

Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.

**Sources of non-Sampling risk are:**

- Human Mistakes
- Misinterpreting the sample result
- Applying audit procedures not appropriate to the objectives of audit
- Relying on erroneous information

**Q.24:** The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement. Explain in detail. [ICAI Study Material]

Or

It is imperative for the auditor to project misstatements for the population while performing audit procedures through sampling. Comment. [Nov. 20 (3 Marks)]

**ANSWER**

**Projection of Misstatements:**

- As per SA 530 "Audit Sampling", 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.

**Q.25:** 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 (4 Marks)]

**ANSWER**

### **Precautions to be taken while applying test check techniques are**

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

**Q.26:** 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 (3 Marks)]**

#### **ANSWER**

##### **Use of Sampling procedure:**

- No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all the efforts are directed to check all transactions without any exception.
- This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved.
- With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished i.e., the internal controls as designed by the management are for the very purpose of Prevention, Detection and Correction of Frauds and Errors.
- Thus, the auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material.
- Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non-consequential routine checking.
- By routine checking, we traditionally think of extensive checking and vouching of all the entries, disregarding the concept of materiality. The extent of the checking to be undertaken is primarily a matter of judgment of the auditor.
- There is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent it has to be done.
- It is also not obligatory that the auditor must adopt the sampling technique. What he is to do as an auditor is to express his opinion on the financial statements and become bound by that.
- To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion.
- This enables the auditor to make conclusions and express fair opinion without having to check all of the items within the financial statements.

**Q.27:** What are the matters that the auditor shall consider while designing an audit sample?

**[Nov. 22 (3 Marks)]**

#### **ANSWER**

**Matters to be considered while designing an Audit Sample:**

As per SA 530, "Audit Sampling", when designing and audit sample, the auditor shall

- (i) Consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn.
- (ii) Determine a sample size sufficient to reduce sampling risk to an acceptably low level.
- (iii) Select items for the sample in such a way that each sampling unit in the population has a chance of selection.
- (iv) Determine that sample selected must be representative of the population.
- (v) Consider including the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose.
- (vi) Consider nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.
- (vii) Performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

**Q.28:** JK Exports Ltd is a manufacturer exporter having its own production capacity and also gets the job work done through various job workers. The auditor of JK Exports Ltd. Considers that inventory held with job workers is material to the financial statements.

**Required:** Suggest the audit procedures in the given case.

**[ICAI Study Material]**

**ANSWER**

**Audit Procedures w.r.t. Inventory lying with Third party:**

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.

**Q.29:** Parag India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements.

**Required:** Suggest the auditor with reference to SAs.

**[ICAI Study Material]**

**ANSWER**

**Audit Procedures w.r.t. Litigation and Claims:**

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:

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

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

**Q.30:** 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? [ICAI Study Material]

**ANSWER**

**Requirement of Direct Communication with External Lawyer:**

- 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.
- Situation as stated in question warrants direct communication with company's standing external lawyer.

**Q.31:** 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 March 18, Aug. 18, Oct. 18, March 19, May 20]

**ANSWER**

**Procedure to be performed to obtain sufficient and appropriate evidence regarding existence and condition of inventory:**

SA 501 "Audit Evidence – Specific Considerations for selected items" deals with specific considerations by the auditor in obtaining sufficient and appropriate audit evidence, with respect to certain aspects of inventory, litigation and claims, and segment information in an audit of financial statements.

Accordingly, when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the **existence and condition** of inventory by:

- (a) Attendance at physical inventory counting, unless impracticable, to:
  - (a) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
  - (b) Observe the performance of management's count procedures;
  - (c) Inspect the inventory; and
  - (d) Perform test counts; and
- (b) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

**Q.32:** SPR Ltd has been into the media business since 1990. During the F.Y 2023-2024 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 (3 Marks)]

**ANSWER**

**Circumstances requiring meeting with 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.

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

**Q.33:** During the financial year 2023-24, the auditor of Healthy and Wealthy Limited asked a Trade Receivable to respond directly to the auditor whether or not the amount they were required to pay to Healthy and Wealthy Limited was ₹ 1,23,000. That trade receivable confirmed to the auditor of Healthy and Wealthy Limited, that they were required to pay an amount of ₹ 1,23,000 to Healthy and Wealthy Limited. State and explain the type of Confirmation Request as required by the auditor. [ICAI Study Material]

**ANSWER**

**Type of Confirmation Request:**

Situation as stated in the question is an example of Positive Confirmation Request because in Positive Confirmation Request the party confirms the auditor of a company whether such party agrees or whether such party disagrees with the information for which the confirmation is required by auditor of that company.

**Q.34:** 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? [ICAI Study Material]

**ANSWER**

**Control over External Confirmation Requests:**

- When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:
  - (a) Determining the information to be confirmed or requested;
  - (b) Selecting the appropriate confirming party;
  - (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
  - (d) Sending the requests, including follow-up requests when applicable, to the confirming party.
- In the given case, it appears that external auditor has delegated entire work of sending out external confirmation requests to internal audit department over which he has no control. Further, responses to external confirmation requests are received on mail id of internal audit department.
- All these acts are not in line with requirements under SA 505.

**Q.35:** 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? [ICAI Study Material]

**ANSWER**

**Management refuses to allow the auditor to send a confirmation request:**

- 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 and untimely confirmation request. Further, fraud risk factors do not exist.
- Keeping in view, unwillingness of CFO is justifiable.

**Q.36:** While conducting the audit of Amrit Ltd. the auditor A of ABC and Associates, Chartered Accountants observes that there are a large number of trade receivables standing in the books of account as on 31st March. The auditor wanted to send confirmation request to a few large trade receivables but the management refused the auditor to send confirmation request. How would the auditor proceed? **[Nov. 20 (4 Marks)]**

Or

CA P is the auditor of MN Ltd. While scrutinising the accounts of MN Ltd., he observed that the company had large volume of Trade payable outstanding in the Balance sheet as on 31st March, 2024 for which external confirmations are not available, CA P wants to send external confirmation request to selected Trade payables but management of MN Ltd. refused for the same. Discuss how CA P should deal in this regard as per relevant Standard on Auditing. **[May 23 (4 Marks)]**

#### ANSWER

##### **Management refusal to allow auditor to send confirmation request.**

- SA 505, "External Confirmations", establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. It requires that the auditor should employ external confirmation procedures in consultation with the management.
- The auditor may come across certain situations in which the management may request him not to seek external confirmation from certain parties because of some reasons, for example, due to a dispute with the particular creditor or debtor.
- In such cases, if management refuses to allow the auditor to send a confirmation request:
  - (a) Inquire as to management's reasons for the refusal and seek audit evidence as to their validity and reasonableness;
  - (b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
  - (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.
- If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with SA 260. The auditor shall also determine the implications for the audit and the auditor's opinion in accordance with SA 705.
- The auditor should also ask the management to submit its request in a written form, detailing therein the reasons for such a request.

**Q.37:** 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 (4 Marks)]**

#### ANSWER

**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:**

Negative confirmations 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.

**Q.38:** An auditor is appointed for the first time for audit of accounts of an entity. The accounts of previous year were unaudited. He is unable to obtain sufficient appropriate audit evidence regarding the opening balances. What is his responsibility in this regard. **[ICAI Study Material]**

**ANSWER**

**Reporting w.r.t. Opening Balances**

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

**Q.39:** M/s Pankaj & Associates, Chartered Accountants, have been appointed as an auditor of ABC Limited. CA Pankaj did not apply any audit procedures regarding opening balances. He argued that since financial statements were audited by the predecessor auditor therefore he is not required to verify them. Is CA Pankaj correct in his approach? **[Nov. 18 (5 Marks)]**

**ANSWER**

**Auditor's procedures w.r.t. Opening balances in case of Initial audit engagement:**

- Initial audit engagement is an engagement in which either:
  - (i) The financial statements for the prior period were not audited; or
  - (ii) The financial statements for the prior period were audited by a predecessor auditor.
- As per SA 510 "Initial Audit Engagements – Opening Balances", in case of initial audit engagement auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's F.S. by:
  - (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
  - (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
  - (c) Performing one or more of the following:
    - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;

(ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

(iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

- In the present case, M/s Pankaj & Associates, Chartered Accounts, have been appointed as an auditor of ABC Limited. CA Pankaj did not apply any audit procedures regarding opening balances. He argued that since financial statements were audited by the predecessor auditor therefore, he is not required to verify them.

**Conclusion:** Approach of Mr. Pankaj is not correct. He needs to apply procedures as stated in SA 510.

**Q.40:** 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 (3 Marks)]**

**ANSWER**

**Audit Procedure Regarding Opening Balances:**

The newly appointed auditor of BTN Ltd shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

The auditor of BTN Ltd shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

- (1) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss.
- (2) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- (3) Performing one or more of the following:
  - (i) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements.
  - (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
  - (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

**Q.41:** 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 (4 Marks)]**

**ANSWER**

**Duties of Auditor in identifying Significant Related Party Transactions:**

SA 550 "Related parties" deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements.

For identified significant related party transactions outside the P Ltd.'s normal course of business, the auditor shall:

- (a) 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

(b) Obtain audit evidence that the transactions have been appropriately authorised and approved.

**Q.42: Define Analytical Procedures.**

**[ICAI Study Material]**

**ANSWER**

**Meaning of Analytical Procedures:**

- As per the Standard on Auditing (SA) 520 “Analytical Procedures” “the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.
- Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.
- Thus, analytical procedures include the consideration of comparisons of the entity’s financial information with as well as consideration of relationships.

**Q.43: CA Aarav wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2023-24. The rent amounts to ₹ 50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of ₹ 10,000/- per month for a similar location. How will applying the analytical procedures impact the verification process of such rental payment by XYZ Ltd.?**

**[ICAI Study Material]**

**ANSWER**

- If CA Aarav checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e. XYZ Ltd. paid ₹ 50,000/- per month as rent and the same is getting reflected in the rent agreement. Here, CA Aarav may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location.
- If CA Aarav applies analytical procedure i.e. compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.
- However, if CA Aarav does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.

**Q.44: Analytical procedure involves analysis of relationship among financial and nonfinancial data. Explain with the help of an example as to how, the statutory auditor of ABC Ltd. will analyse such relationship with respect to the total wages paid by ABC Ltd. during the FY 2023-24.**

**[ICAI Study Material]**

**ANSWER**

**Analysing relationship w.r.t. Total Wages:**

- As per SA 520, Analytical Procedures means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. The following example explains the analysis of relationship between financial and non-financial data while applying analytical procedures.
- The statutory auditor of ABC Ltd. has to verify the total wages paid by the company having factories in various states. He can verify the same by analyzing the relationship between wages per worker and total number of workers across all the factories.  
  
i.e. Total wages = Wages per worker x Total number of workers.
- Here wages per worker is financial data i.e. in ₹ and total number of workers is a number which is a non-financial data. Thus, the statutory auditor of ABC Ltd. is evaluating financial information i.e. total wages paid (in ₹) by

analyzing the relationship between wages per worker (in ₹) which is financial data and number of workers which is a non-financial data.

**Q.45:** List various analytical procedure that can be used from below data:

| Particulars        | Client  |         | Industry |         |
|--------------------|---------|---------|----------|---------|
|                    | 2021-22 | 2022-23 | 2021-22  | 2022-23 |
| Inventory Turnover | 2.8     | 2.9     | 3.1      | 2.8     |
| Gross Margin       | 22.5%   | 22.7%   | 23.6%    | 22.2%   |

[ICAI Study Material]

#### **ANSWER**

##### **Types of Analytical Procedures:**

- Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques.
- Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.
- Analytical Procedures may be segregated into the following major types:
  - (a) comparison of client and industry data,
  - (b) comparison of client data with similar prior period data,
  - (c) comparison of client data with client-determined expected results,
  - (d) comparison of client data with auditor-determined expected results and
  - (e) comparison of client data with expected results, using non-financial data.

**Q.46:** 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. [ICAI Study Material]

#### **ANSWER**

##### **Analytical procedures in relation to revenue:**

- (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.

**Q.47:** 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 (3 Marks)]

#### **ANSWER**

##### **Factors to be considered while using substantive analytical procedures:**

- (1) **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.
- (2) **Predictability:** Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable

A predictable relationship is one that may reasonably be expected to exist and continue over time.

- (3) **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).

**Q.48:** The statutory auditor of ABC Ltd., CA Raj identifies certain inconsistencies while applying analytical procedures to the financial and non-financial data of ABC Ltd. With reference to SA 520 on "Analytical Procedures", how CA Raj shall investigate such differences? **[July 21 (3 Marks)]**

**ANSWER**

**Investigation of Identified fluctuations:**

**As per SA 520 – “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.

In the present case, Auditor identifies certain inconsistencies while applying analytical procedures to the financial and non-financial data of client.

Auditor should inquire the management and obtain sufficient and appropriate audit evidences relevant to the management response.

Further, Auditor should also perform other audit procedures if required in the circumstances of the case to obtain further sufficient and appropriate evidence.

**Q.49:** 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 (3 Marks)]**

**ANSWER**

- 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.

**Q.50:** Tree Limited presented its financial statements for the F.Y. 2023-2024 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 (4 Marks)]**

**ANSWER**

**Purpose of Applying Analytical Procedure:**

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

The auditor of 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 the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.
- (iii) If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.
- (iv) It would be possible to identify the existence of unusual transactions, amounts, ratios and trends that might indicate matters that have audit implications.

### **Division C - Case Study Based Questions**

#### **Case Study-1**

CA Drishti Khandelwal is conducting audit of a company engaged in manufacturing of towels and bedspreads. The company is having its own manufacturing set-up. However, it also gets some manufacturing processes outsourced from third parties. The company has three locations having substantial quantities of inventories in the same city. Besides, due to outsourcing of some processes, inventories are also held in premises of third parties in the same city. As part of audit procedures, she is performing many audit procedures required by different Standards on Auditing.

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

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

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

**Based on above description, answer the following questions:**

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

- (b) She should inspect the inventory to ascertain its existence at all locations, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.
- (c) She should inspect the inventory to ascertain its existence at selected location, observe how company personnel are carrying out count procedures and perform test counting. The matter of condition of inventories falls in domain of expert.
- (d) She should inspect the inventory to ascertain its existence and condition at all locations and perform counting of each and every item.
- (2) As regards inventories lying with third parties, which of following statements meets requirements of SA 501?**
- (a) She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company as well as request third parties to allow her to inspect inventories held by them. Both requirements are necessary to be complied with.
- (b) She should request confirmation from third parties regarding quantity and condition of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these or both is required for purposes of SA 501.
- (c) There is no obligation cast upon an auditor in respect of inventories lying with third parties.
- (d) She should request confirmation from third parties regarding quantity, condition and value of inventories held on behalf of the company or request third parties to allow her to inspect inventories held by them. Compliance of any one of these is sufficient for purposes of SA 501.
- (3) Keeping in view description regarding trade receivables, identify the most appropriate statement in context of SA 505?**
- (a) She should not plan and design confirmation requests for large number of parties having small balances.
- (b) She should plan and design positive confirmation requests for large number of parties having small balances.
- (c) She should plan and design positive confirmation requests for large number of parties having small balances and meticulously analyse exception rate
- (d) She should plan and design negative confirmation requests for large number of parties having small balances.
- (4) As regards sampling, which of the following statements is most appropriate in terms of requirements of SA 530?**
- (a) Sampling is used in tests of transactions as well as tests of controls.
- (b) Sampling is used in tests of balances as well as tests of controls.
- (c) Sampling is used in tests of details.
- (d) Sampling is used in tests of details as well as tests of controls.
- (5) Since she intends to rely upon sampling extensively, which of the following statements is true about sampling risk?**
- (a) Sampling risk can be eliminated.
- (b) Increase in sampling risk would lead to decrease in detection risk.
- (c) Decrease in sampling risk would lead to increase in detection risk.
- (d) Sampling risk will always be in existence.

[ICAI Study Material]

#### ANSWER

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

### Case Study-2

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

- (A) She plans to verify some major bills debited in “Machinery repair” account. The purpose of it is to ensure that bills are entered correctly and their classification is proper.
- (B) She plans to verify that all balances appearing under trade payables are genuine and not fake.
- (C) She plans to compare amount of wages paid in current year and last year. It is also planned to verify relationship between the number of employees and wages paid in both years.
- (D) She is of the view that it is necessary to examine title deeds of “land” appearing in financial statements of the firm.
- (E) The firm is engaged in export of goods to Europe. The sales invoices raised in Euros are converted into Indian rupees as per applicable norms.

**Based on above description, answer the following questions:**

- (1) As regards description given regarding verification of bills debited in “Machinery repair” account, identify what she intends to perform?
  - (a) Tests of Controls
  - (b) Tests of transactions
  - (c) Tests of balances
  - (d) Risk assessment procedures
- (2) Identify which type of assertion she intends to focus when she wants to ensure genuineness of trade payables.
  - (a) Occurrence
  - (b) Cut-off
  - (c) Existence
  - (d) Accuracy
- (3) As regards comparison of wages of current year and last year and comparison of relationship between the number of employees and wages paid in both years, identify what she is trying to do?
  - (a) She is intending to perform tests of details.
  - (b) She is intending to perform tests of transactions.
  - (c) She is intending to perform tests of balances.
  - (d) She is intending to perform substantive analytical procedures.
- (4) In case of examination of title deeds of “land”, which of the following fits into most appropriate description of such an audit procedure?
  - (a) Observation
  - (b) Inspection
  - (c) External confirmation
  - (d) Enquiry
- (5) She wants to verify whether conversion of foreign currency into Indian rupees is proper or not. Identify what she is trying to do?
  - (a) Reperformance

- (b) Recalculation
- (c) Observation
- (d) Inspection

[ICAI Study Material]

ANSWER

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



# AUDIT OF ITEMS OF FINANCIAL STATEMENTS

## Division A - Multiple Choice Questions

**Q.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

[ICAI Study Material]

ANSWER: (a)

**Q.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.

[ICAI Study Material]

ANSWER: (c)

**Q.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

[ICAI Study Material]

ANSWER: (c)

**Q.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

[ICAI Study Material]

ANSWER: (c)

**Q.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

[ICAI Study Material]

**ANSWER: (b)**

**Q.6:** One of your junior audit team members is confused with the term 'material misstatement'. You explain him that a material misstatement is untrue information in a financial statement that could affect the financial decisions of one who relies on the statement.

1. An error of ₹ 5,000 in relation to assets of ₹ 20 lakhs.
  2. A payroll fraud of ₹ 100 in a company where profit before tax is ₹ 11,000.
  3. Non-disclosure of a material uncertainty.
  4. Financial statements have been prepared on a going concern basis when the company is in the process of being liquidated. Which of the above-mentioned would constitute material misstatement?
- (a) 1 and 2
  - (b) 3 and 4
  - (c) 2 and 3
  - (d) 1 and 4

[MTP April 19]

**ANSWER: (b)**

**Q.7:** ABC Ltd. is a renowned food chain supplier in a posh area providing restaurant facility along with food delivering. CA. Ram was appointed as an auditor of the company for the Financial Year 2023-24. While examining the books of account of the company, auditor came to know about one of the major expenses of the company i.e. rent expense of ₹ 1,20,000 per month, for which he applied substantive analytical procedure for verification purpose. Explain, how would auditor perform substantive analytical procedure in the given scenario?

- (a) Auditor would inspect every single rent invoice per month of ₹ 1,20,000 and verify other elements appropriately.
- (b) Auditor would compare the rental expense of the company with that of another nearby company having corresponding dimensions, for high degree of accuracy.
- (c) Auditor would select the first month rent invoice of ₹ 1,20,000 and appropriately verifying other elements would predict that the rent for the whole year would be ₹ 14,40,000 (i.e. ₹ 1,20,000\*12). Thereafter, he would compare the actual with his prediction and follow-up for any fluctuation.
- (d) Both (a) and (b).

[RTP May 19]

**ANSWER: (c)**

**Q.8:** In July, 2023, M/s. ABC & Co. entered into an agreement with M/s. X & Co. under which a machinery would be let on hire and M/s. X & Co. would have the option to purchase the machinery in accordance with the terms of the agreement. Thus, M/s. X & Co. agreed to pay M/s. ABC & Co. a settled amount in periodical instalments. The property in the goods shall be passed to M/s. X & Co. on the payment of last of such instalments. While checking such hire-purchase transaction, what would the auditor examine?

- (a) That the periodical instalments paid are charged as an expenditure by M/s. X & Co.
- (b) That M/s. ABC & Co instalments paid are charged as an expenditure by M/s. X & Co. charges depreciation throughout the life of the machinery.
- (c) That the hire purchase agreement specifies clearly the hire-purchase price of the machinery to which the agreement relates.
- (d) All of the above.

