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CA Inter Dec-21

AIR 49



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CA Inter May-22

What Our Students have to Say....

Aman Mahajan (CA AIR 19)

I really liked your classes, especially the practical linkages explained with amazing graphics. The full subject test series helped a lot in improving my writing speed and presentation skills.

Sundar Sri Renganathan B (AIR 33)

I took Accounting from IndigoLearn and the classes were really good. They emphasized on conceptual clarity over getting things done quickly, which is really vital to score good marks in practical papers. Other resources like Notes, Quizzes and Forum was beneficial too.

Dwarakesh

Thank you IndigoLearn team for the guidance and support throughout the past few months. I had great conceptual clarity in all the subjects and the revision classes by Suraj Sir were very helpful. Study planner and Free resources were very useful. Thank you Team IndigoLearn.

Yug Manoj Kumar Bhattad

I have cleared my CA Foundation examination with the total of 286. And this was not possible without the efforts and support of IndigoLearn. The way of teaching with utmost conceptual clarity is the best thing at IndigoLearn.

Prakash Bhatt

Superb, one stop solution for All CA and Accountancy students they serve real Education at very very reasonable price

Naveen Kumar S

Good experience, unlimited views helped a lot in last one month preparation. Looking forward for

Bhagyasree Chougule

It was only because of IndigoLearn that my concepts became very clear, and I was able to crack the exam. I wasn't 100% prepared I needed more practice but luckily I got through. I'm definitely choosing IndigoLearn for group 2 preparation. A big thanks!

Mohd Thayyab

Theoretical subjects made easier through story based examples and charts. Concept clarity 100%. Fully exam+practical oriented classes will help not only to retain the concepts during exams but for the longer duration.

Lalit Chetan Sanpal

IndigoLearn has been fantastic and brilliant. Helped me a lot in my preparations. I cleared both the groups in first attempt with your brilliant classes and notes. Thanks to all the faculties, coordinators, forum admins and everyone at IndigoLearn. Really grateful. Will go for CA Finals at IndigoLearn For sure. Thank you so much IndigoLearn.

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Abishek M

I'd like to thank IndigoLearn for all the support they've provided me with. Modules were great. They were time saving and straight to the point. I extensively used the materials provided before exams, they were so helpful. Also I'd appreciate them for providing unlimited views as I kept looking into the maths modules till the end.

Munnur Nandini Sree

Accounting classes I have taken from IndigoLearn. Now I feel that it's a great choice that I have made (after seeing my result) because only in Accounting I got exemption. Thank you IndigoLearn.

Harshita G

Thank u so much IndigoLearn for your guidance. This is only possible because of u people.... For my finals also my journey will continue with IndigoLearn.

Bharathsha PS

I purchased Economics, IT, FM, EIS and Audit from IndigoLearn. All your classes are superb and anyone can easily crack the CA exams. What makes u special is your classes help us to understand the concepts very well. Special thanks to the FM faculty, I studied only 2 chapters in economics, and still managed to score exemption in the 8th paper.

Nayi Mihir kumar

This platform is very helpful in all activity like mcq practise, notes, teaching activities, revisions and the forum interaction with all students which I like the most. If anybody want to clear their exams in first attempt then IndigoLearn is the best platform for them. My all regards to IndigoLearn. Thank you so much.

Rajalaxmi CA Inter

Can't believe I cleared. Sathya Sir, Suraj Sir, Yogita Mam ... thanks to all my faculties. Basically an Eng student with zero accounts knowledge. Thanks IndigoLearn for making me clear in first attempt.

Priyanka Udeshi

All the faculties have excellent knowledge of the subject and deliver it in very crisp & effective manner. Also, quick response at Forums never let any of my doubts go unresolved no matter how small they were. Thank you once again to all the teachers & staff at IndigoLearn!

Naveen Kumar T

It been a great journey with indigo learn team. Thanks to all the facilities and forum friends who support me a lot.

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Chapter 1

Nature, Objective and Scope of Audit

Question 1

In case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Explain such assertions or subject matters. (RTP Nov'23)

Answer 1

In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
- The existence and completeness of related party relationships and transactions.
- The occurrence of non-compliance with laws and regulations.
- Future events or conditions that may cause an entity to cease to continue as a going concern.

Question 2

The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organizations where audit is not compulsory. Explain. (RTP Nov '18)

Answer 2

The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory, these advantages are given below:

It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders, bankers, FI's, public at large etc.

- a. **It acts as a moral check on the employees** from committing defalcations or embezzlement.
- b. Audited statements of account are **helpful in settling liability for taxes**, negotiating loans and for determining the purchase consideration for a business.
- c. These are **also useful for settling trade disputes** for higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.

- d. An audit can also **help in the detection of wastages and losses** to show the different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures.
- e. **An audit ascertains whether the necessary books of account and allied records have been properly kept** and helps the client in making good deficiencies or inadequacies in this respect.
- f. As an appraisal function, **audit reviews the existence and operations of various controls in the organisations** and reports weaknesses, inadequacies, etc., in them.
- g. Audited accounts are of great help in **the settlement of accounts at the time of admission or death of partner.**
- h. Audited accounts are of great help in **the settlement of accounts at the time of admission or death of partner.**

Question 3

Examine with reasons (in short) whether the following statements are correct or incorrect: Mr. Z, a team member of auditor of Grateful and Competent Limited was of the opinion that while conducting an audit of a company no distinction is required to be made between revenue expenditure and capital expenditure. (MTP 2 Marks Oct 20)

Answer 3

Incorrect: The opinion of Mr. Z is incorrect because one of the important aspects to be followed while conducting audit of a company is that a distinction is required to be made properly between revenue expenditure and capital expenditure.

Question 5

The auditor has to form an opinion on the financial statements within a reasonable period of time and at a reasonable cost. Explain the above statement with reference to "Timeliness of Financial Reporting and the Balance between Benefit and Cost". (RTP-May'18]

Answer 5

Timeliness of Financial Reporting and the Balance between Benefit and Cost: The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. There is an expectation by users of financial

statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognizing that it

is practicable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

Question 6

Discuss the following:

CA Jatin is the auditor of JP Ltd. The auditor expressed his opinion on the financial statements without ascertaining as to whether the financial statements as a whole were free from material misstatements. Explain w.r.t SA 200. (MTP 3 Marks April '23)

OR

Mr. Z, auditor of the Company, Different and Capable Limited for the financial year 2022-23, explained to audit team members about the objectives of the Independent Auditor in accordance with the relevant Standard on Auditing. Explain those objectives. (RTP Nov '23)

Answer 6

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

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

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

Question 7

Both accounting and auditing are closely related with each other. Explain (RTP Nov'20)

Answer 7

Both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process. It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements. In fact, auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities. To begin with, it may be noted

that the discipline of auditing itself is a logical construct and everything done in auditing must be bound by the rules of logic. Ethical precepts are the basis on which the foundation of the entire accounting profession rests. The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work.

Question 8

The knowledge of human behavior is indeed very essential for an auditor so as to effectively discharge his duties. Explain. (RTP Nov '21)

Answer 8

The field of auditing as a discipline involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also possesses a good knowledge about the fields in respect of which he is conducting such a review.

The discipline of behavioral science is closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organization. As against the financial Auditor, the internal auditor or a management auditor is expected to deal with human beings rather than financial figures. One of the basic elements in designing the internal control system is personnel. However, if a sound internal control structure is designed, it cannot work until and unless the people who are working in the organization are competent and honest. The knowledge of human behavior is indeed very essential for an auditor so as to effectively discharge his duties.

Question 9

There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain giving examples. (RTP Nov '21, May'20,)

Answer 9

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

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
2. Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Question 10

The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit. Explain. (RTP Nov '18)

Answer 10

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

- I. **The Nature of Financial Reporting:** The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.
- II. **The Nature of Audit Procedures:** There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:
 1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
 2. Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
 3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.
- iii. **Timeliness of Financial Reporting and the Balance between Benefit and Cost:** The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of

information and its cost.

- iv. **Other Matters that Affect the Limitations of an Audit:** In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:
- Fraud, particularly fraud involving senior management or collusion.
 - The existence and completeness of related party relationships and transactions.
 - The occurrence of non-compliance with laws and regulations.
 - Future events or conditions that may cause an entity to cease to continue as a going concern.

Question 11

There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain giving examples. Also explain the difference between audit and investigation. (RTP Nov 22, Nov'23)

Answer 11

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

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.
2. Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents
3. An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

We have to clearly understand that audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.

The objective of audit, on the other hand as we have already discussed, is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.

Therefore, audit is never started with a pre-conceived notion about state of affairs; about wrong- doing; about some wrong having been committed.

The auditor seeks to report what he finds in normal course of examination of accounts. However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor. It may happen that auditor has given some findings of serious concern. Such findings may prompt for calling an investigation.

Question 12

Standards on Auditing (SAs) apply in “audit of historical financial information” whereas Standards on Review Engagements (SREs) apply in “review of historical financial information.” Explain in detail giving examples. (RTP May '22)

Answer 12

It is to be understood that Standards on Auditing (SAs) apply in “audit of historical financial information” whereas Standards on Review Engagements (SREs) apply in “review of historical financial information”. Remember that Standards on auditing apply in “audit” of historical financial information which is a reasonable assurance engagement whereas Standards on Review Engagements apply in “review” of historical financial information which is a limited assurance engagement only.

“Historical financial information means” information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

Here, we have to broadly understand that “audit” and “review” are two different terms. Audit is a reasonable assurance engagement, and its objective is reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement. However, “review” is a limited assurance engagement, and its objective is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement. Standards on Auditing have been issued on wide spectrum of issues in the field of auditing including (but not limited to) overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit evidence, audit sampling, going concern and forming an opinion and reporting on financial statements.

Some examples of Standards on Auditing are:

- I. SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
- II. SA 230 Audit Documentation
- III. SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
- IV. SA 500 Audit Evidence
- V. Revised SA 700 Forming an Opinion and Reporting on Financial Statements
- VI. SRE 2400 (Revised) Engagements to Review Historical Financial Statements

VII. SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity.

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Chapter 2

Audit Strategy, Audit Planning and Audit Programme

Question 1

The engagement partner of AST AND ASSOCIATES, firm of Chartered Accountants appointed as auditor of Fabric India Ltd is considering as to management of key resources to be employed to conduct audit. Discuss how overall audit strategy would assist the auditor. (MTP 5 Marks)

OR

Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. The process of establishing the overall. (RTP May '20 & Nov '18)

Answer 1

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

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

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

In establishing the overall audit strategy, the auditor shall

- **Ascertain the nature, timing and extent of resources necessary to perform the engagement**

Example

- **The selection of engagement team and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.**
- **Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material**

Question 2

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. (RTP Nov '20 & Nov '18)

Answer 3

The auditor shall document:

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

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

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

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

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

For instance-

The following things should form part of auditor's documentation:

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

Question 3

The established of the overall audit strategy and the detailed audit plan are closely inter-related explain (MTP 3 marks March 19)

Answer 3

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

Question 4

M & Co. was appointed as auditor of IGI Ltd. As an auditor what are the factors that would be considered in the development of overall audit plan? (MTP 4 Marks April 19, May '18)

OR

Your firm has been appointed as an auditor to audit the accounts of an auto parts manufacturer, ABC LTD. Elucidate the matters to be considered by an auditor in developing his overall plan for the expected scope and conduct of audit. (MTP 4 Marks Oct 20)

Answer 4

Development of an Overall Plan: The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit-

- The terms of his engagement and any statutory responsibilities
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.
- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- The degree of reliance he expects to be able to place on accounting system and internal control.
- Possible rotation of emphasis on specific audit areas.
- The nature and extent of audit evidence to be obtained.

- The work of internal auditors and the extent of their involvement, if any, in the audit.
- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.
- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- Establishing and coordinating staffing requirements.

Question 5

The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. Explain the factors due to which above varies. (May 20, RTP Nov '20)

Answer 5

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

1. The size and complexity of the entity.
2. The area of the audit.
3. The assessed risks of material misstatement

Example

An increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work.

4. The capabilities and competence of the individual team members performing the audit work.

Example

We may have identified a problem related to the production process that raised concerns about inventory obsolescence. After obtaining an understanding of the entity's process that raised concerns about inventory obsolescence (which we had identified as a significant class of transactions), we concluded that additional tests of details were required. Therefore, the senior will likely take part, along with the team, in the discussions with management about the provision for obsolescence and examine related documentation supporting the provision, rather than just reading the memo on file. These procedures should be completed as the work is being performed rather than as an after the fact review. The extent of the senior's involvement requires judgment, taking into consideration the complexity of the area and the experience of the team.

Question 6

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

A detailed Audit Programme once prepared for a business can be used for all business under all circumstances. (Nov '21, March 22 & Oct 22)

OR

Evolving one audit programme applicable to all business under all circumstances is not practicable. Explain (RTP May '19 & May '18)

Answer 6

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

Question 7

“In establishing the overall audit strategy, the auditor shall, among other considerations, ascertain the nature, timing and extent of resources necessary to perform the engagement” Explain those considerations in detail. (RTP Nov'23)

Answer 7

In establishing the overall audit strategy, the auditor shall:

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

Question 8

CA Vikas Jain discussed with his audit team about advantages and disadvantages of audit programme. He explained to his team that –“work may become mechanical” as disadvantage of the audit programme. Discuss explaining the disadvantages of an audit programme (MTP 4 Marks March 22)

Answer 8

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

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

Question 9

“An adequate planning benefits the audit of financial statements.” Discuss. (May '23, Nov '19, Nov '21, May '18)

Answer 9

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

1. Helping the auditor to devote appropriate attention to important areas of the audit.
2. Helping the auditor identify and resolve potential problems on a timely basis.
3. Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
4. Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
5. Facilitating the direction and supervision of engagement team members and the review of their work
6. Assisting, where applicable, in coordination of work done by auditors of components and experts.

Question 10

XYZ & associates are appointed as the statutory auditors of Fisco Ltd. for the FY 2021

-22. While constructing the audit programme, the engagement partner, CA X, should keep in mind various points. List such points. (MTP 4 Marks Oct'22)

OR

Arpan Hospitals Ltd having Gross Professional Charges of ₹ 50 crores are engaged in providing healthcare services. STP & Co., a firm of auditors is appointed as its auditors.

Advise what special points to be kept in mind for the purpose of construction of an Audit programme.

Explain. (May '19)

OR

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

Answer 10

For the purpose of audit programme construction, CA X should keep in mind the following points:

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

Question 11

As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan. Explain (May 22)

Answer 11

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

from the information available when the auditor planned the audit procedures. **For example**, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

Question 12

Evolving one audit programme applicable to all business under all circumstances is not practicable. Explain clearly stating in detail the meaning of audit programmer. (RTP Nov'20)

Answer 12

Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programmer applicable to all business under all circumstances is not practicable. However, it becomes a necessity to specify in detail in the audit programmer the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

It is desirable that in respect of each audit and more particularly for bigger audits an audit programmer should be drawn up. Audit programmer is a list of examination and verification steps to be applied and set out in such away that the interrelationship one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or based on an appraisal of the accounting records of the client.

Definition: An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements.

In other words, an audit programmer is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

Question 13

Without adequate knowledge of client's business, a proper audit is not possible. It is one of the important principles in developing an overall audit plan. Explain in context with relevant SA, knowledge to be obtained by the auditor in establishing overall plan. Also explain how such an understanding would be helpful to the auditor. (RTP May '21)

Answer 13

Without adequate knowledge of client's business, a proper audit is not possible. It is one of the important principles in developing an overall audit plan. As per SA-315, "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment", the auditor shall obtain an

understanding of the following:

- a) Relevant industry, regulatory and other external factors including the applicable financial reporting framework.
- b) The nature of the entity, including:
 - I. its operations;
 - II. its ownership and governance structures;
 - III. the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - IV. the way that the entity is structured and how it is financed;
to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
- c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
- d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
- e) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations and to make judgements regarding the appropriateness of accounting policies and disclosures

Question 14

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

Answer 14

Periodic Review of the Audit Programme

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

Example- if the audit programme for the audit of a branch of a financing house,

drawn up a number of years ago, fails to take into consideration that the previous policy of financing of a vehicle has been changed to financing of real estate acquisition, the whole audit conducted thereunder would be entirely misdirected and may even result into nothing more than a farce. [Pacific Acceptance Corporation Ltd. v. Forsyth and Others.]

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

Question 15

Without adequate knowledge of client's business, a proper audit is not possible. The auditor shall obtain an understanding of the entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

Explain giving examples. (RTP May '22)

Answer 15

Knowledge of the client's business is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of client's business, a proper audit is not possible. As per SA-315 "Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment", the auditor shall obtain an understanding of the entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

Example

1. If one of management's objectives is to grow the business, management may develop a strategy of steady but regular growth through specific marketing campaigns and development of new markets. Alternatively, management may develop a more aggressive, complex strategy of acquiring competitors. Each of these strategies gives rise to differing business risks and potentially differing risks of material misstatement.
2. Examples of potential business risks include:
 - I. Failure to keep up to date with new products, technologies or services.
 - II. Excessive reliance on a key supplier, product or individual, such as the owner.
 - III. Lack of personnel with expertise to react to changes in the industry.

- IV. Insufficient or excessive production capacity caused by inaccurate estimation of demand. Loss of financing due to the entity's inability to meet financial covenants

Question 16

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

Development of an audit plan is important before the establishment of the overall audit strategy to address the various matters. (RTP Nov'22)

Answer 16

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

Question 17

Explain what do you mean by documentation of audit plan. Discuss the purpose served by it and also elaborate the tools used by the auditor to reflect the particular engagement circumstances. (RTP Nov'22)

Answer 17

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.

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

Question 18

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

Once the overall audit has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy. The establishment of the overall audit strategy and the detailed audit plan are closely inter-related. (RTP May '23)

Answer 18

Correct: Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but

are closely inter-related since changes in one may result in consequential changes to the other.

Question 19

In establishing the overall audit strategy, the auditor shall identify the characteristics of the engagement that define its scope. Explain with example. (RTP May '23)

Answer 19

In establishing the overall audit strategy, the auditor shall Identify the characteristics of the engagement that define its scope.

For Example:

- The expected audit coverage, including the number and locations of components to be included.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.

Question 20

The audit plan includes the nature, timing and extent of audit procedures to be performed by engagement team members. Explain. (RTP Nov '23)

OR

Engagement Partner CA Hitesh Kapur of Kapur and Associates wanted to develop an audit plan of

Sampurna Fabrics Ltd. Discuss the matters to be described in such an audit plan. (RTP May'22)

Answer 20

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

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

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

Example

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

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

Question 21

Documentation of audit plan serves as a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. What all activities in the planning phase should form part of auditor's documentation? State with examples. (- 4 Marks, July '21)

Answer 21

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks.