[RTP May 19]

**ANSWER: (c)**

**Q.9:** The management of M Ltd. has developed a strong internal control in its accounting system in such a way that the work of one person is reviewed by another. Since no individual employee is allowed to handle a task alone from the beginning to the end, the chances of early detection of frauds and errors are high, CA. Amar has been appointed as an auditor of the company for current Financial Year 2023-24. Before starting the audit, he wants to evaluate the internal control system of M Ltd. To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, CA. Amar decided to use internal control questionnaire to know and assimilate the system and evaluate the same. Which of the following questions need not be framed under internal control questionnaire relating to purchases?

- (a) Are authorized signatories for purchases limited to elected officials?
- (b) Are payments approved only on original invoices?
- (c) Are monthly bank reconciliations implemented for each and every bank accounts of the company?
- (d) Does authorized officials thoroughly review the documents before signing cheques?

[RTP May 19]

ANSWER: (c)

**Q.10:** While auditing the books of accounts of ABC Ltd., CA. Sanyam, the statutory auditor of the company, came to know that the management of the company has recognized internally generated goodwill as a fixed asset. CA. Sanyam discussed with the management that according to AS 26, internally generated goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost. However, the management is quite rigid to the accounting treatment followed for internally generated goodwill and not paying attention to the auditor. Thus, through an example, CA. Sanyam explained which type of goodwill may be recognized as a fixed asset for which the management got justified. State which of the following examples the auditor must have given to the management?

- (a) If an item meeting the definition of an intangible asset is acquired in a business combination, it forms part of the goodwill to be recognized at the date of the amalgamation.
- (b) Goodwill is recognised only when there is a contractual or other legal rights for a physical asset which shall not be amortized over the period.
- (c) Only those goodwill needs to be recognized as a fixed asset which can be touched like physical assets, for example, land and buildings.
- (d) All of the above

[RTP May 19]

ANSWER: (a)

## Division B - Descriptive Questions

**Q.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?

[ICAI Study Material]

### ANSWER

#### Identification of Assertions examined:

- 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.

- 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.

**Q.2:** 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. **[ICAI Study Material]**

Or

The securities premium account may only be applied by the company towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares, Comment. **[May 19 (3 Marks)]**

### **ANSWER**

#### **Issue of Shares at Premium:**

Where a company has issued shares at a premium, whether for cash or otherwise, aggregate amount of the premium received on those shares shall be transferred to security premium account.

As per Sec. 52 of Companies Act, 2013 the securities premium account may be applied by the company for the following purposes:

- issue of unissued shares of the company to the members of the company as fully paid bonus shares;
- writing off the preliminary expenses of the Company;
- writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
- 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.

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.

**Q.3:** 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 shares capital of the company:

- He noticed that some of the equity shares are held by promoters.
- 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 (4 Marks)]**

### **ANSWER**

#### **Meaning 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 known-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

#### **Disclosure requirements of promoter’s shareholding:**

Schedule III (Division I) of Companies Act, 2013 requires that a company shall disclose shareholding of Promoters as below:

| Should held by promoters at the end of the year |               |               |                     | % Change during the year** |
|-------------------------------------------------|---------------|---------------|---------------------|----------------------------|
| S. No.                                          | Promoter Name | No. of shares | % of total shares** |                            |
| Total                                           |               |               |                     |                            |

**\*\* Details shall be given separately for each class of shares.**

**\*\*\* % 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.**

**Q.4: How will you vouch/verify: Borrowings from banks?**

**[ICAI Study Material]**

**ANSWER**

**Verification of Borrowings 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 RoC 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 BoD is authorised to raise a loan or borrow from a bank.
- (iv) Confirm, in the case of a company, that the restraint contained in Sec. 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.
- (v) Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

**Q.5: 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.**

**[ICAI Study Material]**

**ANSWER**

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

**Q.6: How will you vouch or verify: Goods sent on consignment.**

**[ICAI Study Material]**

**ANSWER**

**Verification of Goods sent on Consignment:**

**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.

**Q.7:** 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 31.03.2024. What audit procedures should the statutory auditor of the company perform? **[ICAI Study Material]**

**ANSWER**

**Audit Procedure to establish the Ownership Rights:**

- 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.

**Q.8:** Briefly mention the matters that are relevant in planning attendance at physical inventory counting.

**[Nov. 18 (5 Marks)]**

**ANSWER**

**Physical attendance by auditor during inventory taking:**

- (a) The physical verification of stock is the responsibility of the management. The auditor may find it appropriate to attend the stock taking, if the inventory value is material in his opinion.
- (b) The extent of participation in inventory taking depends upon the internal control system prevailing, results of examination of inventory records and analytical review procedures.
- (c) When auditor attends inventory taking, he ensures that the instructions given for inventory taking are followed.
- (d) Auditor should test check a few items by himself for their existence and quantum. He selects to test high value items importantly.
- (e) The physical conditions of stock – like its age, deterioration, obsolescence etc., are looked into by auditor.
- (f) The auditor reviews stores records and notes down major discrepancies for reconciling them in a subsequent date.
- (g) The cut off arrangement is also looked into to ensure that the entity accounts for stock for which liability had been booked and excludes stock which had been sold.

**Q.9:** Write the audit procedure to be performed as an auditor for valuation (assertion) of following: Finished goods and goods for resale. **[Nov. 18 (5 Marks)]**

**ANSWER**

**Audit procedures to be performed for valuation of Finished Goods and Good for Resale:**

- (i) Enquire as to 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 F.S.
- (ii) Ensure that inventories are valued at net realisable 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 (WIP) and raw materials have also been written down.
- (iii) Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. Carefully examine the valuation of obsolete and damaged inventory. For the purpose, request the client to provide inventory ageing split between less than 30 days, 30-60 days old, 60-90 days old, 90-180 days old, 180-365 days old and more than 365 days old.
- (iv) Follow up any inventories which at time of observance of physical counting were noted as being damaged or obsolete.

**Q.10:** ABC Limited has a closing balance of work in progress of inventories aggregating ₹ 850 lakhs in their balance sheet as at March 31, 2024. 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 (3 Marks)]**

**ANSWER**

**Verification of Capital Work-in-Progress:**

- (1) Ascertain how the various stages of production/ value add are measured and in case estimates are made, understand the basis for such estimates.
- (2) Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity.
- (3) Ensure that material costs exclude any abnormal wastage factors.

**Q.11:** You are the statutory auditor of Jupiter Ltd. for the FY 2023-24. 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? **[ICAI Study Material]**

**ANSWER**

**Disclosures w.r.t. Capital-Work-in Progress**

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

**CWIP ageing schedule**

|                                |                                |           |           |                   | (Amount in ₹) |
|--------------------------------|--------------------------------|-----------|-----------|-------------------|---------------|
|                                | Amount in CWIP for a period of |           |           |                   | Total*        |
| CWIP                           | Less than 1 year               | 1-2 years | 2-3 years | More than 3 years |               |
| Project in Progress            |                                |           |           |                   |               |
| Projects temporarily suspended |                                |           |           |                   |               |

\* Total shall tally with CWIP amount in the balance sheet.

- (b) For capital-work-in progress, whose completion is overdue or has exceeded its cost compared to its original plan, following CWIP completion schedule shall be given\*\*:

| (Amount in ₹) |                    |           |           |                   |
|---------------|--------------------|-----------|-----------|-------------------|
| CWIP          | To be completed in |           |           |                   |
|               | Less than 1 year   | 1-2 years | 2-3 years | More than 3 years |
| Project 1     |                    |           |           |                   |
| Project 2     |                    |           |           |                   |

\*\*Details of projects where activity has been suspended shall be given separately.

**Q.12:** Expenses which are essentially of a revenue nature if incurred for creating an asset or adding to its value of achieving higher productivity are regarded as expenses of a capital nature. Describe any five such expenses.

[May 18 (5 Marks)]

#### ANSWER

**Expenses of Revenue Nature regarded as Capital Expenditure:**

- (1) Material and wages when expended on the construction of a building or erection of machinery.
- (2) Legal expenses incurred in connection with the purchase of land or building.
- (3) Freight when incurred in respect of purchase of plant and machinery.
- (4) Major repairs of a fixed asset that increases its productivity.
- (5) Wages paid on installation costs incurred in Plant & Machinery.
- (6) Interest paid for the qualifying period as per AS 16 i.e. before the asset is constructed.

**Q.13:** You are an auditor of PQR Ltd. which has spent ₹ 10 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.

[May 19 (4 Marks)]

#### ANSWER

**Conditions to be fulfilled to recognise the intangible assets in the financial statements:**

- 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.

**Q.14:** 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 (3 Marks)]

**ANSWER**

**Audit procedures to be applied to ensure appropriate valuation of Intangible assets:**

- (i) Verify that the entity has charged amortization on all intangible assets;
- (ii) 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.
- (iii) The auditor should also verify whether the management has done an impairment assessment to determine whether an intangible asset is impaired. For this purpose, the auditor needs to verify whether the entity has applied AS 28 - Impairment of Assets for determining the manner of reviewing the carrying amount of its intangible asset, determining the recoverable amount of the asset to determine impairment loss, if any.

**Q.15:** MNO & Associates are the statutory auditor of Venus Ltd. for the FY 2023-24. 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? [ICAI Study Material]

**ANSWER**

**Disclosure requirements with respect to loans:**

Mr. Manik should advise Mr. Viaan to consider whether the following disclosures as required by Schedule III to the Companies Act, 2013, has been made in respect of the loans granted to promoters, namely, Mr. Raj and Mr. Rajeev, either severally or jointly with any other person, that are:

- (a) Repayable on demand or
- (b) Without specifying any terms or period of repayment

| Type of Borrower | Amount of loan or advance in the nature of loan outstanding | Percentage to the total Loans and Advances in the nature of loans |
|------------------|-------------------------------------------------------------|-------------------------------------------------------------------|
| Promoters        |                                                             |                                                                   |
| Directors        |                                                             |                                                                   |
| KMPs             |                                                             |                                                                   |
| Related Parties  |                                                             |                                                                   |

**Q.16:** Write the audit procedures to be performed as an auditor for valuation (assertion) of: Loans and Advances and other current assets. [Nov. 18 (5 Marks)]

**ANSWER**

**Audit procedures to be performed for valuation of Loans and Advances and other current assets:**

- (i) Examine the provision made for doubtful accounts. For this purpose, auditor need to review the process followed by the entity to derive an allowance for doubtful accounts. Compare the process used in the last year and determine the appropriateness of method used.
- (ii) 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.

- (iii) Obtain list of loans and advances under dispute and compare with previous year.
- (iv) Identify loans and advances that appear doubtful and check the respective provisions made. In case provisions are not been made, inquire the reasons from management
- (v) Examine bad loans/advances write-offs. Prepare schedule of movements on Bad loans/ advances-Provision Accounts and loans/advances written off.
- (vi) Examine whether the write-offs of other reductions in the recoverable balances have been approved by appropriate authority.
- (vii) Examine whether the restatement of foreign currency loans and advances/other current assets has been done properly.

**Q.17:** How will you vouch/verify: Provision for Tax.

[ICAI Study Material]

**ANSWER**

**Payment of Taxes:**

- (1) 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.
- (2) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.
- (3) Examine relevant records and documents pertaining to advance tax, self-assessment tax and other demands.
- (4) Compute tax payable as per the latest applicable rates in the Finance Act.
- (5) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provisions, advance tax paid, assessment orders, etc.
- (6) Ensure that the requirements of AS 22 on "Accounting for Taxes on Income" have been appropriately followed for the period under audit.

**Q.18:** CA Q, the auditor of XYZ Ltd, while conducting audit observes that the company has made various provisions in the books of account. What are the audit procedures that CA Q will follow to verify the existence, completeness, and valuation of the provisions made?

[May 23 (3 Marks)]

**ANSWER**

**Audit procedures for verification of existence, completeness & valuation of provisions:**

- (1) Obtain a list of all provisions and compare them with balances in the ledger.
- (2) Inspect the underlying agreements like appointment agreement with employees to understand the entity's commitment towards defined benefits, agreement with customers to assess warranty commitments, any legal and other claims on the entity i.e. litigations.
- (3) Obtain the underlying working and the basis for each of the provisions made, from the management and verify whether the same is complete and accurate.
- (4) Review minutes of the meetings of the Board of Directors or other similar bodies.
- (5) Review list of pending law suits and obtain a certificate and opinion of the lawyer dealing with the cases.
- (6) Review of records relating to contingent liabilities maintained by the company.
- (7) Review of terms and condition of grants and subsidy availed.
- (8) Obtain representation from the management that all known contingent liabilities have been included in the accounts and disclosed properly.
- (9) Ensure that proper disclosure is made of all the contingent liabilities as per the requirements of AS-29 and Schedule III to the Companies Act, 2013.

**Q.19:** 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. **[ICAI Study Material]**

**ANSWER**

**Substantive Analytical Procedures in respect of Sales:**

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.

**Q.20:** How will you vouch/verify the following: Goods sent out on sale or return basis.

**[ICAI Study Material]**

Or

Discuss the audit procedures generally required to be undertaken by the auditor while auditing Goods sent out on Sale or Return Basis. **[May 23 (3 Marks)]**

**ANSWER**

**Vouching of Goods sent on sale or return basis:**

- (1) Check maintenance of separate memoranda records of goods sent out on sale or return. Only after approval from customer, personal account of customer is debited and the sales account is credited.
- (2) Ensure that the price of such goods is unloaded from the sales account and the debtor's record before the approval from customer.
- (3) In respect of the good for which approval period has expired, ensure that either goods have been received back or customer's account have been debited.
- (4) In respect of the goods for which approval period has not expired till the close of the year and lying with the party, ensure that cost of such goods has been included in the closing stock.

**Q.21:** 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 (4 Marks)]**

**ANSWER**

**Audit procedures to be undertaken to ensure revenue is not overstated:**

- 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.)

**Q.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. **[July 21 (4 Marks)]**

**ANSWER**

**Audit Procedure to check that sales are accurately measured:**

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.

- (1) 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.
- (2) If the client is engaged in export sales, then compliance with AS 11 shall be ensured.
- (3) Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.
- (4) 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.

**Q.23:** As statutory auditor of the company, list out audit procedures required to be undertaken for the following:

- (i) Interest income from fixed deposits,
- (ii) Dividend income.
- (iii) Gain/(loss) on sale of investment in Mutual funds.

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

**[May 18 (4+2+2+2 Marks)]**

Or

ABC limited appointed XYZ & Company, Chartered Accountants, as a Statutory Auditor of the Company for the year 2023-24. 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 2023-24?

**[Nov. 20 (4 Marks)]**

Or

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 (3 Marks)]**

**ANSWER**

**Audit procedure for financial items:**

- (i) **Interest income from fixed deposits:**
  - (a) Obtain a list of all fixed deposits exist at the beginning of the year and newly made during the audit, along with the applicable interest rate and the number of days for which the deposit was made.
  - (b) Verify the arithmetical accuracy of the interest calculation by multiplying the deposit amount with the applicable rate and number of days during the period under audit.

- (c) For deposits outstanding as at the year end, obtain direct confirmation from the respective bank/financial institution.
- (d) 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.
- (e) Obtain a copy of Form 26AS (TDS) and reconcile the interest reflected therein to the calculation shared by client.

**(ii) Dividend Income:**

Verify that the dividend is recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established, provided it is probable that the economic benefits associated with the dividend will flow to the entity and the amount of the dividend can be measured reliably.

**(iii) Gain/(Loss) on sale of investment in Mutual funds:**

- (a) Verify that gain /(loss) on sale of investment in mutual funds is recognised as other income only on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.
- (b) For this purpose, obtain the mutual fund statement and trace the gain/loss as recorded in the books of account to the gain/loss as reflected in the statement.

**Disclosure Requirements of Schedule III:**

Other income shall be classified as:

- (i) Interest Income (except for a financial company)
- (ii) Dividend Income
- (iii) Net gain/loss on sale of Investments
- (iv) Other Non-Operating Income (net of expenses directly attributable to such income)

**Q.24:** How would you vouch/verify the following: Sale of Scrap.

[ICAI Study Material]

Or

X Ltd. is a hardware manufacturing company. At each and every stage of production processes large amount of scrap is generated in the factory and subsequently sold. As an auditor how will you vouch/ verify the sale of scrap?

[May 23 (3 Marks)]

**ANSWER**

**Vouching of Sale of Scrap:**

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

**Q.25:** State the disclosure requirements in respect of Statement of point and loss as per Schedule III of Companies Act, 2013, in case of Employee benefits expenses.

[ICAI Study Material]

### **ANSWER**

#### **Disclosure requirements w.r.t. employee benefit expenses as per Schedule III:**

Schedule III requires that a Company shall disclose by way of notes additional information regarding the employee benefit expenses as:

- (i) Salaries and wages,
- (ii) Contribution to provident and other funds,
- (iii) Expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP),
- (iv) Staff welfare expenses

**Q.26:** While reviewing Employee benefits expenses of a company, how you as an auditor you will evaluate its hiring, appraisal and retirement process? **[May 19 (3 Marks)]**

### **ANSWER**

#### **Evaluation of hiring, appraisal and retirement process:**

- Tests the controls the company has set around employee benefit payment process to determine how effective and reliable they are. If they are effective, the auditor can minimise the amount of transaction testing he must do.  
  
Common internal controls over the employee benefit payment cycle includes maintaining of attendance records, employee master, authorisation and approval of monthly payroll processing and disbursement, computation of employee deductions like payroll taxes, accrual of other benefits like gratuity, leave encashment, bonus etc.
- Select a random sample of transactions and examines the related appointment letters, appraisal letters, attendance records, HR policies, employee master etc.
- Perform substantive analytical procedures, which may comprise of evaluation of reasonable of monthly expense, comparison with previous accounting period, any analysis auditor may find relevant and most important of all setting an expectation in relation to the expense incurred during the period under audit and compare that with the client's business operations and overall trend in the industry.

**Q.27:** While verifying depreciation charged to statement of profit and loss account of a company, it is noticed by auditor that one new machinery was purchased and installed in month of April. The necessary trials were carried out and machinery was ready for use in April itself. However, owing to lack of orders in the market, the said machinery was put into actual operation from 1st October. The company has, accordingly, provided depreciation in its books on this machinery w.e.f. 1st October. Is above recording of depreciation by company proper in its books? **[ICAI Study Material]**

### **ANSWER**

#### **Charging Depreciation from date of actual usage:**

- 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.

**Q.28:** Mention any five attributes to be considered by an auditor while verifying for depreciation and amortisation expenses. **[May 18 (5 Marks)]**

Or

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 (4 Marks)]**

## **ANSWER**

### **Attributes to be considered by auditor while verifying depreciation and amortisation:**

Depreciation and amortisation generally constitute an entity's significant part of overall expenses and have direct impact on the profit/ loss of the entity, hence auditors need to verify and ensure that such expenditure is appropriate, accurately calculated and has been accounted as per applicable provisions of Companies Act or other statutes, to the extent applicable on the respective industry and as per generally accepted accounting principles.

Auditor needs to consider the following attributes while verifying for depreciation and amortisation expenses:

- (1) Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- (2) Ensure the Company policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act/ applicable accounting standards.
- (3) The accounting policy has been applied consistently year on year. Any change in the accounting policy has been adequately disclosed.
- (4) Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- (5) Whether depreciation and amortisation charges are valid.
- (6) Whether depreciation and amortisation charges are accurately calculated and recorded.
- (7) Whether all depreciation and amortisation charges are recorded in the appropriate period.
- (8) Ensure the parts (components) of each item of property, plant and equipment that are to be depreciated separately have been properly identified.

### **Q.29: How will you vouch/ verify the following: Foreign travel expenses.**

**[ICAI Study Material]**

## **ANSWER**

### **Vouching of Foreign Travel Expenses:**

- (i) Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.
- (ii) Verify that the tour programme was properly authorised by the competent authority.
- (iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.
- (iv) See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.
- (v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".

### **Q.30: How will you vouch/ verify the following: Advertisement Expenses.**

**[ICAI Study Material]**

## **ANSWER**

### **Vouching of 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.

**Q.31:** “While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel but for other expense, an auditor generally prefers to verify other attributes.” Mention those attributes.

[Nov. 18 (5 Marks)]

Or

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 (5 Marks)]

Or

M/s SS & Associates have been appointed as statutory auditors of Green Limited, a company engaged in the business of manufacturing of hardware products. They are analyzing the monthly trends for other expenses like rent, power and fuel, repairs, etc. and are also verifying attributes of such types of expenses. List down the attributes for verifying such expenses.