Example

The following things should form part of auditor's documentation:

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

Question 22

You have been appointed as an auditor of a health care service provider. Briefly discuss the special points that should be kept in mind as an auditor for developing an audit program. (- 4 Marks July 21) (Includes concepts of Audit of Different Type of Entities) (RTP May '19)

Answer 22

The special points to be kept in mind as an auditor for developing an audit program of healthcare service provider are:

1. **Register of Patients:** Auditors to vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see

that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

2. **Collection of Cash:** Auditor to check cash collections as entered in the Cash Book with the receipts counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.
3. **Income from Investments, Rent etc.** See 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.
4. **Legacies and Donations:** Ascertain that legacies and donation 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. **Authorization 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 authorized.
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 authorization.
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

Alternative Answer

Developing the Audit Programme:

- 1. Written Audit Programme:** The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan
- 2. Audit Objective and Instruction to Assistants:** The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.
- 3. Reliance on Internal Controls:** In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.
- 4. Timings of Performance of Audit Procedures:** The auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.
- 5. Audit Planning:** The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures

Chapter 3

Risk Assessment and Internal Control

Question 1

Examine with reasons (in short) whether the following statement is correct or incorrect: When we are designing audit procedures to address an inherent risk or “what can go wrong”, we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. (RTP Nov '20)

Answer 1

Correct: When we are designing audit procedures to address an inherent risk or “what can go wrong”, we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

Question 2

Examine with reasons (in short) whether the following statement is correct or incorrect: Misstatements in the financial statements can arise from fraud only.

Answer 2

Incorrect: Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

Question 3

Examine with reasons (in short) whether the following statement is correct or incorrect: The assessment of risks is a matter of professional judgement. (RTP 2 Marks)

Answer 3

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

Question 4

The auditor shall identify and assess the risks of material misstatement at both levels to provide a basis for designing and performing further audit procedures. For the purpose of Identifying and assessing the risks of material misstatement the auditor shall Identify risks, assess the identified risks, relate the identified risks and consider the likelihood of misstatement. Explain the above in detail.

OR

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

OR

Discuss the steps to be taken by the auditor for the purpose of Identifying and assessing the risks of material misstatement as per SA 315. (MTP 4 Marks Sep'22)

Answer 4

Identify and assess the risks of material misstatement

- I. The auditor shall **identify and assess** the risks of material misstatement at:
 - A. the financial statement level –
 - B. the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures
- II. For the purpose of Identifying and assessing the risks of material misstatement, the auditor shall:
 - a. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
 - b. Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
 - c. Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
 - d. Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Question 5

In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment.

Answer 5

Obtaining Knowledge of the Business: The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information among other things.

As per SA 315 – “Identifying and Assessing the Risk of Material Misstatement

Through Understanding the Entity and its Environment”, the auditor shall obtain an understanding of the following:

- a. Relevant industry, regulatory, and other external factors including the applicable financial reporting framework
- b. The nature of the entity, including:
 - i. its operations;
 - ii. its ownership and governance structures;
 - iii. the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - iv. the way that the entity is structured and how it is financed;

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

- c. The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.
- d. The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
- e. The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

Question 6

Examine with reasons (in short) whether the following statement is correct or incorrect: Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur. (March '23)

Answer 6

Incorrect: Assertions refer to representations by management that are embodied in the financial statements as used by the auditor to consider the different types of the potential misstatements that may occur.

Question 7

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. (RTP May 23)

Answer 7

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

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

Question 8

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the classes of transactions in the entity's operations that are significant to the financial statements, controls surrounding journal entries etc. Explain the other considerations in this regard. (RTP May '21)

Answer 8

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

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

Question 9

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

Misstatements in the financial statements can arise from either fraud or error.

Answer

Correct: Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. Hence misstatement can arise from error or fraud.

Alternative solution: Misstatement refers to a difference between the amount, classification, presentation, or disclosure of a reported financial statement item

and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Hence misstatement can arise from error or fraud.

Question 10

Explain what understanding should an auditor obtain regarding an entity's risk assessment process (one of the components of the internal control of the entity).

Answer 10

The Entity's Risk Assessment Process– Component of Control Environment

The auditor shall obtain an understanding of whether the entity has a process for:

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

The entity's risk assessment process forms the basis for the risks to be managed. If that process is appropriate, it would assist the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

Question 11

The auditor of MARUT Ltd, engaged in manufacturing of Smart Motor Bikes, 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 strength 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.

OR

The auditor of FAST CARS Ltd 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. (RTP Nov '19)

OR

Advise what is included in control environment. Also explain the elements of control environment. (RTP May '18)

Answer 10

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

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

What is included in Control Environment? The control environment includes:

- i. the governance and management functions and
- ii. the attitudes, awareness, and actions of those charged with governance and management.
- iii. The control environment sets the tone of an organization, influencing the control consciousness of its people.
- iv. **Elements of the Control Environment:** Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

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

2. 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

3. Participation by those charged with governance –Attributes of those charged with governance such as:

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

4. Management's philosophy and operating style – characteristics such as management's:

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

5. **Organizational structure** – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
6. **Assignment of authority and responsibility** - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.
7. **Human resource policies and practices** – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Question 11

What is tolerable misstatement and total rate of deviation?

Answer 11

Tolerable misstatement is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.

Total rate of deviation / Tolerable rate of deviation - A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Question 12

While obtaining audit evidence about the effective operation of internal controls, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognizes that some deviations may have occurred. Analyze and Explain.

OR

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. Analyse and Explain. (RTP Nov '19)

Answer 12

While obtaining audit evidence about the effective operation of internal controls, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of

transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed. In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures. It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorization, recording and documentation of transaction at each stage through which it flows.

Question 13

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as complex calculations. Also, risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as accounting principles for accounting estimates may be subject to differing interpretation etc. Explain in detail. (RTP Nov '21)

OR

Examine with reasons whether the following statements are correct or incorrect.

Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates. (Nov'20)

Answer 13

Risks of Material Misstatement– Greater for Significant Non-Routine Transactions
Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment.
- Greater manual intervention for data collection and processing.

- Complex calculations or accounting principles.
- The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

Risks of material misstatement– Greater for Significant Judgmental Matters

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

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

Question 14

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

Answer 14

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

Question 15

Briefly discuss the limitations of Internal Control. (May '23)

Answer 15

Limitations of Internal Control:

- Internal control can provide only reasonable assurance:** Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.
- 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.
- 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.
- Collusion among People:** Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. **For example**, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard

sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

- v. **Judgements by Management:** Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.
- vi. **Limitations in case of Small Entities:** Smaller entities often have fewer employees due to which segregation of duties is not practicable. However in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

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

Question 16

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.

Answer 16

Evaluating the Operating Effectiveness of Controls: When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective.

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:

- i. The tests of controls that have been performed provide an appropriate basis for reliance on the controls;
- ii. Additional tests of controls are necessary; or
- iii. The potential risks of misstatement need to be addressed using substantive procedures

A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

Question 17

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, size of the entity etc. Explain the other relevant considerations in the above context. (RTP May 21, RTP Nov'22)

Answer 17

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

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

Question 18

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

Answer 18

Identification of Significant Risks: SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment" defines 'significant risk' as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

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

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

- a) Whether the risk is a risk of fraud;
- b) Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
- c) The complexity of transactions;
- d) Whether the risk involves significant transactions with related parties;
- e) The degree of subjectivity in the measurement of financial information related

to the risk, especially those measurements involving a wide range of measurement uncertainty; and

- f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

Question 19

When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements. Explain.

Answer 19

Control risk assessment when control deficiencies are identified: When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements.

When control deficiencies are identified and auditor identifies and tests more than one control for each relevant assertion, he evaluates control risk considering all of the controls he has tested. If auditor determines that they support a 'rely on controls' risk assessment, or if compensating controls are identified, tested and evaluated to be effective, he may conclude that the 'rely on controls' is still appropriate. Otherwise we change our control risk assessment to 'not rely on controls.'

When a deficiency relates to an ineffective control that is the only control identified for an assertion, he revises risk assessment to 'not rely on controls' for associated assertions, as no other controls have been identified that mitigate the risk related to the assertion. If the deficiency relates to one WCGW (what can go wrong) out of several WCGW's, he can 'rely on controls' but performs additional substantive procedures to adequately address the risks related to the deficiency.

Question 20

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

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

Answer 20

Incorrect: Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. Control risk, on the other hand is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or

when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Question 21

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

The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven.

Answer 21

Correct: The fundamental principle of an automated environment is the ability to carry out business with less manual intervention and more system driven. The complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be more complex.

Question 22

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

Answer 22

The following are different ways testing is performed in an automated environment: There are basically four types of audit tests that should be used. They are inquiry, observation, inspection and reperformance. As shown in the illustration below, Inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.

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

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

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

- Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.

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

Question 23

In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. Explain stating uses of Data analytics. (MTP 4 Marks April 19)

OR

Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform Fraud investigation. Explain the other relevant points in the above context i.e. Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform.

OR

While auditing in an automated environment, how data analytics can be used in testing electronic records and data residing in IT systems using spread sheets and specialised audit tools? (- 3 Marks May '23)

OR

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.

OR

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

Answer 23

In today's digital age when companies rely on more and more on IT systems and networks to operate business, the amount of data and information that exists in these systems is enormous. A famous businessman recently said, "Data is the new Oil". The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called data analytics. While it is true that companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc., even auditors can make use of similar tools and techniques in the audit process and obtain good results. The tools and techniques that auditors use in applying the principles of data analytics are known as Computer Assisted Auditing Techniques or CAATs in short.

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

- check completeness of data and population that is used in either test of controls or substantive audit tests
- selection of audit samples – random sampling, systematic sampling
- re-computation of balances – reconstruction of trial balance from transaction data
- reperformance of mathematical calculations – depreciation, bank interest calculation.
- analysis of journal entries as required by SA 240
- fraud investigation
- evaluating impact of control deficiencies.

Question 24

Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls. Explain stating the points that an auditor should consider to obtain an understanding of the company's automated environment.

OR

List any five points that an auditor should consider to obtain an understanding of the Company's automated environment.

Answer 24

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

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

Question 25

With respect to audit in an automated environment, explain the following: (any four)

- i. CAATs
- ii. Data Analytics
- iii. Database
- iv. Information system
- v. Privileged access

OR

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

- i. CAATs
- ii. Data Analytics
- iii. Database
- Answer 25
- i. **CAATs:** Short form for Computer Assisted Audit Techniques, are a collection of computer based tools and techniques that are used in an audit for analysing data in electronic form to obtain audit evidence.
- ii. **Data Analytics:** A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information.
- iii. **Database:** A logical subsystem within a larger information system where electronic data is stored in a predefined form and retrieved for use.
- iv. **Information Systems:** Refers to a collection of electronic hardware, software, networks and processes that are used in a business to carry out operations and transactions.
- v. **Privileged access:** A type of super user access to information systems that enforces less or no limits on using that system.

Question 26

With respect to audit in an automated environment, explain the following: (any four)

- I. Data Processing
- II. ERP (Enterprise Resource Planning)
- III. General IT control
- IV. Automated
- V. Direct Data change (MTP 4 Marks March '21)

Answer 26

- I. **Data Processing:** Refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.

II. ERP (Enterprise Resource Planning):

A type of business application software that provides an integrated platform to automate multiple interrelated business processes and operations.

- III. **General IT Control:** Are a type of internal controls that help in mitigating risks that arise due to use of information technology and information systems in a business.
- IV. **Automated:** A task or activity that is routinely performed by a computer system and does not require manual effort.
- V. **Direct Data Change:** A backend modification that is made directly to data that is stored in a database bypassing business rules built-in to a business application software.

Question 26

With respect to audit in an automated environment, explain the following: (any four)

- I. **Applications**
- II. **Control Deficiency**
- III. **Data Processing**
- IV. **Enterprise Resource Planning**
- V. **Software**

Answer 26

- I. **Applications:** These are computer software programs that provide a medium for recording, storage and retrieval of business operations or transactions in electronic format.
- II. **Control Deficiency:** It Exists when an internal control is either missing or not operating effectively to prevent or detect misstatement in a timely manner by management.
- III. **Data Processing:** It Refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.
- IV. **Enterprise Resource Planning:** A type of business application software that provides an integrated platform to automate multiple interrelated business processes and operations.
- V. **Software:** A computer program or a collection of computer programs that provides an interface to a user for performing a specific activity, task, operation or transaction in electronic form through a computer or information system.

Question 27

When auditing in an automated environment, inquiry is often the most efficient and effective audit testing method.

Answer 27

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

Question 28

When a business operates in a more automated environment it is likely that we, as auditors, will see several business functions and activities happening within the systems. Explain which of the aspect you will consider relevant as an auditor. (RTP Nov '20 & Nov '18, - 3 Marks Dec'21)

OR

When a business operates in a more automated environment, we are likely to see several business functions and activities happening within the systems. List down the business functions and activities happening within the systems. (RTP Nov '23)

OR

When a business operates in a more automated environment, we are likely to see several business functions and activities happening within the systems. List down the business functions and activities happening within the systems.

Answer 29

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

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

Question 30

The auditor should consider relevance of IT in an audit of financial

statements. Explain giving reasons.

Answer 30

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

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

Question 31

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

Answer 31

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

Program Change

Objective: To ensure that modified systems continue to meet financial reporting objectives.

Activities:

- Change Management Process – definition, roles & responsibilities
- Change Requests – record, manage, track
- Making Changes – analyze, design, develop
- Test Changes – test plan, test cases, UAT
- Apply Changes in Production
- Emergency & Minor Changes
- Documentation – user/technical manuals
- User Training

Question 32

Examine with reasons (in short) whether the following statement is correct or incorrect: Application controls include manual controls only that operate at a business process level.

Answer 32

Incorrect. Application controls include both automated or manual controls that

operate at a business process level. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems.

Question 33

Describe how risks in IT systems, if not mitigated, could have an impact on audit.

OR

Analyse how risks in the IT system if not mitigated could have an impact on the audit.

Answer 33

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

- I. First, auditors may not be able to rely on the data obtained from systems where such risks exist. This means, all forms of data, information or reports that they obtain from systems for the purpose of audit has to be thoroughly tested and corroborated for completeness and accuracy.
- II. Second, auditors will not be able to rely on automated controls, calculations, accounting procedures that are built into the applications. Additional audit work may be required in this case.
- III. Third, due to the regulatory requirement of auditors to report on internal financial controls of a company, the audit report also may have to be modified in some instances.

Question 34

Magical Limited is a company dealing in mobile spare parts and having its showrooms in almost all the states in the country. For FY 2021-22, the company transferred its accounts from manual to computerized system (SAP). PJ & Co., Chartered Accountants have specialization in the system audit and have been appointed as the system auditor. PJ & Co., at the end of the audit concludes that there are certain findings or exceptions in IT environment and IT controls of the company which needs to be assessed and reported. Mention those points of consideration.

Answer 34

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

Some points to consider are as follows:

- Are there any weaknesses in IT controls?
- What is the impact of these weaknesses on overall audit?
- Report deficiencies to management – Internal Controls Memo or Management

Letter.

- Communicate in writing any significant deficiencies to Those Charged with Governance. The auditor needs to assess each finding or exception to determine impact on the audit and evaluate if the exception results in a deficiency in internal control.

Question 35

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

- (i) **Applications**
- (ii) **Automated**
- (iii) **CAATs**
- (iv) **Data Processing**
- (v) **General (IT) Controls]**

Answer 35

- i. **Applications:** These are computer software programs that provide a medium for recording, storage and retrieval of business operations or transactions in electronic format.
- ii. **Automated:** A task or activity that is routinely performed by a computer system and does not require manual effort.
- iii. **CAATs:** Short form for Computer Assisted Audit Techniques, are a collection of computer-based tools and techniques that are used in an audit for analysing data in electronic form to obtain audit evidence.
- iv. **Data Processing:** Refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.
- v. **General (IT) Controls:** Are a type of internal controls that help in mitigating risks that arise due to use of information technology and information systems in a business.

Question 36

Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. Explain with the help of examples. (RTP Nov'20)

OR

The risk assessment procedures shall include the Inquiries of management and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. Explain giving at least three examples.

Answer 36

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

Examples

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

Question 37

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

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, the auditor need not seek direct communication with the entity's external legal counsel. (RTP Nov '21)

Answer 37

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

Question 38

“A satisfactory control environment is not an absolute deterrent to fraud although it may help reduce the risk of fraud.” Explain. (RTP May '18)

OR

The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. Analyse and explain.

Answer 38

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

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

- b.** The auditor of XYZ Ltd, engaged in FMCG (Fast Moving Consumable Goods) obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:
- i. Management has created and maintained a culture of honesty and ethical behavior; and
 - ii. The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

Question 39

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

According to SA 315, the objective of the auditor is to identify and assess the risk of material misstatement, whether due to fraud or error, only at assertion level. (RTP May '23)

Answer 39

Incorrect: According to SA 315, the objective of the auditor is to identify and assess the risk of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control.

Question 40

Obtaining an understanding of the entity and its environment establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit. Explain by giving examples. (RTP Nov '23 & May 20)

Answer 40

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. This understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the financial statements;
- Determining materiality in accordance with SA 320;
- Considering the appropriateness of the selection and application of accounting policies;
- Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

Question 41

Risk of material misstatement refers to the risk that the financial statements are materially misstated prior to audit. Discuss the levels at which this risk exists. (RTP Nov '23 & Nov 20)

Answer 41

The risks of material misstatement may exist at two levels:

- (i) The overall financial statement level - Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.
- (ii) The assertion level for classes of transactions, account balances, and disclosures - Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

Question 42

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

Answer 42

SA 320 “Materiality in Planning and Performing an Audit” prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- i. The **elements of the financial statements** (for example, assets, liabilities, equity, revenue, expenses);
- ii. 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);
- iii. 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.
- iv. 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
- v. The **relative volatility** of the bench.

Question 43

The extent and the nature of the audit programme is substantially influenced by the internal control system in operation. Analyse and explain. (RTP Nov '19)

OR

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. Analyse and explain. (RTP Nov 18)

Answer 43

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers. It is also important for him to know whether the system is actually in operation. Often, after installation of a system, no proper follow up is there by the management to ensure compliance. The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or

may at best operate only partially. This state of affairs is probably the worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.

It would be better if the auditor can undertake the review of the internal control system of client. This will give him enough time to assimilate the controls and implications and will enable him to be more objective in the framing of the audit programmer. He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed.

From the foregoing, it can be concluded that the extent and the nature of the audit programmer is substantially influenced by the internal control system in operation. In deciding upon a plan of test checking, the existence and operation of internal control system is of great significance.

A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programmer.

In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction.

Question 44

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

OR

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

OR

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

Answer 44

Objectives of Internal Control

Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs

that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

Objectives of Internal Control are:

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

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

An understanding of internal control assists the auditor in:

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

Question 45

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

Answer 45

It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorization, recording and documentation of transaction at each stage through which it flows.

For example, the procedure for sales requires the following:

1. Before acceptance of any order the position of inventory of the relevant article should be known to ascertain whether the order can be executed in time.
2. An advice under the authorisation of the sales manager should be sent to the party placing the order, internal reference number, and the acceptance of the order. This advice should be prepared on a standardized form and copy

thereof should be forwarded to inventory section to enable it to prepare for the execution of the order in time.

3. The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.
4. The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.
5. Before deciding upon the credit period, a reference should be made to the credit section to know the creditworthiness of the party and particularly whether the party has honored its commitments in the past.