[Jan. 21 (4 Marks)]

#### ANSWER

##### **Attributes to be examined while vouching expenses:**

An entity in addition to making purchases and incurring employee benefit expenses, also incurs other expenditures like rent, power and fuel, repairs and maintenance, insurance, travelling, miscellaneous expenses etc., that are essential and incidental to running of business operations.

While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify following attributes:

- (a) Whether the expenditure pertained to current period under audit;
- (b) Whether the expenditure qualified as a revenue and not capital expenditure;
- (c) Whether the expenditure had a valid supporting document like travel tickets, insurance policy, third party invoice etc.;
- (d) Whether the expenditure has been classified under the correct expense head;
- (e) Whether the expenditure was authorised as per the delegation of authority matrix;
- (f) Whether the expenditure was in relation to the entity's business and not a personal expenditure.

**Q.32:** Proceedings have been initiated against False Limited for holding benami property under the Benami Transactions (Prohibition) Act, 1988 and the rules made thereunder, but such property is not recorded in books of accounts. As a consultant to the company, what will you advice to the company as far as disclosure requirements are concerned in relation to said proceedings?

[May 22 (4 Marks)]

#### ANSWER

##### **Disclosure requirements in relation to proceedings under Benami Transactions (Prohibition) Act, 1988:**

Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 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 in the books, then reference to the item in the Balance Sheet.
- (e) If property is not in the books, then the fact shall be stated with reasons,

- (f) Where there are proceedings against the company under this law as an abettor of the transaction or as the transferor, then the details shall be provided,
- (g) Nature of proceedings, status of same and company's view on same.

**Q.33:** A Ltd. has traded for ₹ 50.00 Lacs in "TETRA", a virtual currency, during the F.Y. 2023-2024 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 (3 Marks)]**

**ANSWER**

**Disclosures regarding 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.

**Q.34:** How will you vouch/verify the following: Receipt of Capital subsidy.

**[ICAI Study Material]**

**ANSWER**

**Receipt of Capital Subsidy:**

- (ii) Check the application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.
- (iii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.
- (iv) 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.
- (v) Check relevant entries for receipt of subsidy.
- (vi) 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.

### **Division C - Case Study Based Questions**

Sunsteel Ltd. is a company engaged in the manufacture of variety of stainless-steel household items ranging from hot pot, pressure cooker, cutlery set, bottles, to serving trays. The company has its corporate office in Delhi and its plant in Raigarh, a city in the state of Chhattisgarh. The company is planning to expand its manufacturing activities by setting up two new plants in the Raipur district of the state. For this purpose, the company also raised funds by making a follow-on public offer during the financial year 2022-23. R K Maheshwari & Associates are the statutory auditors of the company since the year 2020-21. The engagement team consisted of 5 members, with CA Raman as the engagement partner, CA Madhu as the senior associate and three articled trainees namely, Aman, Chetanya and Depesh.

The company raised fresh capital of ₹ 5 Cr during the FY 2022-23. The shares with the nominal value of ₹ 10 per share were issued at a premium of ₹ 5 per share.

The company has the Reserves and Surplus totaling to ₹ 2 Cr, comprising of securities premium and general reserve.

CA Raman directed CA Madhu to verify the issue of the share capital in detail giving special consideration to the utilization of the securities premium amount. The audit engagement team discussed with the management about the performance of the company during the year under consideration. To this, the management told the

engagement team that the company is performing very well and the company has doubled its revenue during the year as compared to the last year. The management of the company also told the auditors that during the year the company has made majority of its sales on credit basis to its customers.

CA Raman directed Mr. Aman to send balance confirmation requests to debtors having balance in excess of ₹ 1 lakh.

During the course of audit, CA Raman, Chetanya and Depesh also visited the power plants in Raigarh to get a detailed understanding of the manufacturing process. The team performed analytical procedures to obtain audit evidence with respect to the overall reasonableness of purchase quantity and price of inventory. More specifically, Chetanya collected the reports from the management for composition of stock i.e. raw materials as a percentage of total stock and compared the same with the data of the previous year. CA Raman and Chetanya thereafter, discussed the reasons for the variations with the management.

Also, while considering the presentation and disclosure requirements as per Schedule III to the Companies Act, CA Madhu discussed with CA Raman the disclosure with respect to the following account balances:

- Current maturities to long term borrowings
- Long term maturities of finance lease obligations
- Interest accrued but not due on borrowings
- Interest accrued and due on borrowings

**Based on above, answer following questions:**

**(1) Which of the following is not correct with respect to share 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 premiums 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 replay is received, the auditor should perform alternate procedures regarding the balances.**

- (b) Only statement 1 is correct
- (c) Only statement 2 is correct
- (d) Both statements 1 & 2 are correct
- (e) 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?**

- (e) Consumption Analysis

(f) Stock Composition Analysis

(g) Reasonableness test

(h) Ratio analysis

**(5) Which of the following is not correct with respect to the disclosure requirements of Schedule III to the Companies Act 2023?**

(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

Interest accrued and due on borrowings is to be disclosed under the head Other Current Liabilities

**[ICAI Study Material]**

**ANSWER**

**(1)**

**(c)**

**(2)**

**(d)**

**(3)**

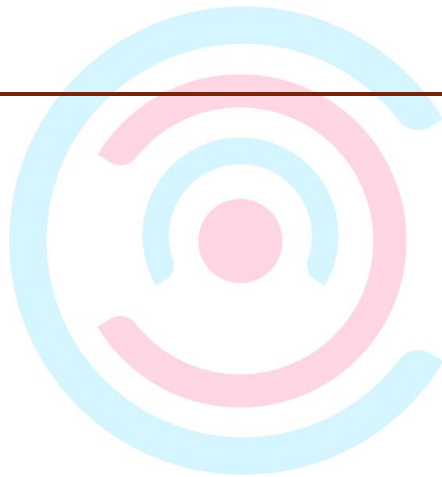
**(c)**

**(4)**

**(b)**

**(5)**

**(a)**



**CA DREAMERS**  
**THE AVENGER**

# AUDIT DOCUMENTATION

## Division A - Multiple Choice Questions

**Q.1:** Which of the following statement is appropriately suited to preparation of audit documentation?

- (a) Audit documentation has to be prepared simultaneously as audit progresses.
- (b) Audit documentation has to be prepared 60 days after date of audit report.
- (c) Audit documentation has to be prepared when information is required by regulator.
- (d) Audit documentation has to be prepared 60 days after completion of audit work

[ICAI Study Material]

ANSWER: (a)

**Q.2:** Audit documentation is owned by: -

- (a) Client
- (b) Auditor
- (c) Team member responsible for documentation
- (d) Regulator

[ICAI Study Material]

ANSWER: (b)

**Q.3:** Which of the following is least likely to be included in audit documentation of a company engaged in manufacturing and export of goods?

- (a) Previous years audited financial statements
- (b) Projected cash flow statement for next twelve months provided by management in support of going concern assumption
- (c) Statements showing dispatch of overseas consignments in accordance with delivery schedules of overseas buyers
- (d) Statement showing verification of ageing of trade receivables as on date of balance sheet

[ICAI Study Material]

ANSWER: (c)

**Q.4:** Which of the following is false in relation to audit documentation when an external auditor relies upon work of internal auditor?

- (a) Evaluation of objectivity and competence of internal auditor has to be documented.
- (b) Nature of work used and reason for relying upon work used forms part of documentation.
- (c) Documentation on whether quality control is exercised in internal audit work forms part of audit documentation.
- (d) Documentation on what specific recommendations were given by internal auditor for risk assessment to external auditor forms part of audit documentation.

[ICAI Study Material]

ANSWER: (d)

**Q.5:** Audit documentation provides:

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

[MTP March 19, March 21, April 21, Nov. 21]

**ANSWER: (b)**

**Q.6:** Which of the following is not an example of audit documentation?

- (a) Audit programmes
- (b) Summaries of significant matters
- (c) Audit file
- (d) Checklists.

[MTP March 19]

**ANSWER: (c)**

**Q.7:** Which of the following is correct:

- (a) The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.
- (b) The auditor shall assemble the audit documentation in an audit file and shall not complete the administrative process of assembling the final audit file.
- (c) The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis before the date of the auditor's report.
- (d) The auditor shall not assemble the audit documentation in an audit file.

[MTP April 19, Oct.19]

**ANSWER: (a)**

**Q.8:** CA. Bobby is a recently qualified Chartered Accountant. He is appointed as an auditor of Droopy Ltd. for the current Financial Year 2023-24. He is quite conservative in nature which is also replicated in his professional work. CA. Bobby is of the view that he shall record all the matters related to audit, audit procedures to be performed, audit evidence obtained and conclusions reached. Thus, he maintained a file and recorded each and every of his findings during the audit. His audit file, besides other thing, includes audit programmes, notes reflecting preliminary thinking, letters of confirmation, e-mails concerning significant matters, etc. State which of the following need not be included in the audit documentation?

- (a) Audit programmes.
- (b) Notes reflecting preliminary thinking.
- (c) Letters of confirmation.
- (d) E-mails concerning significant matters.

[RTP May 19]

**ANSWER: (b)**

**Q.9:** Judging the significance of a matter requires \_\_\_\_\_ of the facts and circumstances.

- (a) Objective analysis

- (b) Subjective analysis
- (c) Both subjective and objective analysis
- (d) Qualitative analysis

[MTP April 22]

**ANSWER: (a)**

**Q.10:** \_\_\_\_\_ requires firms to establish policies and procedures for the retention of \_\_\_\_\_. The retention period for audit engagements ordinarily is no shorter than \_\_\_\_\_ from the date of the auditor's report, or, if later, the date of the group auditor's report

- (a) SA 220, audit evidence, six years
- (b) SA 200, audit documentation, seven years
- (c) SQC 1, engagement documentation, seven years
- (d) SA 230, documentation, six years

[RTP May 22]

**ANSWER: (c)**

## **Division B - Descriptive Questions**

**Q.1:** Define audit documentation. Also give some examples.

[ICAI Study Material]

### **ANSWER**

#### **Audit Documentation:**

SA 230 "Audit Documentation" defines the term as audit documentation as record of:

- Audit procedures performed;
- Relevant audit evidence obtained; and
- The conclusions the auditor reached.

#### **Examples of audit documentation include:**

- (a) Audit programmes.
- (b) Analyses.
- (c) Issues memoranda.
- (d) Summaries of significant matters.
- (e) Letters of confirmation and representation.
- (f) Checklists.
- (g) Correspondence (including e-mail) concerning significant matters.

**Q.2:** A new team member of the auditors of Extremely Vibrant Limited was of the view that Audit Documentation does not help in planning the audit of any company. Explain whether Audit Documentation has any relation with regard to planning the audit of a company.

[ICAI Study Material]

### **ANSWER**

#### **Purposes of Audit Documentation:**

Audit Documentation helps in planning the audit of a company in a proper manner audit also helps in conducting the audit of that company in a more effective way.

**Q.3:** While auditing the books of accounts of Very Careful Limited for the financial year 2023-24, 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. [ICAI Study Material]

**ANSWER**

**Relationship between Audit File and Audit Documentation:**

- 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.
- 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.

**Q.4:** 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. [ICAI Study Material]

**ANSWER**

**Ownership of Audit Documentation:**

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

**Q.5:** 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? [ICAI Study Material]

**ANSWER**

**Documentation of Significant Matters:**

- 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.

**Conclusion:** 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.

**Q.6:** CA Sonali Morarka has completed audit of a listed company. The audit report dated 15th July, 2023 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. [ICAI Study Material]

**ANSWER**

**Assembly of Final Audit File:**

- 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.

**Conclusion:** Facts as stated in this situation shows that part of audit documentation has been prepared afterwards putting a question mark on quality of audit.

**Q.7:** "Audit documentation summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits". Explain. [ICAI Study Material]

Or

"Completion memorandum" is helpful as part of the audit documentation. Explain.

[May 19 (3 Marks)]

**ANSWER:**

**Completion Memorandum (Audit Documentation Summary):**

SA 230 "Audit Documentation" defines the term as "Record of audit procedures performed, relevant audit evidence obtained and the conclusions the auditor reached".

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

- (a) The significant matters identified during the audit and
- (b) How they were addressed.

Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits.

Preparation of such a summary may assist the auditor's consideration of the significant matters. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters.

It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant SA objective that the auditor has not met or is unable to meet that would prevent the auditor from achieving the auditor's overall objective.

### **Division C - Case Study Based Questions**

**CA Rajan Pillai is heading the engagement team conducting audit of a company. While audit is in progress, consider following issues regarding audit documentation:-**

- (A) Audit programme was prepared assigning responsibilities for different types of works to be performed to team members. The engagement team consists of 4 members Mohit (CA final student), Rohit (CA final student), Shobhit (Paid CA) and CA Rajan Pillai (partner of audit firm).
- (B) The team has determined materiality for financial statements as a whole.
- (C) The team has assessed risks of material misstatements to be low.
- (D) CA Shobhit is responsible for attending inventory count process and putting down its documentation part.
- (E) During the course of audit, many related party transactions have come to notice.

**On the basis of above, answer the following questions:**

- (1) **Work relating to verification of revenue was assigned to Mohit in audit programme. However, it is being performed by Rohit actually. Verification of trade receivables was planned to be carried out by Rohit in audit programme. However, it being performed by CA Rajan Pillai due to last minute practical issues. Which of the following statements is most appropriate in this regard relating to audit documentation?**
- (a) Audit programme contains names of person 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 person assigned specific responsibilities can perform those duties.
  - (c) It is necessary that audit programme be suitably updated or notes are given in working papers to this effect so that planned duties are in accordance with actual work performance.
  - (d) Changes in audit programme or notes clarifying the matter are required only when a person not forming part of engagement team is deputed to perform a duty. Otherwise, this issue of inter-shuffling of team members is frivolous.
- (2) **As regards materiality, which of the following statements is most appropriate in context of audit documentation?**
- (a) Materiality has already been determined. There is no need to put it into working papers.
  - (b) Materiality depends upon professional judgment of auditor. Whatever amount has been determined can be documented in working papers.
  - (c) Materiality arrived on basis of professional judgment along with factors considered in the determination has to be documented.
  - (d) Materiality has been arrived upon professional judgment. It also depends upon professional judgment of auditor whether he wants to document it or not.
- (3) **As regards team's assessment that risk of material misstatements is low, which of the following statements is odd one relating to documentation of risk?**
- (a) Discussion amongst engagement team members and detail of significant decisions reached has to be documented.
  - (b) Details of risk assessment procedures have to be documented.
  - (c) Details about how understanding of each component of internal control was obtained has to be documented.
  - (d) Precise calculation of risk of material misstatements has to be documented.
- (4) **CA Shobhit is responsible for attending physical inventory count of the company. Which of the following is not true in this regard relating to audit documentation?**
- (a) Dates on which physical inventory count process was attended by him should be documented. It may also include photographs of that date showing his attendance of inventory counting process at a particular location.
  - (b) Detail of test counting undertaken should form part of audit documentation.
  - (c) Detail of obsolete goods found should form part of audit documentation.
  - (d) Reports showing that stocks conform to quality control standards in accordance with law are essential part of audit documentation.
- (5) **As regards related party transactions, which of the following should not be part of audit documentation?**
- (a) Management representation letter in this regard
  - (b) Related party transaction policy of the company
  - (c) Documentation to show that such transactions are at arm's length basis
  - (d) Documentation to show that such transactions are at close length basis.

[ICAI Study Material]

ANSWER

(1)

(c)

(2)

(c)

(3)

(d)

(4)

(d)

(5)

(d)



# COMPLETION AND REVIEW

## Division A - Multiple Choice Questions

**Q.1:** An auditor of a company communicates significant findings from audit with those charged with governance in the company. Which of the statements is false in regard to communication made?

- (a) Evaluation of adequacy of communication process is required on part of the auditor.
- (b) Planned scope and timing of audit has also to be communicated.
- (c) Communication of rationale behind audit procedures is necessary.
- (d) Significant difficulties encountered during audit, if any, have to be communicated.

[ICAI Study Material]

**ANSWER:** (c)

**Q.2:** Written representations are: -

- (d) Necessary audit evidence
- (e) Sufficient appropriate audit evidence
- (f) Not audit evidence
- (g) Audit evidence depending upon auditor's professional judgment

[ICAI Study Material]

**ANSWER:** (a)

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

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

[ICAI Study Material]

**ANSWER:** (b)

**Q.4:** Which of the following is not an example of subsequent event?

- (a) Event occurring between date of financial statements and date of auditor's report.
- (b) Event occurring on date of financial statements.
- (c) Event occurring after filing audit report with tax authorities. Had such an event been known earlier, auditor would have amended report.
- (d) Event occurring during course of performing audit procedures after date of financial statements.

[ICAI Study Material]

**ANSWER:** (b)

**Q.5:** Which of the following is not an example of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern?

- (a) Adverse key financial ratios
- (b) Inability to invest in modernisation of plant
- (c) Inability to pay creditors on time
- (d) Inability to pay salary of staff

[ICAI Study Material]

**ANSWER:** (b)

**Q.6:** Which of the following is incorrect:

- (a) Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements.
- (b) Similar to responses to inquiries, written representations are audit evidence.
- (c) Written representations are requested from those responsible for the preparation and presentation of the financial statements.
- (d) Written representations provide necessary audit evidence and also, they provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

[MTP March 19]

**ANSWER:** (d)

**Q.7:** A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework is:

- (a) Misstatement
- (b) Error
- (c) Fraud
- (d) Any of the above

[MTP April 19, Oct, 19]

**ANSWER:** (a)

**Q.8:** Which of the following is not an example of an event or condition that may cast significant doubt on entity's ability to continue as a going concern:

- (a) Loss of key management without replacement
- (b) Adverse key financial ratios
- (c) Inability to pay creditors on due date
- (d) Current year profit turns to loss after providing depreciation

[MTP Oct. 20, Oct. 21, MTP March 22]

**ANSWER:** (d)

**Q.9:** A company is engaged in business of obtaining eggs from one day old chicks. Which of the following is NOT an example of an event or condition that may cast significant doubt on the ability of the company to continue as a going concern?

- (a) Mortality of 90% of livestock of the company
- (b) Decision by govt to ban commercial rearing of birds amidst protests by activists for preventing cruelty to animals

(c) Shifting of farm labour to respective villages due to MGNREGA scheme of Govt causing acute scarcity throughout the year

(d) Increase in cost of feed of chicks by 20% during the year

[RTP Nov. 22]

**ANSWER:** (d)

**Q.10:** The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

(a) Discuss the matter with management and, where appropriate, those charged with governance.

(b) Determine whether the financial statements need amendment.

(c) Inquire how management intends to address the matter in the financial statements.

(d) All of the above

[MTP March 23]

**ANSWER:** (d)

### **Division B - Descriptive Questions**

**Q.1:** 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. (Marks)]

**ANSWER**

**Factors relevant to Management Assessment of Going Concern:**

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.

**Q.2:** 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

[May 23 (4 Marks)]

**ANSWER**

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

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

**(a) Adequate Disclosure of a Material Uncertainty is Made in the Financial Statements**

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

**(b) Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements**

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

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

**Q.3:** 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 ₹ 2 crore. It has also been noticed that freight of ₹ 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. **[ICAI Study Material]**

**ANSWER**

- The instances highlighted in above situation are examples of misstatements identified during the audit.
- Over valuation of inventory of finished goods by ₹ 2 crore and wrongly charging freight of ₹ 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.

**Q.4:** Discuss documentation requirements for an auditor regarding misstatements identified during audit under SA 450. **[ICAI Study Material]**

**ANSWER**

**Documentation regarding misstatements identified during audit:**

Documentation shall include:

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

**Q.5:** CA R Gurumurthy is about to complete audit of a company. Before completion, he asks management to provide him a written representation confirming that management has fulfilled its responsibilities regarding preparation of financial statements. He also wants management to confirm in writing about providing of all the necessary information and completeness of transactions to him. The management feels that auditor is seeking

irrelevant documents near the completion of audit. Why view of management is not proper? What possible implications it may lead to? **[ICAI Study Material]**

**ANSWER**

**Requirement of Management Representations:**

- 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.

**Q.6:** Explain the objectives of the auditor regarding written representations.

**[Jan. 21 (3 Marks)]**

**ANSWER**

**Written Representation:**

- SA 580 "Written Representation" defines the term as a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.
- Written representation in this context do not include financial statements, the assertions therein or supporting books and records.
- Written representations are necessary information that the auditor requires in connection with the audit, hence they are recognised as audit evidence as a response to inquiries.
- Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.
- Auditor requires the written representation from the management to support other audit evidence relevant to the Financial Statements. or specific assertion in the Financial Statements.