Question 46

Generally, IT benefits an entity's internal control by enabling an entity to enhance the timeliness, availability, and accuracy of information. Discuss explaining the other relevant points in the above context. (RTP May '22)

Answer 46

Generally, IT benefits an entity's internal control by enabling an entity to:

- (i) Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- (ii) Enhance the timeliness, availability, and accuracy of information;
- (iii) Facilitate the additional analysis of information;
- (iv) Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- (v) Reduce the risk that controls will be circumvented; and
- (vi) Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

Question 47

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware. Explain (RTP Nov '23)

OR

Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Explain in detail. (RTP Nov'20)

OR

Discuss how "analytical procedures" performed as "risk assessment procedures"

can be useful to an auditor. Answer 47

Analytical procedures performed as risk assessment procedures may identify

aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

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

However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Question 48

Explain some of the commonly used methods for testing in an automated environment. (RTP May '20)

Answer 48

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

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

Question 49

With the increasing adoption of information technology, business today relies on software systems and applications more than ever. Many of these IT systems generate and process data that is used in the preparation of financial statements of a company. The auditors also often rely on the data and reports that are generated from these systems. Explain stating clearly the meaning of Automated environment with example. (RTP Nov'20)

Answer 49

With the increasing adoption of information technology, business today relies on software systems and applications more than ever. Many of these IT systems

generate and process data that is used in the preparation of financial statements of a company. The auditors also often rely on the data and reports that are generated from these systems. In this context, it is critical to understand the IT specific risks that could potentially impact the integrity and reliability of financial transactions and data flowing through a company's systems.

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

Example

Think about how banking transactions are carried out using ATMs (Automated Teller Machines), or how tickets can be purchased using “apps” on mobile phones, etc. In these examples, you can see how these computer systems enable us to transact business at any time and any day.

Question 50

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

Answer 50

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

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

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

These are IT controls generally implemented to mitigate the IT specific risks and applied commonly across multiple IT systems, applications and business processes. Hence, General IT controls are known as “pervasive” controls or “indirect” controls. Let us now learn about each of the General IT controls in more detail.

Data Center and Network Operations

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

Activities:

1. Overall Management of Computer Operations Activities
2. Batch jobs – preparing, scheduling and executing
3. Backups – monitoring, storage & retention
4. Performance Monitoring – operating system, database and networks
5. Recovery from Failures – BCP, DRP
6. Help Desk Functions – recording, monitoring & tracking
7. Service Level Agreements – monitoring & compliance
8. Documentation – operations manuals, service reports.

Question 51

Explain the meaning of Internal Financial Controls clearly stating reporting requirement (with reference to audit) on adequacy of internal financial controls. Also discuss about its (reporting requirement on adequacy of internal financial controls) applicability on various types of Companies. (RTP May '22)

Answer 51

Explanation given in Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as, “the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company’s policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.”

From the above definition, it is clear that **internal financial controls are** the policies and procedures adopted by the company for:

1. ensuring the orderly and efficient conduct of its business, including adherence to company’s policies,
2. the safeguarding of its assets,
3. the prevention and detection of frauds and errors
4. the accuracy and completeness of the accounting records, and
5. the timely preparation of reliable financial information.”

Section 143(3)(i) of the Act requires an auditor to report whether the company has adequate internal financial controls **with reference to financial statements** in place and the operating effectiveness of such controls.

However, it may be noted that the reporting requirement on adequacy of internal financial controls

(IFCs) with reference to financial statements shall **not** be applicable to a private company which is a–

- (i) One person company; or
- (ii) Small company; or
- (iii) Company having turnover less than ` 50 crore as per latest audited financial

statement and having aggregate borrowings from banks or financial institutions

or anybody corporate at any point of time during the financial year less than ` 25 crore.

Question 52

List the points that an auditor should consider to obtain an understanding of the Company's automated environment. (RTP Nov'22)

Answer 52

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

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

Question 53

Which are specific risks to the company's internal control having IT environment? (RTP Nov'22)

Answer 53

IT poses specific risks to the Company's internal control, which include-

- (i) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- (ii) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or nonexistent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- (iii) The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- (iv) Unauthorised changes to data in master files.
- (v) Unauthorised changes to systems or programs.

- (vi) Failure to make necessary changes to systems or programs. Inappropriate manual intervention.
- (vii) Potential loss of data or inability to access data as required.

Question 54

The auditor's responsibility includes reporting on Internal Financial Controls over Financial Reporting which includes an understanding IT environment of the company and relevant risks and controls. Mention the situations where IT will be relevant to an audit. (RTP May '23)

OR

Discuss the situations in which IT will be relevant to an audit.

OR

The auditor's responsibility includes reporting on Internal Financial Controls over Financial Reporting which includes an understanding IT environment of the company and relevant risks and controls. Mention any three situations where IT will be relevant to an audit.

Answer 54

With the introduction of the Companies Act 2013, there is greater emphasis given to internal financial controls (IFC) from a regulatory point of view. Directors and those charged with governance (including Board of directors, Audit committee) are responsible for the implementation of internal controls framework within the company. The auditors' responsibilities now include reporting on Internal Financial Controls over Financial Reporting which include and understanding IT environment of the company and relevant risks & controls.

Following are some situations in which IT will be relevant to an audit:

- (i) Increased use of Systems and Application software in Business (for example, use of ERPs)
- (ii) Complexity of transactions has increased (multiple systems, network of systems)
- (iii) Hi-tech nature of business (Telecom, e-Commerce).
- (iv) Volume of transactions are high (Insurance, Banking, Railways ticketing).
- (v) Company Policy (Compliance).
- (vi) Regulatory requirements - Companies Act 2013 IFC, IT Act 2008.
- (vii) Required by Indian and International Standards - ISO, PCI-DSS, SA 315, SOC, ISAE.
- (viii) Increases efficiency and effectiveness of audit.

Question 54

Examine with reasons whether the following statements are correct or incorrect.

For an auditor, the Risk assessment procedure provides sufficient appropriate

audit evidence to base the audit opinion.

Answer 54

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

Question 55

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

Answer 55

Difference between internal financial control and internal control over financial reporting

Internal Financial Control as per Section 134(5)(e), "the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information."

On the other hand, Internal controls over financial reporting-is required where auditors are required to express an opinion on the effectiveness of an entity's **internal controls over financial reporting**, such opinion is in addition to and distinct from the opinion expressed by the auditor on the financial statements.

Question 56

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

Answer 56

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

Question 57

When the company is working in an automated environment, it is not necessary for its auditor to understand its automated environment and depends upon the professional judgement of the auditor as to whether gaining knowledge of company's IT systems is required or not. Do you agree with this statement?

Answer 57

Understanding and Documenting Automated Environment: When a business operates

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

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

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

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

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

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

Alternative Solution

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

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

- (i) Information systems being used (one or more application systems and what they are).
- (ii) Their purpose (financial and non-financial).
- (iii) Location of IT systems - local vs global.
- (iv) Architecture (desktop based, client-server, web application, cloud based).

- (v) Version (functions and risks could vary in different versions of same application).
- (vi) Interfaces within systems (in case multiple systems exist).
- (vii) In-house vs Packaged.
- (viii) Outsourced activities (IT maintenance and support).
- (ix) Key persons (CIO, CISO, Administrators).

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

Question 58

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

Answer 58

Access Security in Automated Environment:

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

Activities:

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

SA 500- Audit Evidence

Question 1

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

Answer 1

Correct: Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

Question 2

State with reason (in short) whether the following statements are true or false Inquiry alone provides sufficient audit evidence of the absence of a material misstatement at the assertion level and of the operating effectiveness of controls.

Answer 2

Incorrect: Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

Question 3

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

Answer 3

Certificate from a Management's Expert: In the given case, SMP Limited has provided a sum of 20 lakh in the books of accounts as gratuity payable on the basis of certificate obtained from an actuary. The liability towards gratuity payable to the employees at the time of cessation of service should be ascertained and provided for in the accounts when the employees are in service, it is an ascertained present liability accruing over the period of service but payable upon cessation of service. The auditor should check the quantification of the gratuity liability. He should

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

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

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

Question 4

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

Answer 4

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

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

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

Question 5

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

OR

The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. Analyse and Explain stating clearly the factors affecting the auditor's judgement as to sufficiency of audit evidence.

OR

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

Answer 5

Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

Following are the factors affecting the auditor's judgement as to the sufficiency of audit evidence:

- (i) **Materiality:** It may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand, if assertions are more material to the users of the financial statements, more evidence would be required.
- (ii) **Risk of material misstatement:** It may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level:
 - Inherent risk—The susceptibility of an assertion to a misstatement

that could be material before consideration of any related controls.

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

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

Question 6

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

While auditing the books of accounts of XYZ Ltd., the auditor of the company was involved in examining records and documents in paper form, electronic form etc. and was also conducting physical examination of assets. In the present case, audit procedure used by the auditor is known as "Observation".

Answer 6

Incorrect: The audit procedure used by the auditor of XYZ Ltd. is known as "Inspection" Whereas Observation consists of looking at a process or procedure being performed by others.

Question 7

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

Answer 7.

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

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

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

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

Explaining this further, audit evidence includes:-

- 1) Information contained in the accounting records: Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
- 2) Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements: Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

Question 8

Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and Analyse and explain with the help of example of evidence in respect of Sales. (RTP May '20)

Answer 8

Evidence is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and experience. This is the primary task before the auditor when he draws up the audit programme. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.

Example Sales are evidenced by:

- (i) invoices raised by the client;
- (ii) price list;
- (iii) forwarding notes to client;
- (iv) inventory-issue records;
- (v) sales managers' advice to the inventory section;
- (vi) acknowledgements of the receipt of goods by the customers; and collection of money against sales by the client. explain with the help of example of

evidence in respect of Sales.

Question 9

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

OR

Evaluating responses to inquiries is an integral part of the inquiry process. Explain.

Answer 9

Inquiry: As per SA 500 Audit Evidence: -

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

Question 10

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

Nov'22)

Answer 10 If:

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

Question 11

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

While auditing the books of accounts of XYZ Ltd., the auditor of the company looked at the inventory counting process to obtain audit evidence. In the present case, audit procedure used by the auditor is known as "Inspection".

Answer 10

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

Question 11

T Ltd has used the services of an expert for the purpose of physical verification of its inventory which is appearing in the financial statements of the company at ` 75 Crores. Discuss the broad parameters auditor would take into consideration while deciding about using the work performed by the Management's Expert in physical verification of company's inventory. (RTP Nov '23)

Answer 11

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

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

Question 12

SA 500 – "Audit Evidence", explains what constitutes audit evidence in an audit of financial statements. A combination of tests of accounting records and other information is generally used by the auditor to support his

opinion on the financial statements. Explain and discuss the meaning of Audit Evidence in detail. (RTP Nov '23)

OR

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

Answer 12

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

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

Explaining this further, audit evidence includes:

- (1) Information contained in the accounting records: Accounting records include
 - the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers;
 - invoices;
 - contracts;
 - the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and
 - records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
- (2) Other information that authenticates the accounting records and also supports the auditor’s rationale behind the true and fair presentation of the financial statements: Other information which the auditor may use as audit evidence includes, for example
 - minutes of the meetings,
 - written confirmations from trade receivables and trade payables
 - manuals containing details of internal control etc.

A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

Question 13

SPR Ltd has been into the media business since 1990. During the F.Y 2021-2022 many notices were received by the company for hurting public sentiments and financial claims were filed against the company. As an

auditor of the company, you requested the management for arranging the meeting with company's external legal counsel. Management is of the view that such meetings are necessary in some certain circumstances only. Can you list down those certain circumstances?

Answer 13

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

In certain circumstances, the auditor also may judge it necessary to meet with the entity's

external legal counsel to discuss the likely outcome of the litigation or claims.

This may be the case, for example, where:

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

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

Question 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?

Answer 14

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

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

SA 610- Using the Work of Internal Auditors

Question 1

Explain whether the following statements are correct or incorrect, with reasons/ explanations/ examples The objectives and scope of internal audit functions are restricted to activities relating to evaluation of internal control only.

Answer 1

Incorrect: As per SA-610, "Using the Work of an Internal Auditor", the objectives of internal audit functions vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control.

From the above, it can be concluded that the objective and scope of internal audit function are not restricted to activities relating to evaluation of control only.

Audit Sampling

Question 1

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

According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to 100% of items within a population of audit relevance.

Answer 1

Incorrect: According to SA 530 "Audit sampling", 'audit sampling' refers to the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

Question 2

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

Stratified Sampling involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them.

Answer 2

Correct: Stratified Sampling involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them.

Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

Question 3

Discuss the following:

The sample size can be determined by the application of a statistically -based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.

Explain Stating the examples of factors that the auditor may consider when determining the sample size for tests of controls.

OR

The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be. Explain Stating the examples of factors that the auditor may consider when determining the sample size for tests of controls.

Answer 3

The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen.

Examples of Factors Influencing Sample Size for Tests of Controls: The following are factors that the auditor may consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the auditor does not modify the nature or timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

- When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls. Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased). Thus, sample size will increase.
- If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be.
- When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as higher the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.
- An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger

the sample size needs to be.

- In case of large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling may not be as efficient as alternative means of obtaining sufficient appropriate audit evidence. Therefore, there will be negligible effect on sample size due to increase in the number of sampling units in the population.

Question 4

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

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.

OR

“Sampling risk can lead to erroneous conclusions”. Justify. (RTP May’22)

OR

Sampling risk is the risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk leads to erroneous conclusions. Explain in detail distinguishing it from non-sampling risk with examples.

OR

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

Answer 4

Risk Factors while applying Sampling Techniques: As per SA 530 “Audit Sampling” **Sampling Risk.** The risk that the auditor’s conclusion based on a sample may be different from the

conclusion if the entire population were subjected to the same audit procedure.

Sampling risk can lead to two types of erroneous conclusions:

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

Non-Sampling Risk. The risk that the auditor reaches an erroneous conclusion for

any reason not related to sampling risk.

Example

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

Sources of Non-Sampling risk are

- (i) Human Mistake
- (ii) Applying audit procedures not appropriate to the objectives of audit.
- (iii) Relying on erroneous information e.g. erroneous confirmation
- (iv) Misinterpreting the sample results
- (v) Non sampling risk can never be mathematically measured

Question 5

Audit testing done through Statistical sampling is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Explain and also state advantages of Statistical sampling. (MTP 4 Marks Oct 20)

OR

What are the advantages of statistical sampling techniques in Auditing?

Answer 5

- (1) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- (2) The sample selection is more objective and thereby more defensible.
- (3) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
- (4) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) *i.e.* the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
- (5) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.
- (6) It is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

Question 6

State the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

Answer 6

Audit Sampling: As per SA 530 on "Audit Sampling", the meaning of the term Audit Sampling is – the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

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

Sample design - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

Sample Size- The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Selection of Items for Testing- The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

Question 7

CA X is not sure about the kind of Sampling method to be used for audit of a company.

Advise him about the choice of methods (name of methods only) of Sampling to be used in various circumstances. Also explain briefly the advantages of the Sampling to be used by him in auditing.

Answer 7

Sample Selection:

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

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

Advantages of Statistical Sampling in Auditing:

- (i) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
- (ii) The sample selection is more objective and thereby more defensible.
- (iii) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
- (iv) It provides a means for deriving a "calculated risk" and corresponding precision (sampling error i.e. the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.

- (v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

Question 8

The level of sampling risk that the auditor is willing to accept will not affect the sample size. (RTP Nov '22)

Answer 8

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

Question 9

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

Systematic sampling means dividing heterogeneous population into homogeneous sub population, where samples are drawn from each sub population.

Answer 9

Incorrect: Stratification means dividing heterogeneous population into homogeneous sub population, where samples are drawn from each sub population. Systematic sampling is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

Question 10

There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. Explain.

Answer 10

No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished and auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of

checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non-consequential routine checking. By routine checking we traditionally think of extensive checking and vouching of all entries.

Question 11

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

Statistical sampling being more scientific and without personal bias will always be appropriate to use under all circumstances.

Answer 11

Incorrect: Statistical sampling is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort. For instance, when exact accuracy is required or in case of legal requirements etc.

Question 12

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

Answer 12

- (i) The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded.
- (ii) When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.
- (iii) For tests of details, the auditor shall project misstatements found in the sample to the population whereas for tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

Question 13

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

population of entries. Explain in detail. (RTP May '21)

Answer 13

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

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

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the client's organization because they provide the reliability of the records. Sampling is used as a part of Test of controls. Auditor will check few internal controls and their operating effectiveness. Based on the conclusion derived, he can then design the sample size for test of details (i.e. checking of transactions and balances).

If the internal control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains.

Question 14

Chintamani Ltd appoints Chintan & Mani as statutory auditors for the financial year 2022- 2023. Chintan & Mani seem to have different opinion on audit approach to be adopted for audit of Chintamani Ltd. Mani is of the opinion that 100% checking is not required and they can rely on Audit Sampling techniques in order to provide them a reasonable basis on which they can draw conclusions about the entire population.

Chintan is concerned whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

You are required to guide Chintan about his role if audit sampling has not provided a reasonable basis for conclusions about the population that has been tested in accordance with SA 530. (RTP Nov '23)

Answer 14

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

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

If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

- (i) Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or
- (ii) Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Question 15

What are the matters that the auditor shall consider while designing an audit sample?

Answer 15

Matters to be considered while designing an Audit Sample:

As per SA 530, "Audit Sampling",

- (i) When designing an audit sample, the auditor shall consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn.
- (ii) When designing an audit sample, the auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.
- (iii) When designing an audit sample, the auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.
- (iv) When designing an audit sample, the auditor shall determine that sample selected must be representative of the population.
- (v) When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose.
- (vi) When designing an audit sample, Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling.
- (vii) In fulfilling the requirement of SA 500 "Audit Evidence", when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

SA 501- Audit Evidence-Specific Considerations for Selected Items

Question 1

Krishna Cycles Ltd is engaged in manufacturing of different type of Bicycles. Ongoing through its financial statements for the past years, it is observed that inventory is material to the financial statements. You as an auditor of the company wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss, how would you proceed as an auditor.

OR

ABC Ltd is engaged in manufacturing of different type of yarns. Ongoing through its financial statements for the past years, it is observed that inventory is material to the financial statements. You as an auditor of the company wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss, how would you proceed as an auditor.

Answer 1

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

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

Question 2

While conducting audit of Vee Ltd, CA Aman, auditor of the company, found that some goods are lying with third party for a long period. Advise Aman how will he verify them.

Answer 2

Goods Lying with Third Party: The auditor should check that the materiality of the item under this caption included in inventories.

- (i) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.
- (ii) He should inquire into the necessity of sub contractor retaining the

inventory. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.

- (iii) The goods lying with them for the very long period would merit auditors' special attention for making provision.
- (iv) The records, voucher/slips for the regulating the movement of inventory into and out of entity for sub-contracting work be reviewed by vouching for few transaction for ensuring existence and working of internal control system for them.
- (v) The excise gate pass, entry in such records, information in returns, be also cross-verified.
- (vi) The valuation of inventories should be correctly made for including material cost on appropriate inventory valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.
- (vii) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.
- (viii) Evaluate condition of goods and see whether adequate provision has been made.
- (ix) Check whether subsequently the goods lying with third party were sold or received back after the expiry of stipulated time period.
- (x) Ensure that the goods have been included in the closing inventory though lying with third party.

Question 3

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

Answer 3

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

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

Question 4

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

incorrect:

When inventory under the custody and control of a third party is material to the financial statements, the auditor cannot obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by taking written representation from management.