**Objectives of Auditor regarding Written representation:**

- (a) To obtain written representations from management that management believes that it has fulfilled the fundamental responsibilities that constitute the premise on which an audit is conducted;
- (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and
- (c) To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

**Q.7:** 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 (4 Marks)]**

**ANSWER**

**Other Written Representation:**

SA 580 "Written Representation" deals with the requirements related to written representations to be obtained by auditor from management and TCWG.

Other SAs also 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. In this given case.

Auditor, 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.

**Q.8: In what ways an effective two-way communication between auditor and those charged with governance is important?** **[ICAI Study Material]**

**ANSWER**

**Role of Communication:**

Effective two-way communication is important in assisting:

- (a) Auditor and TCWG in understanding matters related to the audit and in developing a constructive working relationship;
- (b) Auditor in obtaining from TCWG information relevant to the audit.
- (c) For example, TCWG may assist auditor in understanding entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events; and
- (d) TCWG in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the RoMM.

**Q.9: Discuss with reference to SAs: The auditor shall communicate all significant findings with those charged with Governance.** **[ICAI Study Material]**

Or

**“The auditors should communicate audit matters of governance interest arising from the audit of financial statements with those charged with the governance of an entity”. Briefly state the matters to be included in such Communication.** **[ICAI Study Material]**

**ANSWER**

**Communicating Significant Finding to TCWG:**

SA 260 “Communication with Those charged with Governance” deals with auditor’s responsibilities to communicate with TCWG in an audit of financial statements.

As per SA 260, auditor should communicate all significant findings with the TCWG, stated as below:

- (a) The auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures.
- (b) Significant difficulties, if any, encountered during the audit;
- (c) Unless all of those charged with governance are involved in managing the entity:
  - Significant matters, arising from the audit that were discussed, or subject to correspondence with management; and
  - Written representations the auditor is requesting;

- (d) Circumstances that affect the form and content of the auditor's report, if any; and
- (e) Any other significant matters that in the auditor's professional judgement, are significant to the oversight of the financial reporting process.

**Q.10:** 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.

**[ICAI Study Material]**

#### **ANSWER**

##### **Communicating Deficiencies in Internal Control:**

- 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.

**Q.11:** 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".

**[ICAI Study Material]**

#### **ANSWER**

##### **Matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency**

- (1) Likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- (2) Susceptibility to loss or fraud of the related asset or liability.
- (3) Subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- (4) Financial statement amounts exposed to the deficiencies.
- (5) Volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- (6) 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).

- (7) Cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- (8) Interaction of the deficiency with other deficiencies in internal control.

**Q.12:** Auditor are required to obtain an understanding of internal control relevant to the audit when identifying and assessing its effectiveness and risk of material misstatement. During the course of audit of ABC Ltd., you observed that significant deficiency exists in the internal control system and you want to ascertain the same. Elucidate the various indicators of significant deficiencies which will help you in assessing the efficiency of internal control system of the organisation. **[ICAI Study Material]**

**ANSWER**

**Indicators of significant deficiencies:**

As per SA 265, "Communicating Deficiencies in Internal Control to Those charged with Governance and Management", Indicators of significant deficiencies in internal control include, for example:

- (i) Evidence of ineffective aspects of the control environment, such as:
  - (a) Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
  - (b) Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
  - (c) Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
- (ii) Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.
- (iii) Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
- (iv) Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
- (v) Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
- (vi) Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss.
- (vii) Evidence of management's inability to oversee the preparation of the financial statements.

**Q.13:** Write short note on: Contents of written communication of significant deficiencies in internal control. **[ICAI Study Material]**

**ANSWER**

**Contents of written communication of significant deficiencies in internal control:**

- (a) A description of the deficiencies and an explanation of their potential effects; and
- (b) Sufficient information to enable those charged with governance and management to understand the context of the communication.

In particular, the auditor shall explain that:

- (ii) The purpose of the audit was for the auditor to express an opinion on the financial statements;
- (iii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
- (iv) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

## **Division C - Case Study Based Questions**

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 matter above concerning issue of going concern, which of the following statements is most appropriate for auditor's report?**
  - (a) The auditor should express an unmodified opinion.
  - (b) The auditor should express a qualified opinion as material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
  - (c) Besides expressing an unmodified opinion, the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" drawing attention to the note in which such disclosure is made in financial statements along with related matters.
  - (d) Such an issue does not affect auditor's opinion.
- (2) As regards going concern basis of accounting is concerned, which of the following statements is true?**
  - (a) A company showing net loss in its financial statements is essentially not a going concern.
  - (b) Following going concern assumption of accounting is primary duty of auditor.
  - (c) In case, a company is not a going concern, its financial statements must be prepared on liquidation basis.
  - (d) Audit procedure seeking confirmation from banker regarding outstanding balance relates to verification of going concern assumption.
- (3) Which of the following statements is true in respect of auditor's responsibilities in respect of subsequent events?**
  - (a) There is no obligation for an auditor to perform audit procedures for events occurring between date of financial statements and date of auditor's report.
  - (b) There is no obligation for an auditor to perform audit procedures after signing of auditor's report, even if he comes to know of an event, which if known to him earlier would have caused him to amend the audit report.
  - (c) The auditor has only to rely upon written representation of management regarding subsequent events. He has no other means to know about such events.
  - (d) The auditor should perform necessary audit procedures to know about events occurring between the date of financial statements and date of auditor's report.
- (4) As regards use of qualifying language in written representations, which of the following statement is most appropriate?**
  - (a) It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.

- (b) Written representations should be unconditional. Such a wording is not acceptable.
- (c) Such a wording dilutes intent of written representations. However, it can be accepted by auditor only in exceptional circumstances.
- (d) Qualifying language in written representations is compulsory.

**(5) As regards auditor's responsibility regarding matters communicated orally with those charged with governance, which of following is most appropriate?**

- (a) Matters communicated orally have to be documented by the auditor stating when and to whom these were communicated.
- (b) Matters communicated orally need not be put into writing. It is sufficient for auditor to have communicated orally.
- (c) Matters communicated orally need not be put into writing. It is not practically feasible.
- (d) Matters communicated orally have to be documented by the auditor stating to whom these were communicated.

**[ICAI Study Material]**

**ANSWER**

|            |     |            |     |            |     |            |     |            |     |
|------------|-----|------------|-----|------------|-----|------------|-----|------------|-----|
| <b>(1)</b> | (c) | <b>(2)</b> | (c) | <b>(3)</b> | (d) | <b>(4)</b> | (a) | <b>(5)</b> | (a) |
|------------|-----|------------|-----|------------|-----|------------|-----|------------|-----|



# AUDIT REPORTS

## Division A - Multiple Choice Questions

**Q.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

[ICAI Study Material]

ANSWER: (c)

**Q.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.

[ICAI Study Material]

ANSWER: (a)

**Q.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

[ICAI Study Material]

ANSWER: (d)

**Q.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

[ICAI Study Material]

ANSWER: (c)

**Q.5:** Responsibilities of Joint Auditors are governed by:

- (a) SA 200
- (b) SA 229
- (c) SA 299
- (d) SA 230

[ICAI Study Material]

**ANSWER: (c)**

**Q.6: Which of the following is correct?**

- (a) The auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
- (b) The auditor shall express a disclaimer opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
- (c) The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
- (d) The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements.

[MTP March 19]

**ANSWER: (c)**

**Q.7: In case of a fraud involving less than ₹ 1 crore, the auditor shall.**

- (a) Report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as prescribed.
- (b) Report the matter to the audit committee constituted under section 177 within such time and in such manner as prescribed.
- (c) Report the matter to the Board within such time and in such manner as prescribed.
- (d) Report the matter to the audit committee constituted under section 177 and also to the Board within such time and in such manner as prescribed.

[MTP March 19]

**ANSWER: (a)**

**Q.8: Which of the following is correct?**

- (a) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor need not disclose the substantive reasons for the different opinion.
- (b) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with SA 706.
- (c) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an emphasis of Matter paragraph in accordance with SA 706.
- (d) When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the

auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph or emphasis of matter paragraph in accordance with SA 706. **[MTP April 19]**

**ANSWER: (b)**

**Q.9: Which of the following is incorrect?**

- (a) Communicating key audit matters in the auditor's report is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
- (b) Communicating key audit matters in the auditor's report is not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);
- (c) Communicating key audit matters in the auditor's report is not a substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern;
- (d) Communicating key audit matters in the auditor's report is a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

**[MTP April 19]**

**ANSWER: (d)**

**Q.10: CA. Goofy has been appointed as an auditor for audit of a complete set of financial statements of Dippy Ltd., a listed company. The financial statements of the company are prepared by the management in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013. However, the inventories are misstated which is deemed to be material but not pervasive to the financial statements. Based on the audit evidences obtained, CA. Goofy has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570. Further, CA. Goofy is also aware of the fact that a qualified opinion would be appropriate due to a material misstatement of the Financial Statements. State what phrases should the auditor use while drafting such opinion paragraph?**

- (a) In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.
- (b) In our opinion and to the best of our information and according to the explanations given to us, with the foregoing explanation, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.
- (c) In our opinion and to the best of our information and according to the explanations given to us, subject to the misstatement regarding inventories, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.
- (d) In our opinion and to the best of our information and according to the explanations given to us, with the explanation described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the applicable financial reporting framework.

**[RTP May 19]**

**ANSWER: (a)**

## **Division B - Descriptive Questions**

**Q.1:** “The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity’s accounting practices, including indicators of possible bias in management’s judgements.” Discuss stating clearly qualitative aspects of the entity’s accounting practices **[ICAI Study Material]**

### **ANSWER**

#### **Qualitative Aspects of the Entity’s Accounting Practices**

- (1) Management makes a number of judgements about the amounts and disclosures in the financial statements.
- (2) SA 260 contains a discussion of the qualitative aspects of accounting practices.
- (3) In considering the qualitative aspects of the entity’s accounting practices, the auditor may become aware of possible bias in management’s judgements.

The auditor may conclude that the cumulative effect of lack of neutrality, together with the effect of uncorrected misstatements, causes the financial statements as a whole to be materially misstated.

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.

**Q.2:** “The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.” Explain. **[ICAI Study Material]**

Or

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. 2023-2024. 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 (4 Marks)]**

### **ANSWER**

#### **Forming an Opinion:**

- Auditor shall form an opinion on whether the financial statements are prepared, in all material respects in accordance with the applicable financial reporting framework.
- To form that opinion, auditor needs to conclude as to whether he 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.

**Q.3:** M/s Smart & Associates are the statutory auditors of Hotmeals Ltd. for the FY 2023-24. How will the auditor address the audit report issued on the financial statements for the FY 2023-24? Also give a title to the report. **[ICAI Study Material]**

### **ANSWER**

#### **Title and Addressee in Audit Report:**

**Title:** Independent Auditor's Report

**Addressee:** To the Members of Hotmeals Ltd.

**Q.4:** Richa International is a partnership firm dealing in export of blankets. The partners of the firm are Richa and Ashish. Explain how the statutory auditor of the firm will address the auditor's report.

[ICAI Study Material]

**ANSWER**

**Addressee in Audit Report in case of partnership firm:**

Independent Auditor's Report

To the Partners of Richa International

**Q.5:** M/s Amitabh & Associates are the statutory auditors of Ringston Ltd. which is a company engaged in the business of manufacture of pen drives. The auditor has started drafting the audit report for the FY 2023-24. CA Amitabh, the engagement partner is of the view that the financial statements of Ringston Ltd. represent a true and fair view. Give the draft of the opinion paragraph of the audit report.

[ICAI Study Material]

**ANSWER**

**Draft of Opinion Paragraph:**

- We have audited the financial statements of Ringston Limited which comprise the Balance Sheet as at 31.03.2024 and the statement of Profit and Loss Account and the notes to the financial statements, including a summary of significant accounting policies and other explanatory information.
- In our opinion and to the best of our information and according to the explanations given to us, the aforesaid financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the company as at 31.03.2024 and the Profit & Loss for the year ending on that date.

**Q.6:** M/s Kite Rite & Associates are the statutory auditors of Prime Deluxe Limited, for the FY 2023-24. At the time of finalising audit report, one of the engagement team members, Mr. Robin, asked the engagement partner, CA Kite as to what all should be included in the Basis of Opinion Paragraph. The engagement partner CA Kite, explained the team in detail and asked Mr. Robin to draft such section for the auditor's report of Prime Deluxe Limited. Help Mr. Robin to draft the Basis for opinion section.

[ICAI Study Material]

**ANSWER**

**Draft of Basis for Opinion Section:**

- We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013.
- Our responsibilities under those Standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report.
- We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics.
- We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

**Q.7:** Diamond Shine Ltd. is a company engaged in the manufacture of detergent. M/s Bright & Associates are the statutory auditors of the company. Explain how the paragraph related to the management's responsibility will come in the auditor's report.

[ICAI Study Material]

## **ANSWER**

### **Management's Responsibility for the Standalone Financial Statements**

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity) and cash flows of the Company in accordance with the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act.

This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgements and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclose, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so. Those Board of Directors are also responsible for overseeing the Company's Financial reporting process.

**Q.8:** M/s Ajay Vijay & Associates are the statutory auditors of Sarovar Ltd. for the FY 2023-24. The company is engaged in the business of manufacture of water bottles. At the time of finalising the auditor's report, one of the audit team members asked CA Ajay, the engagement partner to advise as to how the auditor's responsibilities can be shown in an appendix to the auditor's report. Draft the auditor's responsibility paragraph so as to advise the audit team member. **[ICAI Study Material]**

## **ANSWER**

### **Auditor's Responsibilities for the Audit of the Financial Statements**

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor's report. This description, which is located at [indicate page number or other specific reference to the location of the description], forms part of our auditor's report.

**Q.9:** M/s TUV & Associates are the statutory auditors of Venus Ltd. for the FY 2023-24.

At the time of finalising the auditor's report, one of the audit team members asked the engagement partner, CA Tarun, to explain as to how the auditor's report will be signed. Help CA Tarun in explaining the same.

**[ICAI Study Material]**

## **ANSWER**

The following is the correct way of signing an audit report.

M/s TUV & Associates  
Chartered Accountants  
(Firm's Registration No.)  
Signature

(Name of the Member Signing the Audit Report)

(Designation)

(Membership No. XXXXX)

Place of Signature:

UDIN: 20037320AAAAAH1111

Date:

**Q.10:** 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? [ICAI Study Material]

**ANSWER**

**UDIN:**

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.

**Q.11:** 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. [ICAI Study Material]

**ANSWER**

**Need of Basis of Opinion Section:**

“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.

**Conclusion:** Sana’s thinking is not proper.

**Q.12:** Super Duper Ltd. is a company engaged in the manufacture of office furniture. M/s Young Old & Associates are the statutory auditors of the company for the FY 2023-24. During the year under audit, the engagement partner CA Young noticed that the company has not bifurcated its loans into long term and short term. CA Young understands that such misstatement is not pervasive though the same is material. Explain the type of opinion that should be given by M/s Young Old & Associates in this case. [ICAI Study Material]

**ANSWER**

**Type of Opinion:**

M/s Young Old & Associates should give a qualified opinion as the effect of the misstatement on account of the non-bifurcation of loans into long term and short-term loans, is material but not pervasive.

**Q.13:** M/s Taj Raj & Associates are the statutory auditors of Porex Ltd. engaged in the manufacture of premium watches, for the FY 2023-24. During the course of audit, CA Taj, the engagement partner found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Both the facts are not reflected in the financial statements for the year ending 31.03.2024. Accordingly, CA Taj is of the view that the impact of both the situations on the financial statements is material and pervasive and thus, the financial statements represent a distorted view of the state of affairs of the company. Explain the reporting requirements of CA Taj. [ICAI Study Material]

## **ANSWER**

### **Reporting Requirements:**

- Auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
- In the case Porex Ltd., CA Taj found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable.
- Further, the cashier of the company has committed a fraud during the year under audit. Such situations are not reflected in the financial statements of the company despite having a material and pervasive impact on the financial statements. As such, CA Taj should give an adverse opinion.
- Further, CA Taj should also consider the reporting responsibilities under CARO 2020 and section 143(12) of the Companies Act, 2013.

**Q.14:** Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2023-24 the company transferred its accounts to computerised system (SAP) from manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such the statutory auditors of the company were not able to extract correct data and reports from the system. Such data was not available manually also. Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. Explain the kind of audit report that the statutory auditor of the company should issue in this case.

[ICAI Study Material]

## **ANSWER**

### **Issue of Disclaimer of Opinion:**

- When the statutory auditor of the company is unable to obtain sufficient and appropriate audit evidence, the auditor should give disclaimer of opinion as per SA 705.
- In the present case, the statutory auditor of the company is unable to extract correct data and reports from the SAP system for conduct of audit.
- Also, such data and reports are not available manually. As such, the statutory auditor of Delightful Ltd. should give a disclaimer of opinion.

**Q.15:** CA. Sarasbhai Patel, while conducting audit of an entity, feels that there is an atmosphere of non-cooperation all around. He has not been provided with necessary support for attending inventory count process of entity as at year end. Besides, CFO is not providing him present addresses of customers as well as suppliers for sending external confirmations. Even mail ids have not been provided on the pretext of business confidentiality.

He was not able to verify revenues of entity due to lack of complete details. For verifying expenses, he has been asking for bills on a sample basis, but staff has been making lame excuses. The matter was brought to knowledge of higher echelons of management, but of no avail. The auditor feels that there could be misstatements and their possible effects would be material and affecting many aspects of financial statements.

Assuming it is not possible to withdraw from engagement, what type of opinion should be expressed by auditor?

[ICAI Study Material]

## **ANSWER**

### **Issue of Disclaimer of Opinion:**

- In the given case, auditor has not been able to obtain sufficient appropriate audit evidence relating to inventories, debtors, creditors, revenues and expenses.

- The matter has brought to knowledge of management but no result has been achieved.
- Besides, auditor opines that there could be misstatements and their possible effects could be both material and pervasive.
- In such circumstances, he should make disclaimer of opinion in accordance with SA 705.

**Q.16:** M/s Daisy & Associates are the statutory auditors of Zebra Ltd. for the FY 2023-24. CA Daisy, the engagement partner wants to verify the cash in hand as on 31.03.2024. The cash balance of the company as on 31.03.2024 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. **[ICAI Study Material]**

#### **ANSWER**

##### **Limitations Imposed after accepting the audit:**

- 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 31.03.2024.
- The same is due to a limitation imposed by the management of Zebra Ltd. which is due to the non-availability of the cashier.
- In such situation, CA Daisy should perform alternate procedures to verify the cash on hand of the company.
- Further, CA Daisy should consider the impact on the auditor's report and may consider issuing a qualified opinion in this case.

**Q.17:** M/s Sun Moon & Associates are the statutory auditors of Venus Ltd. for the FY 2023-24. Owing to the pervasive nature of material misstatements in the financial statements of the company, CA Moon, the engagement partner decided to give an adverse opinion. Explain the responsibility of CA Moon with respect to communication with those charged with governance. **[ICAI Study Material]**

#### **ANSWER**

##### **Communication with TCWG:**

CA Moon, being the statutory auditor of Venus Ltd. should communicate with those charged with governance about the circumstances that led to the expected modification i.e. an adverse opinion. Further the wording of such modification also needs to be discussed.

**Q.18:** Discuss the factors affecting the decision of the auditor regarding which type of modified opinion is appropriate. **[ICAI Study Material]**

#### **ANSWER**

##### **Factors affecting the decision regarding type of modified opinion:**

The decision regarding which type of modified opinion is appropriate depends upon:

- The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

**Q.19:** Discuss the objective of the auditor as per Standard on Auditing (SA) 705 “Modifications to The Opinion in The Independent Auditor’s Report”. **[ICAI Study Material]**

**ANSWER**

**Objective of the auditor as per SA 705:**

To express clearly an appropriately modified opinion on the financial statements that is necessary when:

- (a) Auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or
- (b) Auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

**Q.20:** Distinguish between and adverse opinion and a qualified opinion. Also draft an opinion paragraph for both types of opinion. **[ICAI Study Material]**

**ANSWER**

**Adverse opinion and a Qualified opinion:**

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.

SA 705 – “Modifications to The Opinion in The Independent Auditor’s Report” deals with the form and content of both types of report. The following are the draft of the opinion paragraphs of the reports.

**(a) Adverse Opinion**

- We have audited the accompanying consolidated financial statements of ABC Company Limited and its subsidiaries, associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2024, 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, 2024, of its consolidated profit/loss, (consolidated position of changes in equity) and the consolidated cash flow for the year then ended.