Answer 4

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

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

Question 5

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

Answer 5

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

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

Question 6

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

Answer 6

The auditors, GPS & Co wanted to ensure and obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by obtaining an understanding of the methods used by management in determining segment information. SA 501 guides in this regard. As per SA 501- "Audit Evidence—Specific Considerations for Selected Items", example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

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

Question 7

Pachranga International Ltd is manufacturer of pickles, ginger garlic paste, jams etc having its plant at Jaipur. Being in food industry, the company is facing many litigations in various courts across India. Auditors SPV & Co. wants to identify such litigations and claims involving the company which may give rise to risk of material misstatement. Guide the auditor as to how they should proceed for the purpose. (RTP May '22)

Answer 7

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. Further if:

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

SA 505- External Confirmations

Question 1

External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements but need not be restricted to these items. Apart from confirmations for bank balances and accounts receivables, what are the other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement? (RTP Nov'22)

Answer 1

Other examples of situations where external confirmations may be used include the following:

- Inventories held by third parties at bonded warehouses for processing or on consignment
- Property title deeds held by lawyers or financiers for safe custody or as security
- Investments held for safekeeping by third parties, or purchases from stockbrokers but not delivered at the balance sheet date
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms
- Long outstanding share application money.

Question 2

Define the following:

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

Answer 2

Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

Non-response – A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.

Exception – A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by

the confirming party.

Question 3

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.

Answer 3

Negative confirmations are a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative information provides less persuasive audit evidence than positive confirmations. Accordingly, CA Rohit, Auditor of Grace Ltd, shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

- a) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
- b) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
- c) A very low exception rate is expected; and
- d) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

Question 4

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, 2023 for which external confirmations are not available, CA P wants to send external confirmation request to selected Trade payables but management of MN Ltd. refused for the same. Discuss how CA P should deal in this regard as per relevant Standard on Auditing.

Answer 4

If management refuses to allow the auditor to send a confirmation request, CA P should deal in this regard in the manner prescribed in SA 505 explained hereunder:

- (a) Inquire as to management’s reasons for the refusal and seek audit evidence as to their validity and reasonableness;
- (b) Evaluate the implications of management’s refusal on the auditor’s assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit

procedures; and

- (c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

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

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

SA 510- Initial Audit Engagements – Opening Balances

Question 1

What is the objective of the auditor with respect to the opening balances when conducting an initial audit engagement as per the relevant SA?

OR

M/s PQR and associates are the statutory auditors of TUV Ltd. for the FY 2020- 21-. They have been appointed as statutory auditors of TUV Ltd. for the first time. What is the objective of the engagement partner in terms of SA 510?

Answer 1

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

- a) Opening balances contain misstatements that materially affect the current period's financial statements; and
- b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Question 2

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

An auditor is not concerned with consistency of accounting policies relating to opening balances

Answer 2

Incorrect: In conducting an initial audit engagement, one of the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and

disclosed in accordance with the applicable financial reporting framework.

Question 3

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?

OR

The newly appointed auditor of BTN Limited wants to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. What audit procedures should he perform for this purpose

Answer 3

Initial audit engagement is an engagement in which either

- (i) The financial statements for the prior period were not audited; or
- (ii) The financial statements for the prior period were audited by a predecessor auditor.

From the above, it is quite clear that CA Pankaj is not correct in his approach and therefore would be required to follow the initial audit engagement and also apply audit procedures regarding opening balances.

Audit Procedures regarding Opening Balances; The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures. The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

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

SA 550- Related Parties

Question 1

The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances.

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the records or documents that may provide information about related party relationships and transactions. Explain in detail with examples.

Answer 1

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. He may inspect the following records or documents that may provide information about related party relationships and transactions, **for example:**

1. Entity income tax returns.
2. Information supplied by the entity to regulatory authorities.
3. Shareholder registers to identify the entity's principal shareholders.
4. Statements of conflicts of interest from management and those charged with governance.
5. Records of the entity's investments and those of its pension plans.
6. Contracts and agreements with key management or those charged with governance.
7. Significant contracts and agreements not in the entity's ordinary course of business.
8. Specific invoices and correspondence from the entity's professional advisors.
9. Life insurance policies acquired by the entity.
10. Significant contracts re-negotiated by the entity during the period.
11. Internal auditors' reports.
12. Documents associated with the entity's filings with a securities regulator e.g., prospectuses)

Question 2

State with reasons whether the following statements are correct or incorrect.

**In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater.
(July'21)**

Answer 2

Correct: In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for

such reasons as the following:

- Management may be unaware of the existence of all related party relationships.
- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

Question 3

P Ltd. is a company from a business group “ABCD” and is engaged in trading of garments. The promoters of the company are promoters and directors of some other group companies also. You have been appointed as an auditor of P Ltd. P Ltd has entered into various intercompany transactions (within group companies) during the year which are outside its normal course of business. What will be your duties as an auditor in relation to those transactions?

Answer 3

Duties of Auditor in identifying Significant Related Party Transactions: For identified significant related party transactions outside the P Ltd.’s normal course of business, the auditor shall:

- I. 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
- II. Obtain audit evidence that the transactions have been appropriately authorised and approved.

Analytical Procedures

Question 1

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, explain the factors that are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures.

Answer 1

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- (i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;
- (ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products;
- (iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing Substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 (Revised) establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

Question 2

CA Amar wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2020-21. The rent amounts to Rs.50,000/- per month for the year. The monthly rent payments are consistent with the

rent agreement. However, the other companies in the similar industry are paying rent of Rs. 10,000/- per month for a similar location. How will applying the analytical procedures impact the verification process of such rental payments by XYZ Ltd

Answer 2

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

However, if CA Amar does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.

Question 3

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

OR

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk. Explain. (RTP Nov'20)

Answer 3

Analytical Procedures are required in the planning phase and it is often done during the testing phase. In addition these are also required during the completion phase.

Analytical Procedures in Planning the Audit

In the planning stage, analytical procedures assist the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he was previously unaware. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures. Analytical procedures in planning the audit use both financial data and non-financial information, such as number of employees, square feet of selling space, volume of goods produced and similar information.

For example, analytical procedures may help the auditor during the planning stage to determine the nature, timing and extent of audit procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.

Question 4

While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence?

OR

The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Explain clearly stating the techniques available as substantive analytical procedures.

OR

Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Explain stating the techniques available as substantive analytical procedures.

The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. In this context, discuss the techniques available as Substantive Analytical Procedures. (RTP May '21)

OR

Ratio analysis is useful for analyzing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Explain stating the techniques available as substantive analytical procedure

OR

Explain techniques available as substantive analytical procedures.

Answer 4

While applying the Substantive Analytical Procedures the statutory auditor of a company may use the following techniques to obtain sufficient and appropriate audit evidence

Trend analysis – Trend analysis is a commonly used technique. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

Ratio analysis – Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.

Reasonableness tests – Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts. In other words these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.

Examples include:

- **Interest expense against interest bearing obligations.**
- **Raw Material Consumption to Production (quantity)**
- **Wastage & Scrap % against production & raw material consumption (quantity)**
- **Work-in-Progress based on issued of materials & Sales (quantity)**
- **Sales discounts and commissions against sales volume**
- **Rental revenues based on occupancy of premises. (Examples included in May 21)**

Structural modelling – A modelling tool constructs a statistical model from financial and/or non- financial data of prior accounting periods to predict current account balances (e.g., linear regression).

The statutory auditor may use any of the above mentioned techniques while applying substantive analytical procedures depending upon the availability of data and requirements of the case.

Question 5

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, how would the auditor investigate such differences.

Answer 5

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- (i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.
- (ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation,

together with the audit evidence obtained relevant to management's response, is not considered adequate.

Question 6

The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment. Explain. (RTP Nov'20)

Answer 6

The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures, is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level.

The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and the results of any such analytical procedures performed by the entity. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

Question 7

For the purposes of the SAs, the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Explain giving examples of both. (RTP Nov'21)

Answer 7

Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entity is of comparable size in the same industry.

Analytical procedures also include consideration of relationships, for example:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Question 8

Analysis by computation of ratios includes the study of relationships between financial statement amounts. State Commonly used ratios (RTP Nov '21)

Answer 8

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

- Elements of income or loss as a percentage of sales
- Gross profit turnover
- Accounts receivable turnover
- Inventory turnover
- Profitability, leverage, and liquidity

Question 9

Discuss the matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated. (RTP May '22)

Answer 9

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

(i) The accuracy with which the expected results of substantive analytical procedures can be predicted

For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

(ii) The degree to which information can be disaggregated.

For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

(iii) The availability of the information, both financial and non-financial.

For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

Question 10

Explain the aspects to be considered by an auditor when designing and performing substantive analytical procedures, either alone or in

combination with test of details, as substantive procedures in accordance with SA 330. (RTP Nov'22)

Answer 10

Analytical procedures used as substantive tests: When designing and performing substantive analytical procedures, either alone or in combination with test of details as, substantive procedures in accordance with SA 330, the auditor shall:

- (i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and test of details, if any, for these assertions.
- (ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation.
- (iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation

Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.

Question 11

Discuss with examples the factors that are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures. (RTP Nov'22)

OR

CA A, auditor of ABC Ltd. wants to design substantive analytical procedure and for that he wants to check whether the data is reliable or not. Mention the relevant points which he has to consider whether data is reliable for purpose of designing the substantive analytical procedures.

OR

What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures".

Answer 11

The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

- (i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity.
- (ii) Comparability of the information available. For example, broad industry

data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

- (iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- (iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls.

For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances,

the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing. SA 500 establishes requirements and provides guidance in determining the audit procedures to be performed on the information to be used for substantive analytical procedures.

Question 12

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

Sample size is not a valid criterion to distinguish between statistical and non-statistical approaches. (RTP Nov '23)

Answer 12

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

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

Question 13

When designing and performing substantive analytical procedures, either alone or in combination with tests of details as substantive procedures in accordance with SA 330, the auditor shall determine the suitability of particular substantive analytical procedures for given assertions, taking

account of the assessed risks of material misstatement and tests of details, if any, for these assertions. Discuss. (RTP Nov '23)

Answer 13

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

- The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary.
- However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
- In some cases, even an unsophisticated predictive model may be effective as an analytical procedure.