**(b) Qualified Opinion**

- We have audited the standalone financial statements of ABC Company Limited, which comprise the balance sheet as at March 31, 2024, 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 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, 2024 and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

**Q.21:** XYZ Ltd. which is in the business of trading of automobile components is following Cash Basis of Accounting for sale of spare parts. As Statutory Auditor of XYZ Ltd. explain the reporting requirements,

manner of qualification and disclosure, if any, to be made in the auditor's report in line with AS-1 'Disclosure of Accounting Policies'. **[Jan. 21 (3 Marks)]**

**ANSWER**

**Reporting requirements, Manner of qualification and disclosure to be made in the auditor's report in line with AS 1, "Disclosure of Accounting Policies":**

- In the case of a company, members should qualify their audit reports in case:
  - (a) accounting policies required to be disclosed under Schedule III or any other provisions of the Companies Act, 2013 have not been disclosed, or
  - (b) accounts have not been prepared on accrual basis, or
  - (c) the fundamental accounting assumption of going concern has not been followed and this fact has not been disclosed in the financial statements, or
  - (d) proper disclosures regarding changes in the accounting policies have not been made.
- Where a company has been given a specific exemption regarding any of the matters stated above but the fact of such exemption has not been adequately disclosed in the accounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.
- In view of the above, the auditor will have to consider different circumstances whether the audit report has to be qualified or only disclosures have to be given.
- In making a qualification / disclosure in the audit report, the auditor should consider the materiality of the relevant item. Thus, the auditor need not make qualification / disclosure in respect of items which, in his judgement, are not material.
- A disclosure, which is not a subject matter of audit qualification, should be made in the auditor's report in a manner that it is clear to the reader that the disclosure does not constitute an audit qualification. The paragraph containing the auditor's opinion on true and fair view should not include a reference to the paragraph containing the aforesaid disclosure.

**Q.22: 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 (4 Marks)]**

**ANSWER**

**Basis for Opinion Section of Auditor's Report:** Refer Answer of Q. No. 16

An auditor should state in "Basis for Opinion" Section of Auditor's Report as under:

**Amendments in "Basis for Opinion" section in case of modified opinions:**

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700:

- (i) Amend the heading "Basis for Opinion" required by para of SA 700 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.

**Q.23: CA Guru is in the process of preparing the final audit report of JPA Private Limited and would like to disclaim his opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence. How CA Guru shall amend the description of the auditor's responsibilities as required by SA 700?**

**[July 21 (4 Marks)]**

**ANSWER**

### **Amending the description of the auditor's responsibilities in case of disclaimer of opinion:**

Since 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 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.

**Q.24:** Elucidate the circumstances when a modification to the Auditor's opinion is required. Also state the factors for making the decision regarding which type of modified opinion is appropriate. **[May 23 (3 Marks)]**

#### **ANSWER**

#### **Circumstances when a Modification to the Auditor's Opinion is Required:**

The auditor shall modify the opinion in the auditor's report in the following circumstances:

- The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

#### **The decision regarding which type of modified opinion is appropriate depends upon:**

- The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

**Q.25:** How would an auditor determine Key Audit Matters as per SA - 701, "Communicating Key Audit Matters in the Independent Auditor's Report"? **[Nov. 20 (3 Marks)]**

#### **ANSWER**

#### **Considerations to determine Key Audit Matters:**

SA per SA 701 "Communicating Key Audit matters in the Independent Auditor's Report" Key Audit Matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the F.S. of the current period. Key audit matters are selected from matters communicated with TCWG.

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 consider following:

- (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA315.
- (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- (c) The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined in accordance with above stated para were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

**Q.26:** When corresponding figures are presented, the auditors' opinion shall not refer to the corresponding figures. Discuss the exceptions of the above statement when the prior period financial statements are audited.

[Nov. 19 (4 Marks)]

Or

The senior member of the firm Kaur & Associates, Chartered Accountants, informed to its auditing staff that at the time of audit reporting regarding corresponding figures, when corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in specified circumstances. What are those exceptional circumstances?

[May 22 (4 Marks)]

**ANSWER**

**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.

**Q.27:** NG Ltd. appointed CA N as the statutory auditor for the F.Y. 2023-2024. Previous year's auditor gave a qualified opinion on the Comparative Financial Statements for the year ended 31.03.2023. 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. 2023-2024?

[Nov. 22 (4 Marks)]

**ANSWER**

**Matters to be stated in Other Matters Paragraph:**

If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor of 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.

**Q.28:** 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. **[ICAI Study Material]**

**ANSWER**

**Rights of Principal Auditor:**

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.

**Q.29:** RJ Limited is in the business of trading of cycles having Head Office at Delhi and branch at Mumbai. Statutory audit of Head Office was to be done by CA D and statutory audit of branch at Mumbai was to be done by CA M. During the course of audit by CA D at head office, CA D Wanted to visit branch at Mumbai and verify the inventory records at Mumbai. The management of RJ Limited did not allow CA D to visit Mumbai office and verify the inventory records as the branch audit of Mumbai was already being undertaken by another CA M. In the above situation, discuss the rights available with CA D in terms of the Companies Act, 2013. **[Nov. 20 (3 Marks)]**

**ANSWER**

**Right of Access of Company Auditor for Branch Records:**

- As per Sec. 143(8) of the Companies Act, 2013 the audit of the branches can be done by the company auditor himself or by another auditor.
- Even where, the branch accounts are audited, the company auditor has right to visit the branch if he deems it necessary to do so for the performance of his duties as auditor.
- Company Auditor has also right of access all times to the books and accounts and vouchers of the company maintained at the branch office. He can appropriately deal with the report of the branch auditor in framing his main report. He will disclose how he had dealt with the branch audit report.
- In this case, the audits of two branches were done by the company auditor and one branch was done by a separate branch auditor.

**Conclusion:** Management's objection that the company auditor is transgressing the scope of audit areas agreed, is absolutely, wrong. The right of company auditor in visiting and accessing the records of branch cannot be forfeited.

Even where the branch accounts are audited by another local auditor, the company auditor has right to visit the branch and have access to the books and vouchers of the company maintained at the branch office.

**Q.30:** A joint auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report. Justify this statement in the light of responsibilities of joint Auditors under SA 299. **[ICAI Study Material]**

**ANSWER**

**Reporting Responsibilities of Joint Auditor:**

- (a) The statement that a joint auditor is not bound by the views of the majority of the joint auditors regarding the matters to be covered in the report is true.
- (b) SA 299 "Joint Audit of Financial Statements" provides the following in respect of reporting responsibilities of joint auditor:

- Joint auditors are required to issue common audit report.
- However, in case of any disagreement among joint auditors with regard to the opinion of any matters to be covered by the audit report, they shall express their opinion in a separate audit report.
- A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement.
- In case of separate reports, the audit report(s) issued by the joint auditor(s) shall make a reference to the separate audit report(s) issued by the other joint auditor(s). Such reference shall be made under the heading "Other Matter Paragraph" as per SA 706.

**Q.31: "Before the commencement of audit, the joint auditors should discuss and develop a joint audit plan." Discuss the points to be considered in developing the joint audit plan by the joint auditors. [Nov. 19 (4 Marks)]**

**ANSWER**

**Points to be considered in developing the joint audit plan:**

As per SA 299 "Joint Audit of Financial Statements" Prior to the commencement of the audit, the joint auditors shall 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;
- Ascertain the reporting objectives of the engagement;
- Consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;
- Consider the results of preliminary engagement activities, or similar engagements performed earlier.
- Ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

**Q.32: HMB Limited's business has grown from one state of India to various countries of the world. Since the business has increased manifold, the management decided to appoint joint auditors for conducting the statutory audit of the company. They appointed three CA firms for it. For which audit work the joint auditors will be jointly & severally responsible? [Nov. 22 (4 Marks)]**

**ANSWER**

**Areas of Joint Responsibility in case of joint auditors:**

As per SA 299, "Joint Audit of Financial Statements", deals with the responsibilities of joint auditors. Accordingly, 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.

All the joint auditors shall be jointly and severally responsible for:

- the audit work which is not divided among the joint auditors and is carried out by all joint auditors;
- decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the NTE of the audit procedure to be performed by each of the joint auditors.
- 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;
- examining that the financial statements of the entity comply with the requirements of the relevant statutes;
- presentation and disclosure of the financial statements as required by the applicable financial reporting framework;
- ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

**Q.33:** Mr. A is appointed as statutory auditor of a company for the Financial Year ended 31st March, 2024. During the course of audit, it was found that few doubtful transactions had been committed by finance manager who retired in March, 2024. The fraud was going on since last 3 years and the total amount misappropriated exceeding ₹ 100 lakhs. As a statutory auditor, what would be reporting responsibilities of Mr. A? **[May 18 (5 Marks)]**

**ANSWER**

**Auditor's duties to report fraud to the Central Government:**

- Sec. 143(12) of Companies Act, 2013 requires that 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 matters to the C.G. within such time and in such manner as may be prescribed. For this purpose, Rule 13 prescribes the amount of ₹ 1 Cr. or more.
- However, in case of a fraud involving lesser than the specified amount, i.e. below ₹ 1 Cr., the auditor shall report the matter to the audit committee constituted u/s 177 or to the Board in other cases within such time and in such manner as may be prescribed:
- The companies, whose auditors have reported frauds to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.
- Rule 13 of Companies (Audit and Auditors) Rules, 2014 prescribes the manner of Reporting of Frauds in various cases.

**Q.34:** As per Sec 143(3)(j) of the Companies Act, 2013, the auditor's report shall also include such other matters as may be prescribed by Rule 11 of the Companies (Audit and Auditors) Rule, 2014. Discuss those matters on which views and comments of the auditor are required. **[Dec. 21 (3 Marks)]**

**ANSWER**

**Matters required to be reported under Rule 11 of CAAR, 2014:**

The auditor's report shall also include their views and comments on the following matters, namely:

- (1) Whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
- (2) Whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;
- (3) Whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.
- (4)
  - (i) Whether the management has represented that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;
  - (ii) Whether the management has represented, that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and

- (iii) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.
- (5) Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.
- (6) Whether the company
- (a) has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and
  - (b) the same has been operated throughout the year for all transactions recorded in the software and
  - (c) the audit trail feature has not been tampered with and
  - (d) the audit trail has been preserved by the company as per the statutory requirements for record retention.

**Q.35:** CA R is the statutory auditor and Mr. P is the cost auditor of DEF Ltd., a company engaged in the production of tyres. Mr. P noticed a fraud of INR 1.25 crores done by the senior manager of the company and immediately informed the audit committee even before CA R was aware of the fraud. State the duty of CA R under section 143(12) of the Companies Act on reporting on frauds already detected and reported.

[Dec. 21 (4 Marks)]

**ANSWER**

**Reporting on Frauds already detected and reported:**

- The auditor, CA R should apply professional skepticism to evaluate/verify that the fraud was indeed identified/detected in all aspects by the management or through the company's vigil/whistle blower mechanism so that distinction can be clearly made with respect to frauds identified/detected due to matters raised by the auditor vis-à-vis those identified/detected by the company through its internal control mechanism.
- Since reporting on fraud under section 143(12) is required even by the cost auditor and the secretarial auditor of the company, it is possible that a suspected offence involving fraud may have been reported by them even before the auditor became aware of the fraud.
- Here too, if a suspected offence of fraud has already been reported under section 143(12) by such other person, and the auditor becomes aware of such suspected offence involving fraud, he need not report the same since he has not per se identified the suspected offence of fraud.
- However, in case of a fraud which involves or is expected to involve individually, an amount of ₹ 1 crore or more, the auditor should review the steps taken by the management/those charged with governance with respect to the reported instance of suspected offence of fraud stated above, and if he is not satisfied with such steps, he should state the reasons for his dissatisfaction in writing and request the management/ those charged with governance to perform additional procedures to enable the auditor to satisfy himself that the matter has been appropriately addressed.
- If the management/those charged with governance fail to undertake appropriate additional procedures within 45 days of his request, the auditor would need to evaluate if he should report the matter to the Central Government in accordance with Rule 13 of the Companies (Audit and Auditors) Rules, 2014.

**Q.36:** Discuss which class of companies are specifically exempt from the applicability of Caro 2020?

[ICAI Study Material]

**ANSWER**

**Companies are specifically exempt from the applicability of CARO 2020**

CARO 2020 shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013, except –

- (ii) A banking company;

- (iii) An insurance company;
- (iv) A company licensed to operate under section 8 of the Companies Act;
- (v) A One Person Company and a small company; and
- (vi) A private limited company, not being a subsidiary or holding company of a public company,
  - having a paid up capital and reserves and surplus not more than one crore rupees as on the balance sheet date and
  - which does not have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year and
  - which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

**Q.37:** Examine the applicability of CARO, 2020 in the below mentioned cases:

- (a) Educating Child' is a limited company registered under section 8 of the Companies Act, 2013.
- (b) Ashu Pvt. Ltd. having paid capital and reserves of ₹ 50 lakh. During the year, the company had borrowed ₹ 70 lakh each from a bank and a financial institution independently. Turnover for the year was ₹ 900 lakh. **[ICAI Study Material]**

### **ANSWER**

#### **Applicability of CARO, 2020**

CARO, 2020 shall apply to every company including a foreign company as defined in Sec. 2(42) of the Companies Act, 2013, except:

- (ii) A banking company;
- (iii) An insurance company;
- (iv) A company licensed to operate under section 8 of the Companies Act;
- (v) A One Person Company as defined in section 2(62) of the Companies Act and a small company as defined in section 2(85) of the Companies Act; and
- (vi) A private limited company, not being a subsidiary or holding company of a public company,
  - having a paid up capital and reserves and surplus not more than ₹ 1 crore rupees as on the balance sheet date and
  - which does not have total borrowings exceeding ₹ 1 crore rupees from any bank or financial institution at any point of time during the financial year and
  - which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding ten crore rupees during the financial year as per the financial statements.

As per Sec. 2(85) of Companies Act, 2013 read with Rule 2(1)(t) of the Companies (Specification of Definitions Details) Rules, 2014 as amended by Companies (Specification of Definition Details) Amendment Rules, 2022 w.e.f. 15.07.2022, small company means a company, other than a public company:

- (i) Paid-up share capital of which does not exceed ₹ 4 crore; and
- (ii) Turnover of which as per its last profit and loss account for the immediately preceding financial year does not exceed ₹ 40 crore.

**Conclusion:** (a) CARO, 2020 is not applicable in case of Educating Child as it is registered under section 8 of the Companies Act, 1956 (b) In case of Ashu Pvt. Ltd., CARO, 2020 is also not applicable assuming that company is classified as small company.

**Note:** Data for the previous year is not provided in the question to determine the status of small company, it is assumed that company satisfy the criteria for the small company.

**Q.38:** CA. Ravi Patnaik is conducting audit of a company for which reporting requirements under CARO, 2020 are applicable. He finds that cash credit facilities amounting to ₹ 4 crores were released to the company by branch of a bank for meeting its working capital requirements. He finds that out of above funds, ₹ 1 crore have been used by company for installing effluent treatment plant to meet State pollution control Board requirements.

Is there any reporting obligation upon him under CARO, 2020?

[ICAI Study Material]

**ANSWER**

**Reporting Obligation under CARO 2020:**

- Clause (ix) (d) of CARO, 2020 whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated.
- In the given situation, funds have been raised for meeting working capital requirements for ₹ 4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings.
- Out of above, ₹1 crore have been used by the company for investment in effluent treatment plant which is ostensibly for a long-term purpose.

**Conclusion:** Matter needs to be reported in accordance with requirements of Clause (ix) (d) of CARO, 2020.

**Q.39:** Discuss the reporting requirements under CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.

[ICAI Study Material]

Or

State the auditor's reporting responsibilities under CARO when:

- The company has raised money by public issue.
- The company has made private placement of shares.

[Dec. 21 (4 Marks)]

**ANSWER**

**Reporting requirements under CARO, 2020:**

**(ii) Private Placement of Preferential issues:**

Para 3(x) of CARO, 2020 requires the following:

- 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;

**(iii) Utilisation of IPO and Further Public Offer:**

Para 3(x) of CARO), 2020 requires the following:

- Whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year were applied for the purposes for which those are raised, if not,
- the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;

**Q.40:** Explain the Reporting requirements the auditor should ensure under CARO related to Property, Plant and Equipment. **[May 19 (3 Marks)]**

**ANSWER**

**Matters to be included in the Auditor's Report under Caro, 2020:**

As per clause (i) of Para 3 of Caro, 2020, reporting requirements in respect of property, plant and equipment are:

**Adequacy of Records**

- Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Property, Plant and Equipment;
- Whether the company is maintaining proper records showing full particulars of intangible assets;

**Physical verification**

- Whether these Property, Plant and Equipment have been physically verified by the management at reasonable intervals;
- Whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

**Title Deeds**

- Whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company.
- If not, provide the details in Specific format.

**Revaluation of Property, plant and Equipment**

- Whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and,
- if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets;

**Proceedings for holding Benami Property**

- Whether any proceedings have been initiated or are pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 and rules made thereunder,
- if so, whether the company has appropriately disclosed the details in its financial statements;

**Q.41:** M Ltd. has given certain loans to related parties and also has accepted certain deposits. As an auditor, how you include the above items in paragraph 3 of CARO? **[Nov. 19 (4 Marks)]**

**ANSWER**

**Reporting under CARO, 2020:**

**(i) Loans to related parties:**

Whether during the year the company has granted any loans or advance in the nature of loans, secured or unsecured, to companies, firms, Limited Liability Partnerships or any other parties, if so,

- (a) Whether during the year the company has provided loans or provided advances in the nature of loans, if so, indicate-
- (ii) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to subsidiaries, joint ventures and associates;

(iii) the aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to parties other than subsidiaries, joint ventures and associates;

- (b) whether the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are not prejudicial to the company's interest;
- (c) in respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
- (d) if the amount is overdue, state the total amount overdue for more than 90 days, and whether reasonable steps have been taken by the company for recovery of the 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 the percentage of the aggregate to the total loans or advances in the nature of loans granted during the year [not applicable to companies whose principal business is to give loans];
- (f) whether the 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 the Companies Act, 2013.

**(ii) Public Deposits:**

In case the company has accepted deposits from the public, Para 3(v) of CARO, 2020 requires the auditor to report the following

- (a) Whether the directives issued by the RBI and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions be stated;
- (b) 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?

**Q.42:** G Pvt. Ltd. had fully paid-up Capital and Reserves of ₹ 1.20 crore as at the end of F.Y. 2022-2023. During the F.Y 2023-2024, business was interrupted and 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 (4 Marks)]**

**ANSWER**

**Applicability of CARO 2020:**

- CARO, 2020 shall apply to every company including a foreign company as defined in Sec. 2(42) of the Companies Act, 2013, except:
  - (1) A banking company;
  - (2) An insurance company;
  - (3) A company licensed to operate u/s 8 of the Companies Act;
  - (4) A one-person Company as defined in Sec. 2(62) of the Companies Act and a Small Company as defined in Sec. 2 (85) of the Companies Act; and
  - (5) A private limited company, not being a subsidiary or holding of a public company.
    - ➔ having a paid-up capital and reserves and surplus not more than ₹ 1 crore as on the balance sheet date; and

- which does not have total borrowings exceeding ₹ 1 crore from any bank or financial institution at any point of time during the financial year; and
- which does not have a total revenue as disclosed in Scheduled III to the Companies Act (including revenue from discontinuing operations) exceeding ₹ 10 crore during the financial year as per the financial statements.

- In case of debit balance of profit or loss, same shall be netted for computing reserves & surplus. In the present case, paid-up capital and reserves as at the end of FY 2022-23 was ₹ 1.20 Cr., and during the FY 2023-24 company has incurred losses to the tune of 25 lacs, so, paid-up capital and reserves of the company as at the end of FY 2023-24 will be considered as ₹ 0.95 Cr.
- As company has borrowed ₹ 55 lakh each from a bank and a financial institution independently, so total borrowings of the company will be ₹ 1.10 Cr.
- Total revenue including revenue from discontinuing operations will be ₹ 11 Cr.
- As per Sec. 2(85) of Companies Act, 2013 read with the Companies (Specification of Definitions Details) Rules, 2014, small company means a company, other than a public company;
  - (i) Paid-up share capital of which does not exceed ₹ 4 crore; and
  - (ii) Turnover of which as per its last profit and loss account for the immediately preceding financial year does not exceed ₹ 40 crore.

**Conclusion:** Considering the financials given in the question, it appears that company is classified as a small company, hence CARO is not applicable over the company.

**Q.43:** 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 (4 Marks)]**

#### ANSWER

**Reporting over properties included in the F.S. based on possession letter:**

Para 3(i)(c) of CARO, 2020 requires the auditor to report the following:

- Whether the title deeds of all the immovable properties (Other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company.
- If not, provide details thereof in the below mentioned format:

| Description of Property | Gross carrying value | Held in name of | Whether promoter, director or their relative or employee | Period held – indicate range, where appropriate | Reason for not being held in name of company* |
|-------------------------|----------------------|-----------------|----------------------------------------------------------|-------------------------------------------------|-----------------------------------------------|
|                         |                      |                 |                                                          |                                                 |                                               |

\*Also indicate if in dispute.

- Based on this, auditor is required to report the matter in his report of CARO, 2020.

**Q.44:** TS Ltd. has raised funds by issuing fully convertible debentures. These funds were raised for the expansion and diversification of the business. However, the company utilised these funds for repayment of long-term loans and advances. What are the reporting requirements under CARO 2020 in this case?

**ANSWER****Reporting requirements under CARO, 2020:**

- 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 instant case, company has raised funds by issuing fully convertible debentures. These funds were raised for the expansion and diversification of the business. However, the company utilized these funds for repayment of long-term loans and advances.

**Conclusion:** 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.

### **Division C - Case Study Based Questions**

M/s AB & Company is a firm of Chartered Accountants based in Mumbai. Mr. A and Mr. B are the Partners of the Firm. The Firm is engaged in various assignments including Audits. The partners are taking a summary of their work in order to prepare themselves to finalize the Audit and issue the audit report to various clients. You are requested to go through the following and answer the questions that follow:

- During the audit of M/s Persistent & Co, Mr. A found that the firm has changed the method of Depreciation from WDV to SLM but has not given the retrospective effect. Mr. A has calculated the difference of depreciation but M/s Persistent & Co. has stated that they don't want to change the financial statement and if auditor persists they may give the effect in the next financial year.
- During the audit of M/s Dubious Brothers, Mr B observed that the firm had a very large amount of cash sales and there were no details of the customers to whom the sales were made. Further, cash generated was not even deposited into bank regularly. When Mr. B asked the firm to give him an opportunity to count cash, the manager of the firm said that the cash is with the owner and it cannot be made available to the auditor for the checking purpose. The manager also declined to give an opportunity for stock verification to Mr B.
- During the audit of M/s Honest & Associates, Mr. A came to know that the firm has changed its method of valuation of stock. This change has a material impact on the financial statement of the firm. The firm has made relevant disclosures in the financial statements and has given proper accounting treatment to this exercise.

**Based 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:
- (a) Modified Opinion
  - (b) Qualified Opinion
  - (c) Disclaimer of Opinion
  - (d) Unmodified Opinion

**ANSWERS**

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

# SPECIAL FEATURES OF AUDIT OF DIFFERENT TYPES OF ENTITIES

## Division A - Multiple Choice Questions

**Q.1:** The audit of municipal corporation of a large metro city is in progress. Which of the following is not likely an objective of such as audit?

- (a) To report on the adherence to legal and administrative requirements
- (b) To report on whether value is being fully received for money spent
- (c) To report on the weakness of systems of financial control
- (d) To provide better civic amenities to residents of metro city

[ICAI Study Material]

**ANSWER:** (d)

**Q.2:** “Save Democracy” is an NGO working in cause of promoting democracy and democratic institutions in many countries including India. Its Indian counterpart has received funds from a renowned “Flower Trust” of US. As auditor of NGO, which of the following laws/orders would be relevant to you in context of above information?

- (a) Income Tax Act, 1961
- (b) Foreign Contribution Regulation Act, 2010
- (c) Companies Act, 2013
- (d) Orders issued by Ministry of Social Justice and Empowerment

[ICAI Study Material]

**ANSWER:** (b)

**Q.3:** The appointment of first auditor of a multi-state cooperative society is made by: -

- (a) Central Registrar
- (b) Board of society
- (c) Members of society
- (d) Central Government

[ICAI Study Material]

**ANSWER:** (b)

**Q.4:** Consider following revenue sources of Union Government.

- (P) Revenues from direct taxes
- (Q) Revenues from Goods and Services Tax
- (R) Revenues from Custom Duties
- (S) Revenues from Excise Duties

Out of P, Q, R and S, which of the following flow to “Consolidated Fund of India”?

- (a) P, Q and R
- (b) P, Q and S
- (c) P and Q

(d) P, Q, R and S

[ICAI Study Material]

**ANSWER:** (b)

**Q.5:** An LLP files compliance returns with: -

- (a) Registrar of firms & societies
- (b) Central Registrar
- (c) Registrar of Companies
- (d) Local fund audit wing

[ICAI Study Material]

**ANSWER:** (c)

**Q.6:** Under section 43(h) of the Central Act, who can frame rules prescribing the books and accounts to be kept by a co-operative society?

- (a) Central Government
- (b) State Government
- (c) Management Committee of the Society.
- (d) Secretary of the Co-operative Society.

[RTP Nov. 21]

**ANSWER:** (b)

**Q.7:** Article 151 requires that the reports of the C&AG relating to the Union/State shall be submitted to the \_\_\_\_\_ who shall cause them to be laid before House of Parliament/State Legislature.

- (a) President /Governor
- (b) Prime Minister/Chief Minister
- (c) Union Finance Minister/State Finance Minister
- (d) Union Cabinet

[MTP April 22]

**ANSWER:** (a)

**Q.8:** The Auditor of a Sole Proprietor Concern is appointed by

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

[MTP April 22]

**ANSWER:** (c)

**Q.9:** The office of C&AG conducted audit in state of Gujarat to assess whether system for enforcement of the provisions of the Air (Prevention and Control of Pollution) Act, 1981 was efficient and effective. It also evaluated whether various schemes and initiatives taken by state government for abatement for air pollution were adequate. Besides, it also assessed adequacy of human resources in State pollution control Board to regulate and monitor air pollution. Which of the following terms best exemplifies such audit carried out by C&AG?

- (a) Propriety audit
- (b) Audit of sanctions
- (c) Audit against rules and orders
- (d) Performance audit

[MTP Oct. 22]

**ANSWER: (d)**

**Q.10:** After a government expenditure has been incurred and the accounts are closed, the Appropriation Accounts are prepared which are scrutinised by the

- (a) CAG
- (b) President
- (c) Public Accounts Committee
- (d) Parliament

**[MTP March 23]**

**ANSWER: (c)**

### **Division B - Descriptive Questions**

**Q.1:** It is the duty of Comptroller and Auditor General of India to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it. Discuss, in above context, what is understood by "Consolidated Fund of India"? What is its importance? **[ICAI Study Material]**

**ANSWER**

**Consolidated Fund of India and 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.

**Q.2:** Discuss the power of C&AG in Government audit.

**[May 19 (3 Marks)]**

**ANSWER**

**Powers of C&AG in connection with the performance of his duties:**

The Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 gives the following powers to the C&AG in connection with the performance of his duties:

- (i) **Inspection:** To inspect any office of accounts under the control of the Union/State including office responsible for the creation of the initial or subsidiary accounts.
- (ii) **Transmission:** 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) **Inquiry:** To put such questions or make such observations as he may consider necessary to the preparation of any account or report which it is his duty to prepare.

In carrying out audit, 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 check in relation to such accounts or transactions as he may determine.

**Q.3:** 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 (4 Marks)]**

**ANSWER**

### Audit of Receipts:

Basic principle of audit of receipts is 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. Audit of receipts includes 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 concerned department/agency to secure an effective check on assessment and collection;
- (iii) Whether such regulations and procedures are actually being carried out;
- (iv) Whether adequate checks are imposed to ensure the prompt detection and investigation of irregularities, double refunds, 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 to suggest improvement.

### Q.4: Define Government Audit and explain its objectives.

[July 21 (4 Marks)]

#### ANSWER

#### Government Audit and its objectives:

Government auditing may be defined as the objective, systematic, professional and independent examination of financial, administrative and other operations of a public entity made subsequently to their execution for the purpose of evaluating and verifying them, presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions by the responsible officials and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

Objectives of Government audit includes the following:

- (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.

### Q.5: 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 (3 Marks)]

#### ANSWER

#### Audit of Accounts of Stores and Inventories in Government Companies:

Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted:

- (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.

**Q.6:** SK & Co, a Chartered Accountant firm has been appointed an auditor of Metro Rail project in City A. Since the project is on large scale, it involves a high volume of resources (financial, human and physical resources). The appointing authority C&AG requires an objective examination of the financial and operational performance of the Metro Rail project. Explain the nature and scope of audit that SK & Co will undertake.

[May 23 (3 Marks)]

**ANSWER**

**Efficiency cum performance audit:**

- For objective examination of the financial and operational performance of an organisation, programme, authority or function C&AG will be required to undertake the efficiency cum performance audit.
- Efficiency cum performance audit is oriented towards identifying opportunities for greater economy, and effectiveness.
- Scope of performance audit covers
  - (a) Identification of topic,
  - (b) Preliminary study,
  - (c) Planning,
  - (d) Execution of audit, and
  - (e) Reporting.

**Q.7:** Explain the different types of revenue grants which local bodies may receive.

[ICAI Study Material]

**ANSWER**

**Different types of revenue grants:**

Local bodies may receive different types of grants from the state administration as well. Broadly, the revenue grants are of three categories:

- (a) **General purpose grants:** These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.
- (b) **Specific purpose grants:** These grants which are tied to the provision of certain services or performance of certain tasks.
- (c) **Statutory and compensatory grants:** These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

**Q.8:** 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 (3 Marks)]

**ANSWER**

**Meaning of Municipality:**

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.

**Head under which expenditures incurred by the Municipalities and Corporations can be broadly classified:**

Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads:

- (a) General administration and revenue collection,
- (b) Public health,
- (c) Public safety,
- (d) Education,
- (e) Public works, and
- (f) Others such as interest payments, etc.

**Q.9:** As an Auditor of NGO, how do you check/verify atleast four receipts of income during the year?

[Jan. 21 (4 Marks)]

**ANSWER**

**Examination of Receipts of Income of NGO:**

- (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, 2010
- (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.
- (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.

**Q.10:** 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.

[ICAI Study Material]

**ANSWER**

- The auditor shall consider provisions of retirement deed/partnership deed for date of retiring and joining of partners.
- It should be ensured that profits are appropriately distributed up to date of retirement.
- Further, profits after retirement should have been distributed among partners as per terms of new partnership deed.

**Q.11:** There are certain points which are required to consider specially in the audit of accounts of a partnership. Discuss any three points briefly.

[Nov. 19 (3 Marks)]

**ANSWER**

### Points to be considered in Audit of Partnership Firms:

- (i) **Letter of Appointment:** Confirming that letter of appointment, signed by a partner, duly authorised, clearly states nature & scope of audit contemplated by the partners, specially limitation, if any.
- (ii) **Partnership Deed:** Examine partnership deed to ensure that it had been signed by all partners & registered with the registrar of firms.  
  
Ascertain from the partnership deed about capital contribution, profit sharing ratios, interest on capital contribution, powers and responsibilities of the partners, etc.
- (iii) **Minute Book:** Study minute book, if any, maintained to record the policy decision taken by partners specially minutes relating to authorisation of extraordinary & capital expenditure, raising of loans, purchase of assets and other matters.
- (iv) **Object of Partnership:** Verifying that the business in which the partnership is engaged is authorised by the partnership agreement.
- (v) **Books of Account:** Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.
- (vi) **Mutual Interest:** Verifying generally that 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.
- (vii) **Division of Profits:** Verifying that the profits/losses have been divided among partners in agreed profit-sharing ratio.
- (viii) **Provision for taxes:** Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.

**Q.12:** 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 (3 Marks)]

#### ANSWER

##### 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.

**Q.13:** Ban LLP is formed during the year 2023-24. They are not sure about the type of books of accounts to be maintained. What are the books of accounts that the LLP is required to maintain? [July 21 (3 Marks)]

#### ANSWER

##### Books of account to be maintained by LLP:

As per Sec. 34 of LLP Act, 2008, LLP shall maintain such proper books of account as may be prescribed relating to its affairs for each year of its existence. Books may be maintained on cash basis or accrual basis and according to double entry system of accounting. Books shall be maintained at registered office for such period as may be prescribed.

As per Rule 24 of LLP Rules, 2019, books of account shall contain:

- (a) 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,
- (b) A record of the assets and liabilities of the LLP,
- (c) Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold; and

(d) Any other particulars which the partners may decide.

**Q.14:** Mention the special points to be examined by the auditor in the audit of a charitable institution running hostel for students pursuing the Chartered Accountancy Course and which charges only INR 500 per month from a student for their lodging/boarding. **[ICAI Study Material]**

### **ANSWER**

#### **Special points to be examined in audit of a Charitable Institution:**

- (i) Determine the constitution under which the charitable institution has been established.
- (ii) Ensure that the institution is being managed in the manner contemplated by the law under which it has been established.
- (iii) Examine the system of internal check, especially as to accounting of receipts.
- (iv) Verifying in detail the income and ensure that the amounts received have been deposited in the bank regularly and promptly.

#### **Subscriptions and donations**

- (i) Determine whether any changes made in amount of annual or life membership subscription during the year.
- (ii) Ensure the following in relation to official receipts;
  - (a) Issue of official receipts
  - (b) Adequate control is imposed over unused receipt books;
  - (c) Obtain all receipts books converting the period under review;
  - (d) Test check the counterfoil with the cash book;
  - (e) Cancelled receipts to be specially looked into;
  - (f) Obtain the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;
  - (g) Examine the system of internal check regarding moneys received from box collections, flag days, etc.; and
  - (h) Verifying the total subscription and donations received with any figures published in reports, etc. issued by the charity.

#### **Other incomes**

- (a) **Legacies and Grants:** Verify amounts of legacies, grants, charities etc. received by reference to correspondence with any figures and other available Information.
- (b) **Investment Income:**
  - Vouch amounts received with dividend and interest counterfoils.
  - Check calculations of interest received on securities bearing fixed rates of interest.
  - Check that appropriate dividend has been received where any investment has been sold ex-dividend or purchase cum-dividend.
  - Compare dividend received with schedule of investments making special enquires into any investments held for which no dividend has been received.

(c) **Rental Income:** If any property is given or taken on rent, the tenancy agreement should be checked to determine the accuracy of rent received or paid.

(d) **Income-tax Refunds:**

Where income-tax has been deducted at source from 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:

- Vouching the refund with correspondence with the Income-tax department; and
- Checking the calculation of the repayment of claims

**(e) Expenditures:**

- In any grant is being allowed to any person, verify whether grant have been paid only for a charitable purpose or purposes falling within the purview of the objects.
- Verify 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.
- Verifying the cash and bank balances.
- Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.

**Q.15:** 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? [ICAI Study Material]

**ANSWER**

**Audit procedure in case of a School w.r.t. Fees Concessions:**

- 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.

**Q.16:** A multi-speciality hospital has come up in your city. You are appointed as auditor for first year. Discuss, any four, broad areas to be kept in mind while conducting audit of accounts of such a newly opened multi-speciality hospital. [ICAI Study Material]

Or

The general transactions of a hospital include patient treatment, collection of receipts, donations, capital expenditure. You are required to mention special points of consideration while auditing such transactions of a hospital? [ICAI Study Material]

Or

You have been appointed auditor of M/s. Divine Children Hospital. Discuss any four important points that would attract your attention while audit. [Nov. 19 (3 Marks)]

**ANSWER**

**Special Points in Audit of books of account of Hospital:**

- 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.
- Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.
- 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.
- Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

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

**Q.17:** 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 (3 Marks)]**

#### ANSWER

##### **Audit of Charitable trust:**

##### **(a) Donations:**

- (i) Examine whether official receipts are issued for all donation received during the year.
- (ii) Examine whether adequate control is imposed over unused receipts books;
- (iii) Obtain all receipt books covering the period under review;
- (iv) Test check the counterfoils with the cash book; any cancelled receipts being specially looked into;
- (v) Obtain printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;
- (vi) Examine the system of internal check regarding moneys received from box collection, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued;
- (vii) Pay 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
- (viii) Verify the total donations receive with any figures published in report, etc. issued by the trust.

##### **(b) Capital Expenditure:**

Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee.

**(c) Tax deducted on Investment Income:**

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.

**Q.18:** 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 2023-24. You are required to mention special points of consideration while auditing such receipts of the club. **[Jan. 21 (4 Marks)]**

**ANSWER**

**Points which merit consideration in the audit of a CLUB w.r.t its members:**

- (1) Entrance Fee:** Vouch the receipt on account of entrance fees with:
  - members' applications, counterfoils issued to them, as well as
  - on a reference to minutes of the Managing Committee.
- (2) Subscriptions:** Vouch members' subscriptions with the
  - counterfoils of receipt issued to them,
  - trace receipts for a selected period to the Register of Members;
  - also reconcile the amount of total subscriptions due with the amount collected and that outstanding.
- (3) Arrears of Subscriptions:** Ensure that
  - arrears of subscriptions for the previous year have been correctly brought over and
  - arrears for the year under audit and subscriptions received in advance have been correctly adjusted.
- (4) Arithmetical accuracy:** Check totals of various columns of the Register of members and tally them across.
- (5) Irrecoverable Member Dues:** See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.
- (6) Pricing:** Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.
- (7) Member Accounts:** Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.
- (8) Purchases:** Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective inventory registers.
- (9) Margins earned:** Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.
- (10) Inventories:** Check the inventory of furniture, sports material and other assets physically with the respective inventory registers or inventories prepared at the end of the year.
- (11) Investments:** Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts; also ascertain that the arrangements for their safe custody are satisfactory.
- (12) Management Powers:** Examine the financial powers of the secretary and, if these have been exceeded, report specific case for confirmation by the Managing Committee.

**Q.19:** M/s PQ & Co., Chartered Accountants have been appointed as statutory auditor of CBD Multiplex Cinema Ltd. The audit team started the audit and verified the ledger and other books of accounts for the F.Y 2023-2024. However, one of the team members is of the view that the internal control mechanism of the company should also be verified. Can you guide the audit team about the areas that will be covered in verifying the internal control mechanism? **[Nov. 22 (4 Marks)]**

**ANSWER**

**Verification points in receipts from sale of tickets:**

**(1) Internal Control Mechanism**

- (a) Verify that entrance to the cinema-hall during show is only through printed tickets;
  - (b) Verify that they are serially numbered and bound into books;
  - (c) Verify that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;
  - (d) Verify that for advance booking a separate series of tickets is issued;
  - (e) Verify that the inventory of tickets is kept in the custody of a responsible official.
- (2) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.
- (3) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.
- (4) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class.
- (5) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

**Q.20:** Define the different types of lease agreements as per Accounting Standard/Ind-AS. **[May 19 (4 Marks)]**

**ANSWER**

**Different Types of Lease Agreements:**

As per AS-19/Ind-AS 17 lease arrangements are of 2 types i.e. Finance Lease and Operating lease.

**(a) Finance Lease:** An arrangement with the following attributes qualifies as a Finance Lease:

- (1) The lease arrangement transfers ownership of the asset to the lessee at the end of the lease term;
- (2) The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- (3) The lease term is for the major part of the economic life of the asset even if title is not transferred;
- (4) 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
- (5) the leased assets are of such a specialized nature that only the lessee can use them without major modifications.

**(b) 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".

**Q.21:** 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. **[ICAI Study Material]**

### **ANSWER**

#### **Maintenance of books in case of multi-state cooperative 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: -

- (a) All sum of money received and expended;
- (b) All sales and purchase of goods;
- (c) Assets and liabilities;
- (d) In case of Multi State Co-operative Society engaged in production, processing and manufacturing. Particulars relating to utilization of materials of labour or other term of cost as specified in bye laws.

**Q.22:** Discuss, in what circumstances, Central Registrar can hold an inquiry into working and financial condition of a multi-state cooperative society. **[ICAI Study Material]**

### **ANSWER**

#### **Circumstances when inquiry may be hold or ordered:**

The Central Registrar may, on a request from

- a federal co-operative to which a Multi- State Co-operative society is affiliated; or
- a creditor; or
- not less than 1/3rd of the members of the board; or
- not less than 1/5th of the total number of members of a Multi-state co-operative society

hold an inquiry or direct some person authorized by him by order in writing in his behalf to hold an inquiry into the constitutions, working and financial condition of a Multi-State Co-operative society.

**Q.23:** Briefly explain the provisions for qualification and appointment of Auditors under the Multi-State Co-operative Societies Act, 2002. **[Nov.18 (5 Marks)]**

### **ANSWER**

**Qualifications of Auditors of Multi-State Co-operative Societies:** Refer answer of Q. No. 50.

#### **Appointment of Auditors of Multi-State Co-operative Societies:**

Sec. 70 of Multi-State Co-operative Societies Act, 2002, provides the provisions as to appointment of auditors of Multi-State Co-Operative Societies. Accordingly:

- First Auditor of Multi-State Co-operative Societies shall be appointed by Board of Directors within one month of registration. If Board fails, company may appoint first auditor at General meeting. Auditor so appointed hold office till conclusion of first AGM.
- Subsequent auditors are appointed at each AGM, Auditor so appointed hold office till conclusion of next AGM.

**Q.24:** 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 (3 Marks)]**

### **ANSWER**

#### **Circumstances requiring Special Audit:**

Section 77 of Multi State Co-operative Societies Act, 2002 empowers Central Government to pass an order for the special audit if they are of opinion:

- (i) that the affairs of any Multi-State co-operative society are not being managed in accordance with co-operative principles or prudent commercial practices or with sound business principles; or
- (ii) that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or
- (iii) that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

**Q.25:** 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:

- (i) Audit classification of society.
- (ii) Discussion of draft audit report with the managing committee. **[Nov. 20 (4 Marks)]**

**ANSWER**

**Audit of Co-operative Society:**

- (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.

**Q.26:** CA. Z. a Chartered Accountant is the Senior manager of a Multi-State Co-operative Society in Mumbai. He is proposed to be appointed as an auditor of the said Multi-State Co-operative Society. Analyse the provisions of the Multi-State Co-operative Societies Act, 2002 and comment on validity of proposed appointment. **[May 23 (4 Marks)]**

**ANSWER**

**Appointment of Auditor in co-operative Society:**

As per Section 72 of Multi-State Co-operative Societies Act, 2002, person who is a CA can only be appointed as auditor of a multi-state co-operative society. Following persons cannot be appointed as auditor:

- (a) Body Corporate
- (b) Officer/Employee of Multi-State Co-Operative Society.
- (c) Partner/Employee of Officer/Employee of Multi State Cooperative Society
- (d) A person who is indebted to the Multi-State co-operative society or who has given guarantee in connection with a loan of third party to multi state cooperative society for an amount exceeding ₹ 1,000.

In the given case, CA. Z, a Chartered Accountant who is the Senior manager of the Multi State Co-operative society is proposed to be appointed as an auditor of the said Multi-State Co-operative society.

**Conclusion:** Proposed appointment is not valid as CA Z is employed with the Multi State Co-operative Society as Senior manager.

## **Division C - Case Study Based Questions**

Consider the following five descriptions: -

- (A) Audit of “Implementation of Nagpur Metro Rail Project” was conducted by the Comptroller and Auditor General of India.

Following is extract of few audit findings placed on website [cag.gov.in](http://cag.gov.in).

“The location of New Airport station was not ideal from the viewpoint of ridership due to sparse population in and around the station and also from the accessibility point of view.

Cotton Market station, the second additional station was projected to have high peak hour peak direction trips but the work was kept on hold midway citing fund crunch due to non-release of pending contribution from stakeholders. However, the situation could have been managed through prioritization of works.”

- (B) Another set of audit findings in respect of audit of Haryana Power Generation Corporation Limited, a wholly owned government company responsible for operation of power generation plants in state of Haryana is as under: -

“The main reason for low generation was higher variable cost of thermal power stations which resulted in backing down of plants.”

- (C) A report was tabled in Parliament highlighting main features of direct taxes administration of country as mandated in Constitution of India. This report primarily discussed compliance to the provisions of the Income Tax Act, 1961 and the associated rules and procedures etc. as applied to administration of direct taxes including irregularities noticed in finalizing assessments etc.

- (D) Radial finance corporation Limited is a government company. The audit of the company is conducted by statutory auditors appointed by Comptroller and Auditor General of India.

- (E) Bharat Insurance Company Limited is a general insurance government owned company.

The statutory auditor is appointed by Comptroller and Auditor General of India. The annual report for a particular year also contains comments of statutory auditors on matters such as whether company has carried out reconciliations in respect of its inter-company balances with other government owned insurance companies.

**Based 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
- (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

**[ICAI Study Material]**

**ANSWERS**

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

# AUDIT OF BANKS

## Division A - Multiple Choice Questions

**Q.1:** Which of the following is included in "Interest Earned" in Profits & Loss A/c of a bank?

- (a) Discount on Bills
- (b) Loan Processing fees
- (c) Commission on bills for collection
- (d) Credit Card Fees

[ICAI Study Material]

ANSWER: (a)

**Q.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

[ICAI Study Material]

ANSWER: (b)

**Q.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

[ICAI Study Material]

ANSWER: (a)

**Q.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.

[ICAI Study Material]

ANSWER: (b)

**Q.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

**ANSWER: (c)****Q.6:** Which of the following is correct in case of Banks?

- (a) The policy of income recognition should be objective.
- (b) The policy of income recognition should be subjective.
- (c) The policy of income recognition may be objective or subjective.
- (d) The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations.

**[MTP March 19]****ANSWER: (d)****Q.7:** Which of the following is correct:

- (a) Sub-section (1) of section 30 of the Banking Regulations Act, 1949 requires that the balance sheet and profit and loss account of a banking company should be audited by a Firm of Chartered Accountants only.
- (b) Sub-section (1) of section 30 of the Banking Regulations Act, 1949 requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under any law for the time being in force to be an auditor of companies.
- (c) Sub-section (1) of section 30 of the Banking Regulations Act, 1949 requires that the balance sheet and profit and loss account of a banking company should be audited by a CAG Auditor only.
- (d) Sub-section (1) of section 30 of the Banking Regulations Act, 1949 requires that the balance sheet and profit and loss account of a banking company should be audited by a person duly qualified under Banking Law.

**[MTP Oct. 19]****ANSWER: (b)****Q.8:** A Ltd. has been assigned a Cash Credit limit of INR 20 lacs as against its Book Debts furnished as security. What kind of Security creation is it?

- (a) Pledge
- (b) Mortgage
- (c) Assignment
- (d) Set-off

**[MTP Oct. 20, MTP March 22]****ANSWER: (c)****Q.9:** The auditors should classify Credit card accounts as NPA, if \_\_\_\_\_ amount due, as mentioned in the credit card statement is not paid fully within \_\_\_\_\_ days from next statement date.

- (a) Total, 90
- (b) Minimum, 90
- (c) Minimum, 30
- (d) Minimum, 60

**[MTP March 22]****ANSWER: (b)****Q.10:** The term "Drawing Power" is associated with which of the following facilities as sanctioned by any Bank:

- (a) Letter of Credit
- (b) Term Loan

- (c) Staff Advances
- (d) Cash Credit Limit

[MTP Sep. 22; RTP May 23]

**ANSWER:** (d)

## **Division B - Descriptive Questions**

**Q.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. **[ICAI Study Material]**

### **ANSWER**

#### **Form and Content of F.S.:**

- As per Sec. 29 of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their authentication. These provisions are also applicable to nationalised banks.
- Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit.
- Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

**Q.2:** List out any four points which highlight peculiarities involved in banking operations. **[ICAI Study Material]**

### **ANSWER**

#### **Peculiarities involved in Banking operations**

- (a) Voluminous and complex transaction.
- (b) Wide geographical spread of banking network.
- (c) Diversified and large range of products and services offered.
- (d) Extensive use of technology
- (e) Strict vigilance and compliance.

**Q.3:** The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country. Explain **[ICAI Study Material]**

### **ANSWER**

#### **RBI – Regulating Body:**

- In India, banking industry is regulated by the Reserve Bank of India (RBI) known as the Central Bank.
- RBI is responsible for:
  - (a) Development and supervision of the banks and non-banking financial institutions
  - (b) Determining the monetary and credit policies.
  - (c) To regulate the activities of commercial and other banks.
- Important functions of RBI are:
  - (a) Issuance of currency;
  - (b) Regulation of currency issue;
  - (c) Acting as banker to the Central and State governments, commercial and other types of banks including term-lending institutions.

**Q.4:** 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

[Dec. 21 (4 Marks)]

**ANSWER**

**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.

**Q.5:** Compute the Drawing Power for Cash Credit A/c of S Limited for the month of March 2023 with following information:

|       | (Amount in ₹) |
|-------|---------------|
| Stock | 50,000        |

|                                                               |        |
|---------------------------------------------------------------|--------|
| Debtors                                                       | 45,000 |
| (Including Debtor of ₹ 5,000 for an invoice dated 17.11.2022) |        |
| Sundry creditors                                              | 15,000 |
| Sanctioned Limit                                              | 45,000 |
| Margin on stock is 20% and on debtors is 50%.                 |        |

Note: Debtors older than 3 months are ineligible for calculation of DP.

[May. 22 (3 Marks)]

### ANSWER

#### Computation of Drawing Power:

| Particulars of Current Assets                  |        | (Amount in ₹) |
|------------------------------------------------|--------|---------------|
| (A) Stock                                      |        |               |
| Stock at realisable value                      | 50,000 |               |
| Less: Unpaid Stocks                            |        |               |
| Creditors                                      | 15,000 |               |
| Paid for Stocks                                | 35,000 |               |
| Less: Margin @ 20%                             | 7,000  | 28,000        |
| (B) Debtors                                    |        |               |
| Total debtors                                  | 45,000 |               |
| Less: Ineligible debtors                       | 5,000  |               |
|                                                | 40,000 |               |
| Less: Margin @ 50%                             | 20,000 | 20,000        |
| Total eligible amount                          |        | 48,000        |
| Drawing Power (Cannot exceed sanctioned limit) |        | 45,000        |

**Q.6:** A Ltd. has availed Cash Credit facilities against Stock and Book Debt, Term Loan for machineries and Bank Guarantee from Big Bank Ltd. A Ltd. furnishes stock statements and age wise list of debtors to Big Bank Ltd. on regular basis. Concurrent Auditors of Big Bank Ltd. mentioned about wrong calculation of Drawing Power by the Bank Branch along with sanctioned limit, and balances overdrawn due to wrong calculation of Drawing Power (DP) in the monthly report. Explain the meaning of drawing power and how it differs from sanctioned limit? What is to be ensured while computing Drawing Power (DP)?

[May 23 (3 Marks)]

### ANSWER

#### Drawing Power:

(a) **Meaning:** Drawing Power is an important concept for Cash Credit (CC) facility availed from banks and financial institutions.

It may be defined as the limit up to which a firm or company can withdraw from the working capital limit sanctioned.

(b) **Drawing Power vs. Sanctioned Limit:** Sanctioned limit is the total exposure that a bank can take on a particular client for facilities like cash credit, overdraft, export packing credit, non-funded exposures etc.

On the other hand, Drawing Power refers to the amount calculated based on primary security less margin as on a particular date.

- (c) **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.

**Q.7:** Discuss importance of implementation of KYC norms by a bank from perspective of an auditor of bank.

[ICAI Study Material]

**ANSWER**

**Importance of implementation of KYC norms:**

- As per SA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, the auditor’s objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately.
- The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.
- The RBI has framed specific guidelines that deal with prevention of money laundering and “Know Your Customer (KYC)” norms.
- The RBI has from time to time issued guidelines (“Know Your Customer Guidelines – Anti Money Laundering Standards”), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

**Q.8:** Is statutory auditor of a bank required to report on the requirements relating to Companies (Auditor’s Report) Order, 2020?

[ICAI Study Material]

**ANSWER**

**Reporting on the requirements of CARO, 2020:**

Reporting requirements relating to the CARO 2020 is not applicable to banking company.

**Q.9:** Mr. Piyush, the Bank Manger 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 (4 Marks)]

**ANSWER**

**Understanding the Risk Management Process:**

An effective risk management system in a bank generally requires the following:

- (a) **Involvement of TCWG:** Risk Management policies should be approved by TCWG. While approving the policies, TCWG should ensure that 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 considers as acceptable.
- (b) **Identification, measurement & monitoring of risks:** Risks that may significantly affect the achievement of bank’s goals and objectives should be identified, measured and monitored against pre-approved limits and criteria.
- (c) **Control Activities:** Banks must have appropriate controls to manage its risks, including the following:
- Effectives segregation of duties,
  - Verification and approval of transaction,
  - Setting of limits, and
  - Reporting and approval of exception.

- (d) **Monitoring activities:** Independent risk management unit should be set up which regularly assess the risk management models, methodologies and assumptions used to measure and manage risk.
- (e) **Reliable information Systems:** Banks must have a reliable information system that provide adequate financial, operational and compliance information on a timely and consistent basis to management and TCWG.

**Q.10:** “The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference”. Explain.

[ICAI Study Material]

Or

You are appointed as an auditor of Banking Co., and hold discussions with engagement team. List out matters which you would discuss at planning stage of an audit to gain better understanding of the bank and its environment.

[May 19 (4 Marks)]

Or

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 (3 Marks)]

Or

Discuss the advantages of engagement team discussion done at the planning stage of the bank audit.

[July 21 (3 Marks)]

#### ANSWER

##### **Engagement Team Discussions:**

- Engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.
- All these discussions should be appropriately documented for future reference.
- The discussion should be done on the susceptibility of the bank's branch financial statements to material misstatements.

These discussions are ordinarily done at the planning stage of an audit.

##### **Benefits of 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.
- Enables engagement partner to delegate the work to the experienced engagement team members, and to determine the procedures to be followed when fraud is identified.
- Engagement Partner may review the need to involve specialists to address the issues relating to fraud.

##### **Matters to be discussed:**

- (a) Errors that may be more likely to occur;
- (b) Errors which have been identified in prior years;
- (c) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
- (d) Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;
- (e) Need to maintain professional skepticism throughout the audit engagement;
- (f) Need to alert for information or other conditions that indicates that a material misstatement may have occurred.

**Q.11:** As an Auditor of XYZ Bank Limited, how would you assess the Risk of Fraud including Money Laundering in line with SA 240? **[Jan. 21 (3 Marks)]**

**ANSWER**

**Assessing Risk of Fraud:**

- As an Auditor of XYZ Bank Limited, risk of fraud including money laundering would be assessed as explained hereunder which is in line with SA 240.
- As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor's objective is to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately.
- The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.
- RBI has framed specific guidelines that deal with prevention of money laundering and "Know Your Customer (KYC)" norms. The RBI has from time to time issued guidelines ("Know Your Customer Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

**Q.12:** 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. **[ICAI Study Material]**

**ANSWER**

**Classification of Advances:**

- 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.

**Q.13:** Account of a borrower availing cash credit facility from branch of a bank has become "Out of order." Discuss the term "Out of order". **[ICAI Study Material]**

**ANSWER**

**Out of Order in relation to Classification of Advances:**

An account should be treated as 'out of order' if:

- outstanding balance remains continuously in excess of the sanctioned limit/drawing power; or
- If there are no credits continuously for 90 days as on the date of Balance Sheet; or
- credits are enough to cover the interest debited during the same period.

**Example:** A Ltd. has been sanctioned a Cash Credit Facility by ADB Bank Ltd. for ₹ 50 lacs but as per the Stock Statements furnished for the last quarter, the Bank has calculated the Drawing power to be ₹ 42 Lakhs. In this case, the account would be termed as OUT OF ORDER if :

outstanding balance remains continuously in excess of the ₹ 50 lacs/42 lacs whatever the case may be; or

outstanding balance in the account is less than ₹ 42 lacs but there are no credits or any payments deposited into this account continuously for 90 days as on the date of Balance Sheet; or

credits are there upto say ₹ 2 lakhs but are not enough to cover the interest debited during the same period which is around ₹ 5 lakhs.

**Q.14:** Mr. A approaches a bank for financial assistance for his upcoming project. The Bank Branch Manager, after verifying the proposal, is agreeable to financing Mr. A, but asks for the security to be offered to the bank. Discuss the nature of securities required to be offered to the bank. **[May 18 (4 Marks)]**

**ANSWER**

**Nature of Securities to be offered:**

- (a) **Primary security:** Security offered by the borrower for bank finance or the one against which credit has been extended by the bank.
- (b) **Collateral security:** It is an additional security and can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Security may be created by different modes like Mortgage, Pledge, Hypothecation, Lien, Assignment.

- (a) **Mortgage:** Registered Mortgage can be affected by a 'Mortgage Deed' signed by the mortgagor. Equitable mortgage, is affected by a mere delivery of title deeds or other documents of title with intent to create security thereof.
- (b) **Pledge:** It involves physical delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. Legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods.
- (c) **Hypothecation:** Hypothecation is the creation of an equitable charge, which is created in favour of the lending bank by execution of hypothecation agreement in respect of the movable securities belonging to the borrower. Borrower holds the physical possession of the goods.

Neither ownership nor possession are transferred to the bank. Borrower periodically submits statements regarding quantity and value of hypothecated assets (like stocks, debtors, etc.) to the bank on the basis of which the drawing power of the borrower is fixed.

- (d) **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.
- (e) **Assignment:** It is 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 movable property) such as book debts and life insurance policies are accepted by bank as security by way to assignment.
- (f) **Set-Off:** Set-off is statutory right of a creditor to adjust, wholly or partly, the debt balance in the debtor's account against any credit balance lying in another account of the debtor.

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.

For this purpose, all branches of a bank are treated as one single entity. Right of set-off can be exercised in respect of time-barred debts also.

**Q.15:** "Ramjilal & Co. had been allotted the branch audit of a nationalized bank for the year ended 31st March, 2024. 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 determine 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 (5 Marks)]**

**ANSWER**

- (i) **NPA Norms for agricultural advances:** Refer answer of Q. No. 23.

- (ii) **NPA Norms where there is erosion in the value of security/frauds committed by the borrowers:** In case there arise erosion in the value of security or any fraud is committed by Borrowers, banks can directly classify these accounts as Doubtful Assets or Loss Assets, irrespective of the period for which the account has remained NPA.
- (i) Erosion in the value of securities by more than 50% of the value assessed by the bank or accepted by RBI inspection team at the time of last inspection, as the case may be, would be considered as "significant", requiring the asset to be classified as doubtful straightaway and provided for adequately.
- (ii) The realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10% of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be classified as loss asset. In such cases the asset should either be written off or fully provided for.

**Q.16:** "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. **[Nov. 19 (4 Marks)]**

**ANSWER**

**Provisioning Requirements of NPA:**

Statement that "There is no difference in provisioning of NPA as regards to categories of NPA, whether the debt is secured or unsecured" is not correct as the provisioning requirements for substandard and doubtful categories of NPA are different for secured and unsecured advances.

- (a) **For Substandard advances:** 15%.
- (b) **For Doubtful Advances:** Provisioning requirements are given below:

|                        | Secured Portion | Unsecured Portion |
|------------------------|-----------------|-------------------|
| Doubtful upto 1 year   | 25%             | 100%              |
| Doubtful 1 to 3 years  | 40%             | 100%              |
| Doubtful above 3 years | 100%            | 100%              |

- (c) **For Loss Assets:** Provision required will be 100%.

**Q.17:** Explain "Advances under Consortium" in the context of Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances. **[Jan. 21 (4 Marks)]**

**ANSWER**

**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.

**Q.18:** N Ltd. has been sanctioned a Cash Credit Facility by XYZ Bank Ltd. for ₹ 1 crore and drawing power as per the stock statements furnished for the last quarter is ₹ 80 Lakh. Outstanding balance in the account is ₹ 75 lakh. Interest charged to the account is ₹ 3.5 Lakh and total credit into the account for the quarter is ₹ 2.5 Lakh. As an auditor how will you report this account in your report. **[July 21 (4 Marks)]**

**ANSWER**

### Reporting of Cash credit Facility:

- An Advance will be classified as non-performing advance if:
  - (a) It ceases to generate income for a bank; or
  - (b) Interest and/or instalment of principal in respect of such an advance have remain overdue or out of order for a specified period of time.
- An account is said to be 'Overdue', if it is not paid on the due date fixed by the Bank. 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 there are no credits continuously for 90 days as on the balance sheet date or the credits are not enough to cover the interest debited during the same period.
- In the given case, though outstanding balance of ₹ 75 lakhs is within the drawing power but, the amount credited in the account (i.e. ₹ 2.5 Lakhs) is not enough to cover the interest charged in the account (i.e. ₹ 3.5 Lakhs).

**Conclusion:** Auditor should report the account as non-performing advance in the report.

**Q.19:** 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. **[ICAI Study Material]**

### ANSWER

#### **Special Mention Accounts (SMA):**

- Special Mention Account (SMA) is an account which is exhibiting signs of incipient stress resulting in the borrower defaulting in timely servicing of debt obligations, though the account has not yet been classified as NPA as per the RBI guidelines.
- In case of SMAs, there are over dues 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.

**Q.20:** CARD Ltd. is into the banking business and handles large amount of loans and advances of different kinds. Non-performing assets are on the rise since last two quarters. The management is concerned with correct provisioning for the same. CA R is appointed to check whether correct provisioning of NPA's is being made by the bank or not. What are the aspects that will be verified by CA R for this purpose?

**[Nov. 22 (4 Marks)]**

### ANSWER

#### **Aspects to be verified by CA R to check correct provisioning of NPAs:**

- (a) For audit of Provisions, the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.
- (b) The auditor should obtain an understanding as to how the bank computes provision on standard assets and non-performing assets.
- (c) It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets.
- (d) The auditor may verify the loan classification on a sample basis.
- (e) The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.

**Q.21:** “The Auditor should examine the efficacy of various internal controls over advances, to determine the nature, timing and extent of his substantive procedures.” Discuss briefly. **[Nov. 18 (5 Marks)]**

**ANSWER:**

**Aspects of internal Control in the area of loans and advances:**

Auditor should examine efficacy of various internal controls over advances to determine the NTE of his substantive procedures. In general, internal controls over advances should include, inter alia, the following:

- (1) Advances should be made only after evaluating creditworthiness of the borrowers and obtaining sanction from proper authorities.
- (2) All loan documents like promissory notes, letters of hypothecation, etc. should be executed by the parties before advances are made.
- (3) Compliance with term of sanction and end use of funds should be ensured.
- (4) Sufficient margin should be kept against securities taken so as to cover any decline in the value thereof and also to comply with RBI directive.
- (5) If securities are in nature of shares, debentures, etc. ownership of the same should be transferred in name of the bank and the effective controls of such securities be retained as a part of documentation.
- (6) Securities required registration should be registered in the name of the bank.
- (7) In case of physical possession of goods as security, goods should be test checked at the time of receipts.
- (8) Drawing Power Register should be updated every month to record value of securities hypothecated.
- (9) Accounts should be kept within both drawing power and sanctioned limit. All accounts which exceed sanctioned limit or drawing power or are otherwise irregular should be brought to notice of the controlling authority regulatory.
- (10) Operations of each advance account should be reviewed at least once a year and at more frequent intervals in the case of large advances.

**Q.22:** 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. **[ICAI Study Material]**

**ANSWER**

**Analytical procedures”, to verify interest on deposits**

- 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.
- 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.

**Q.23:** Write a short note on reversal of income under bank audit.

**[ICAI Study Material]**

**ANSWER**

**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.
- 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.

**Q.24:** Discuss outline of audit approach including audit procedures while auditing “provisions and contingencies” in financial statements of a bank. [ICAI Study Material]

Or

You are appointed as statutory audit of DEF Bank Limited for the year 2023-24. As an auditor how will you verify provision created by DEF Bank Limited? [Nov. 20 (4 Marks)]

**ANSWER**

**Audit Procedure for Verification of Provisions and Contingencies:**

- (1) Ascertain compliance with the various regulatory requirements for provisioning as contained in the various circulars.
- (2) Obtain an understanding as to how the Bank computes provision on standard assets and non-performing assets. It includes the basis of the classification of loans into standard, sub-standard, doubtful and loss assets.
- (3) Obtain the detailed break up standard loans, non-performing loans and agree the outstanding balance with the general ledger.
- (4) Obtain statement of computation of tax provision from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain the same are appropriately considered in the tax provision computation.
- (5) Other provisions for expenditure should be examined vis-à-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

### **Division C - Case Study Based Questions**

**CA M** is conducting statutory audit of branch of MMC Bank. During the course of audit, it is noticed as under:-

- (i) Loans under “Kisan credit card” are given by Bank to farmers to meet their short-term credit needs for cultivation of crops. In respect of one agricultural advance classified under “Kisan Credit Card” having an outstanding balance of ₹ 20 lacs as at year end, there is no transaction in account since last 90 days. The said loan has been granted for cultivation of paddy which is harvested in a period of 3-4 months from sowing. The branch has classified the said advance as “Standard asset”.
- (ii) It is also observed that account of one borrower availing cash credit limit of ₹50 lacs was taken over from another bank. The proposal was sanctioned by branch manager instead of immediate next higher authority as required in “Manual of Delegation of Powers” of Bank.
- (iii) It is noticed that head office of bank has flagged a savings account maintained in branch in which interest was wrongly paid at higher rate due to wrong data feeding entry. Now, situation has been rectified by debiting excess interest paid in the account. Since there was little balance in savings account, a debit balance of ₹1.50 lac was created in the said savings account due to above reversal. The matter was immediately informed to account holder. However, he has not turned up for payment since matter was informed to him about six months ago.

- (iv) There are many cash credit accounts in the branch. Such borrowers are required to submit monthly stock statements to branch showing calculation of drawing power.
- (v) One borrower has availed a housing loan and a car loan from the branch. Housing loan EMIs are overdue for 120 days as on date of Balance sheet. Car loan EMIs are overdue for 60 days as on date of Balance Sheet.

**Based 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 “Non-Performing Assets” in accordance with RBI norms on asset classification.
  - (b) Housing Loan should be classified as “Non-Performing Asset” in accordance with RBI norms on asset classification. However, Car loan should be classified as Standard asset.
  - (c) Car Loan should be classified as “Non-Performing Asset” in accordance with RBI norms on asset classification. However, Housing Loan should be classified as Standard asset.
  - (d) Both Housing as well as car loans should be classified as Standard assets.

**[ICAI Study Material]**

**ANSWERS**

(1)

(c)

(2)

(c)

(3)

(b)

(4)

(b)

(5)

(a)



# ETHICS AND TERMS OF AUDIT ENGAGEMENTS

## Division A - Multiple Choice Questions

**Q.1:** \_\_\_\_\_ are self-evident and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests.

- (a) Self-review threats
- (b) Familiarity threats
- (c) Intimidation threats
- (d) Advocacy threats

[MTP March 19]

ANSWER: (b)

**Q.2:** Professional skepticism is necessary to the critical assessment of \_\_\_\_\_.

- (a) Audit documentation
- (b) Audit evidence
- (c) Audit procedures and techniques
- (d) None of the above

[MTP March 19]

ANSWER: (b)

**Q.3:** As per SA 210 "Agreeing the Terms of Audit Engagements", the auditor shall agree the terms of the audit engagement with:

- (a) Management
- (b) Those charged with governance
- (c) Management or those charged with governance, as appropriate.
- (d) Engagement team members

[MTP Oct. 19]

ANSWER: (c)

**Q.4:** An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of \_\_\_\_\_ exercised in performing the work and evaluating the results.

- (a) Professional skepticism
- (b) Professional integrity
- (c) Professional judgment
- (d) Professional sincerity

[RTP Nov. 19]

ANSWER: (c)

**Q.5:** Direct financial interest or materially significant indirect financial interest in a client is an example of

- (a) Self-review threats
- (b) Self-interest threats
- (c) Advocacy threats
- (d) Intimidation threats

[MTP May 20]

**ANSWER: (b)**

**Q.6:** \_\_\_\_\_ is the threat which occurs when auditors are deterred from acting objectively with an adequate degree of professional skepticism.

- (a) Familiarity threat
- (b) Advocacy threat
- (c) Self-Review threat
- (d) Intimidation threat

**[MTP March 21, RTP Nov. 21]**

**ANSWER: (d)**

**Q.7:** As per SQC 1 the retention period for audit engagements ordinarily is no shorter than \_\_\_\_\_ from the date of the auditor's report.

- (a) 10 years
- (b) 5 years
- (c) 7 years
- (d) 4 years

**[MTP March 21, RTP May 22]**

**ANSWER: (c)**

**Q.8:** In relation to completed engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures is known as:

- (a) Monitoring
- (b) Inspection
- (c) Subsequent Audit procedures
- (d) Compliance procedures

**[MTP March 21, RTP May 21, MTP Sep. 22]**

**ANSWER: (b)**

**Q.9:** If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

- (a) Withdraw from the audit engagement where possible under applicable law or regulation;
- (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.
- (c) Withdraw from the audit engagement where possible under applicable law or regulation and determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.
- (d) Withdraw from the audit engagement where possible under applicable law or regulation or determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

**[MTP March 21, April 21, Nov. 21]**

**ANSWER: (c)**

**Q.10:** The firm R K & Associates has an extensive understanding of Code of Ethics that underlies the fundamental principles relevant to the Auditor when conducting an Audit of Financial Statements and provides a conceptual framework for applying these principles. Which of the following does not form part of the fundamental principle?

- (a) Integrity
- (b) Professional Competence and due care
- (c) Professional Skepticism
- (d) Professional behaviour

[MTP April 21]

**ANSWER:** (c)

## **Division B - Descriptive Questions**

**Q.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.

[ICAI Study Material]

**ANSWER**

**Fundamental Principles governing Professional Ethics:**

- "Professional Behaviour" requires an accountant to comply with relevant laws and regulations and avoid any conduct that the accountant knows or should know might discredit the profession.
- Failure to reply to professional body smacks of lack of courtesy and professional responsibility.

**Conclusion:** The principle of "Professional behaviour" is disregarded.

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

[ICAI Study Material]

**ANSWER**

**Fundamental Principles governing Professional Ethics:**

- 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
  - (a) Contains a materially false or misleading statement;
  - (b) 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.

**Q.3:** Briefly outline how principles-based approach differs from rules-based approach to ethics.

[ICAI Study Material]

**ANSWER**

**Principles Based Approach Vs Rules Based Approach to Ethics:**

- Ethical guidance may follow principles-based approach or rules-based approach.

- Essence of principles-based approach to ethics is that it requires compliance with spirit of ethics. It requires accountants to exercise professional judgement in every situation based upon their professional knowledge, skill and expertise. It requires that accountants should use professional judgement 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. Rules-based approach is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules.

**Q.4:** “Independence of mind and independence in appearance are interlinked perspective of independence of auditors.” Explain. **[May 19 (3 Marks)]**

**ANSWER**

**Perspectives of independence of auditors:**

Professional integrity and independence are considered essential characteristics of all the professions but are more so in the case of accountancy profession. Independence implies that the judgment of a person is not subordinate to the wishes or direction of another person who might have engaged him.

It is not possible to define “independence” precisely. Independence is a condition of mind as well as personal character. It should not be confused with the superficial and visible standards of independence which are sometimes imposed by law.

- (a) **Independence of mind** – state of mind that permits an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.
- (b) **Independence in appearance** – avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm’s, or a member of the assurance team’s, integrity, objectivity or professional skepticism had been compromised.

Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

**Q.5:** 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? **[ICAI Study Material]**

**ANSWER**

**Threats to Independence:**

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.

Self-interest threats 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.

**Q.6:** CA Murli Madhavan provides accounting and book keeping services to 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. **[ICAI Study Material]**

## **ANSWER**

### **Threats to Independence:**

- 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.
- It may occur when a previous judgement needs to be re-evaluated by the professional accountant responsible for that judgement.

Instances where such threats may arise are:

- (a) When an auditor having recently been a director or senior officer of the company; and
- (b) When auditors perform services that are themselves subject matters of audit.

**Q.7:** 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?

**[ICAI Study Material]**

## **ANSWER**

### **Safeguards to Independence:**

- When threats to independence exist, auditor should either desists 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.

**Conclusion:** Considering above, CA Raman 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.

**Q.8:** Describe the guiding principles which the auditor should take into account which serves as the safeguards to eliminate the threats to independence. **[Nov. 20 (4 Marks)]**

## **ANSWER**

### **Safeguards to Independence:**

Chartered Accountants have a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to address the threats.

Safeguards are actions that professional accountant takes that effectively reduce threats to comply with the fundamental principles to an acceptable level. To address the issue, the following guiding principles are to be applied:

- (a) For the public to have confidence in quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
- (b) Before taking on any work, auditor must conscientiously consider whether it involves threats to his independence.
- (c) When such threats exists, 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.
- (d) If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

**Q.9:** 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? **[ICAI Study Material]**

**ANSWER**

**Professional Skepticism:**

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 procedure 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.

**Q.10:** How application of professional skepticism throughout audit is helpful in reducing audit risk? **[ICAI Study Material]**

**ANSWER**

**Professional Skepticism:**

- Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
- It Reduces risk of:
  - (a) Overlooking unusual circumstances.
  - (b) Over generalising when drawing conclusions from audit observations.
  - (c) Using inappropriate assumptions in determining NTE of audit procedures & evaluating the results thereof.

**Q.11:** The auditor shall plan and perform and audit with professional skepticism recognizing that circumstances may exist that cause the financial statement to be materially misstated. Discuss any four examples of professional skepticism. **[Nov. 19 (4 Marks)]**

**ANSWER**

**Professional Skepticism:**

SA 200 "Overall Objectives of the Independent Auditor and Conduct of Audit in accordance with SAs" requires that the auditor shall plan and perform and audit with professional skepticism.

- (a) Meaning of Professional Skepticism: An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.
- (b) Professional Skepticism Reduces risk of:
  - Overlooking unusual circumstances.
  - Over generalising when drawing conclusions from audit observations.
  - Using inappropriate assumptions in determining N, T, E of audit procedures & evaluating the results thereof.
- (c) Professional skepticism includes being alert to:
  - Contradictory audit evidence.
  - Questions on reliability of documents.
  - Conditions indicating possible frauds.
  - Circumstances suggesting need for audit procedures in addition to those suggested in SAs.

- (d) 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.
- (e) 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.

**Q.12:** 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? [ICAI Study Material]

#### ANSWER

##### **Preconditions for an Audit:**

It is necessary for management to give in writing to the auditor that it understands its responsibilities for preparation of F.S. in accordance with applicable FRF. It is a necessary precondition for an audit in accordance with SA 210.

If preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, auditor shall not accept proposed audit engagement:

- (a) If the auditor has determined that the FRF to be applied in the preparation of the F.S. 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.

**Conclusion:** 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 F.S. in accordance with applicable FRF.

**Q.13:** CA S is requested to accept the appointment as an auditor of Luck Ltd. With reference to SA 210, what should the auditor determine in order to establish whether the preconditions for an audit are present?

[Dec. 21 (4 Marks)]

#### ANSWER

##### **Preconditions for an Audit:**

As per SA 210 "Agreeing the terms of Audit Engagement" before accepting an audit engagement auditor is required to ensure existence of preconditions. Accordingly, preconditions to be examined are:

- A. Determine whether FRF to be applied in preparation of financial statements is acceptable; and
- B. Obtain the agreement of management that it acknowledges and understands its responsibilities for followings;
- (i) The preparation of the F.S. in accordance with the applicable FRF.
- (ii) Exercising necessary internal control to enable the preparation of F.S. that are free from material misstatement, whether due to fraud or error.
- (iii) To provide the auditor with:
- (a) Access to all relevant information such as records, documentation and other matters;
- (b) Additional information that the auditor may request from management for the purpose of the audit; and

- (c) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

**Q.14:** CA P is appointed as an auditor of XYZ Limited for the F.Y. 2023-24. The management of XYZ Limited has requested the auditor to change the terms of original engagement as the company has diversified its business and few new products have been introduced by the company. Can CA P agree to the request made by the management? Under which circumstances can the client make a request to the auditor for a change in the terms of engagement? **[Nov. 22 (4 Marks)]**

**ANSWER**

**Acceptance of Changes in terms of engagement:**

SA 210 "Agreeing the terms of Audit Engagement" deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and TCWG. In accordance with SA 210, if, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so.

So, in case of reasonable justification, auditor may accept the request made by the management.

**Circumstance in which client can request the auditor to change the engagement:** Refer answer of Q. No. 18.

**Q.15:** 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. **[ICAI Study Material]**

**ANSWER**

**Terms of engagement in Recurring Audits:**

- In case of recurring audits, 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.
- Auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:
  - (i) Any indication that the entity misunderstand the objective and scope of the audit.
  - (ii) Any revised or special terms of the audit engagement.
  - (iii) A recent change of senior management.
  - (iv) A significant change in ownership.
  - (v) A significant change in nature or size of the entity's business.
  - (vi) A change in legal or regulatory requirements.
  - (vii) A change in the financial reporting framework adopted in the preparation of the financial statements.
  - (viii) A change in other reporting requirements.
- In the given case, auditor noticed that there is substantial change in management and also client has ventured into areas of business activity which were not present at time of accepting initial audit engagement.

**Conclusion:** Auditor may decide to send a new audit engagement letter.

**Q.16:** 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. **[ICAI Study Material]**

**ANSWER**

**Acceptance of Client Relationships and Specific Engagements:**

- SQQ 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 analytical. The firm has no prior experience of audits in emerging “fintech” sector. The firm does not have trained personnel to carry out these audits.

**Conclusion:** Offer should not be accepted.

**Q.17:** How does SQC 1 ensure that independence in engagements is not breached by an audit firm?

**[ICAI Study Material]**

**ANSWER**

**Ensuring Independence:**

- As per SQC 1, firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel maintain independence where required by the Code.
- Such policies and procedure 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 Eps 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 requirement of the Code.

**Q.18:** 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 residence 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? **[ICAI Study Material]**

**ANSWER**

**Information to be considered before accepting an Audit:**

- 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.
- SQQ 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.

**Conclusion:** Proposed offer should not be accepted.

**Q.19:** An engagement partner takes overall responsibility for maintaining audit quality in an audit engagement in accordance with SA 220. What are his objectives in taking and emphasizing such responsibility?

[ICAI Study Material]

Or

The engagement partner shall take the responsibility for the overall 'quality on each audit engagement to which that partner is assigned. Discuss with reference to SA 220 "Quality Control for an audit of financial statements".

[Nov. 19 (3 Marks)]

**ANSWER**

**Leadership responsibilities for Quality on audits:**

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:

- (1) 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
- (2) The fact that quality is essential in performing audit engagements

**Q.20:** CA Raj, an engagement partner wants to take decision regarding acceptance and continuance of an audit engagement. Which information, he should obtain before accepting an engagement? [May 19 (3 Marks)]

**ANSWER**

**Information assisting Auditor in accepting and continuing of relationship with the Client:**

As per SA 220, "Quality Control for an Audit of Financial Statements" the information which assists the auditor in accepting and continuing of relationship with the client may include the following:

- (1) The integrity of the principal owners, key management and those charged with governance of the entity;
- (2) Competency of engagement team to perform the audit engagement and availability of necessary capabilities, including time and resources;
- (3) Compliance with relevant ethical requirements by firm and the engagement team; and
- (4) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

## **Division C - Case Study Based Questions**

Das & Co, a firm of auditors, is offered appointment as auditor of a company, a prospective new client. CA Sukanya, one of partners, is dealing with new client. While meeting with officers of the company, she comes to know that Sushant, CFO of the company, was her class mate. In fact, both of them had started CA together.

However, Sushant had left CA mid-way due to repeated failures and tried his luck to pursue MBA (finance) from one of leading institutions.

During initial discussions, it transpires that company is going to launch new services in the field of weather forecasting". Such services would be available on web site of company and micro weather information would

be available on payment of charges. The company requests audit firm to be visibly associated with their marketing blitz.

Assume that firm chooses to accept the offer and writes to previous auditor, Walker & Co., to advise whether there exist any professional reasons for them not to accept the proposed offer. However, Walker & Co. do not reply to the request of Das & Co.

During preliminary discussions, it also became known that the said company has acquired all shares of another company. Under relevant provisions of law, financial statements of both companies needed to be consolidated and audited. Despite this knowledge, Das & Co. failed to advise their client regarding audit of consolidated financial statements.

The company also offers auditors contract for providing IT services pertaining to information system of company.

Based on above, answer following questions:

- (1) **Considering discussion about Sukanya and Sushant, which of the following statements seems most appropriate?**
  - (a) The above discussion is irrelevant in context of proposed offer.
  - (b) The proposed offer should be accepted by firm. The engagement team may be headed by CA Sukanya for better coordination and results.
  - (c) The proposed offer should be accepted by firm. The engagement team may be headed by a different partner of the firm.
  - (d) The matter is too trivial to be reported by CA Sukanya to other partners of firm.
- (2) **Keeping in view request of the company to be visibly associated with company's new services, identify which type of threat is being faced by audit firm.**
  - (a) Self-interest threat
  - (b) Familiarity threat
  - (c) Self-review threat
  - (d) Advocacy threat
- (3) **The previous auditors, Walker & Co., have not replied to communication of Das & Co. Which fundamental principal 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.

[ICAI Study Material]

ANSWER

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