Different types of analytical procedures provide different levels of assurance. Analytical procedures involving, for example, the prediction of total rental income on a building divided into apartments, taking the rental rates, the number of apartments and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified. In contrast, calculation and comparison of gross margin percentages as a means of confirming a revenue figure may provide less persuasive evidence, but may provide useful corroboration if used in combination with other audit procedures.

The determination of the suitability of particular substantive analytical procedure is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement. For example, if controls over sales order processing are weak, the auditor may place more reliance on tests of details rather than on substantive analytical procedures for assertions related to receivables.

Particular substantive analytical procedures may also be considered suitable when tests of details are performed on the same assertion. For example, when obtaining audit evidence regarding the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables.

Question 14

State with reasons whether the following statements are correct or incorrect

SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit, that assist the auditor in preparation of the financial

statements. .

Answer 14

Incorrect: SA 520 deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements.

Question 15

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

Answer 15

Examples of Analytical Procedure having consideration of relationship:

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

- (i) Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- (ii) Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Chapter 5

Audit of Items of Financial Statements

Question 1

Verification of liabilities is as important as that of assets, considering if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the entity. Explain stating also criteria for a liability to be classified as current liability.

Answer 1

Liabilities in addition to borrowings (discussed above), include trade payables and other current liabilities, deferred payment credits and provisions. Verification of liabilities is as important as that of assets, considering if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the entity.

Further, a liability is classified as current if it satisfies any of the following criteria:

- It is expected to be settled in the entity's normal operating cycle
- It is held primarily for the purpose of being traded
- It is due to be settled within twelve months after the reporting period
- The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could, at the option of the counterparty,

Question 2

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

- I. Loans and Advances and other current assets.
- II. Finished goods and goods for resale.

Answer 2

I. Audit procedure for valuation of Loans and Advances and other current assets

- Assess the allowance for doubtful accounts. Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.
- Obtain the ageing report of loans and advances, split between not currently due, 30 days old, 30-60 days old, 60-180 days old, 180-365 days old and more than 365 days old. Also, obtain the list of loans and advances under litigation and compare with previous year.

- Scrutinize the analysis and identify those loans and advances that appear doubtful; Discuss with management their reasons, if any of these loans/ advances are not included in the provision for bad recoverable; Perform further testing where any disputes exist; Reach a final conclusion regarding the adequacy of the bad and doubtful loans/ advances provision.
- Assess bad loans/ advances write-offs. Prepare schedule of movements on Bad loans/ advances – Provision Accounts and loans/ advances written off.
- Check that write-offs or other reductions in the recoverable balances have been approved by an appropriate and authorised member of senior management, for example the financial controller or finance director.
- Check that the restatement of foreign currency loans and advances/ other current assets has been done properly.

III. Audit procedure for valuation of finished goods and goods for resale

- Enquire into what costs are included, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the draft financial statements.
- Ensure that inventories are valued at net realizable value if they are likely to fetch a value lower than their cost. For any such items, also verify if the relevant semi/ partly processed inventories (work in progress) and raw materials have also been written down.
- Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. For the purpose, request the client to provide inventory ageing split between less than 30 days, 30-60 days old, 60-90 days old, 90-180 days old, 180-385 days old and more than 365 days old (refer screenshot below).
- Follow up any inventories which at time of observance of physical counting were noted as being damaged or obsolete.
- Compare recorded costs with replacement costs. Examine vendor price lists to determine if recorded cost is less than current prices.
- Calculate inventory turnover ratio. Obsolete inventory may be revealed if ratio is significantly lower.
- In manufacturing environments, test overhead allocation rates and ensure that only direct labor, direct material and overhead have been included.
- Verify the correct application of lower-of-cost-or-net realizable value principles

Question 3

No entry is passed for cheques received by the auditee on the last day of the year and not yet deposited with the Bank.

Answer 3

Incorrect: The person who is controlling the trade receivables should ensure that proper accounting entries have been passed by crediting respective trade receivables account. The balance of cheque in hand should be disclosed along with the cash and bank balances in the financial statements.

Question 4

You are an auditor of PQR Ltd. which has spent Rs. 10 lakhs on Research activities of the product during period under audit. Board of Directors want to recognize it as an internally generated intangible asset. Advise and discuss the conditions necessary to be fulfilled to recognize the intangible assets in the financial statements.

OR

You are an auditor of PQR Ltd. which has spent Rs. 50 lakhs on Research activities of the product during period under audit. Board of Directors want to recognize it as an internally generated intangible asset. Advise and discuss the conditions necessary to be fulfilled to recognize the intangible assets in the financial statements.

Answer 4

No Intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research shall be recognised as an expense when it is incurred since in the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Thus, board of directors of PQR Ltd cannot recognize the expense as internally generated intangible asset.

An intangible asset shall be recognised if, and only if:

- I. the said asset is identifiable;
- II. the entity controls the asset i.e. the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits;
- III. it is probable that future economic benefits associated with the asset will flow to the entity;
- IV. the cost of the item can be measured reliably.

Question 5

From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statements as required by AS 29.

What type of disclosures should be made for each class of contingent liability as at the balance sheet date?

Answer 5

Disclosure for each class of Contingent Liability: From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. As per, AS 29 an enterprise should disclose for each class of contingent liability at the balance sheet date.

- I. A brief description of the nature of the contingent liability and where practicable.
- II. An estimate of the amount as per measurement principle as prescribed for provision in AS 29.
- III. Indication of the uncertainty relating to outflow.
- IV. The possibility of any reimbursement.

Question 6

Management of Z Ltd. wants to include all the cost incurred by the Company in valuing the cost of its inventories. The Accountant is, however, of the view that certain costs should be excluded from the cost of inventories and should be recognised as expenses for the period in which they are incurred. What are such costs that should be excluded while determining the cost of inventories?

Answer 6

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

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

- I. abnormal amounts of wasted materials, labour, or other production costs;
- II. storage costs, unless those costs are necessary in the production process prior to a further production stage;
- III. administrative overheads that do not contribute to bringing the inventories to their present location and condition; and
- IV. selling and distribution costs.

In the given situation, contention of Z Ltd. is not correct to include all the cost of its inventories while determining the cost of inventory. However, contention of accountant is correct that certain cost should be excluded from the cost of inventories and to be recognised as expenses in period in which they are incurred.

Question 7

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

Answer 7

Issue of Sweat Equity Shares: As per section 54 of the Companies Act, 2013, the employees may be compensated in the form of 'Sweat Equity Shares'.

“Sweat Equity Shares” means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

The auditor may see that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions are fulfilled.

- a) The issue is authorized by a special resolution passed by the company;
- b) The resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;
- c) Not less than one year has, at the date of such issue, elapsed since the date on which the company ~~had commenced business~~; and **(Removed as per Nov 21 amendment)**
- d) Where the equity shares of the company are listed on a recognized stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

The rights, limitations, restrictions and provisions as are for the time being applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank paripassu with other equity shareholders.

Question 8

While conducting audit of Air Space Ltd, the auditor observes that it has issued shares at discount to its creditors when its debt is converted into shares in pursuance of debt restructuring scheme in accordance with any guidelines specified by the Reserve Bank of India. Discuss explaining clearly the provisions relating to discount on issue of shares and its verification by the auditor.

OR

Any share issued by a company at a discounted price shall be void. Explain stating also the audit procedure in this regard.

OR

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

OR

Management of D Ltd. has issued shares at a discount to its creditors. Explain the provisions of the Companies Act, 2013 when shares are issued at a discount to creditors?

As an auditor what will be your concern of checking in such a case? Answer 8

Shares issued at a discount According to Section 53 of the Companies Act, 2013,

1. a company shall not issue shares at a discount, except in the case of an issue of

sweat equity shares given under Section 54 of the Companies Act, 2013.

2. any share issued by a company at a discounted price shall be void.

(2A) Notwithstanding anything contained in sub-sections (1) and (2), a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.

1. Where any company fails to comply with the provisions of this section, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of twelve per cent. per annum from the date of issue of such shares to the persons to whom such shares have been issued.

The auditor needs to check

- i. the movement in share capital during the year and wherever there is any issue,
- ii. he should verify that the Company has not issued any of its shares at a discount by reading the minutes of meeting of its directors and shareholders authorizing issue of share capital and the issue price.
- iii. Further, auditor should also verify that in case a company has issued shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.

In the given case of Air Space Ltd, it is clear that it can issue shares to its creditors when its debt is converted into shares in accordance with approved restructuring scheme.

Question 9

XYZ Ltd made huge additions to Intangible assets during the period 01-04-2021 to 31-03-2022 i.e period under audit. You have been appointed as an auditor and you want to verify the additions made to intangible assets during the period. Suggest the audit procedure to verify the additions to intangible assets.

Answer 9

1. Verify the movement in the intangible assets schedule (asset class wise like software, designs/ drawings, goodwill etc.) compiled by the management i.e. Opening balances + Additions – Deletions = Closing balances. Tally the closing balances to the entity's books of account.

2. Check the arithmetical accuracy of the movement in intangible assets schedule.

For additions during the period under audit, obtain a listing of all additions from the management and undertake the following procedures:

- I. For all material additions, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26.
- II. Ensure that no cost related to research (or from the research phase of an internal project) gets recognized as intangible asset.
- III. Check the certificate or report or other similar documentation maintained by the entity to verify the date of use of the intangible which could be linked to date of commencement of commercial production/ economic use to the entity, for all additions to intangible assets during the period under audit.
- IV. Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel.
- V. Verify whether proper internal processes and procedures like inviting competitive quotations/ proper tenders etc. were followed prior to finalizing the vendor for procuring item of intangible assets by testing those documents on a sample basis.
- VI. In relation to deletions of intangible assets, understand from the management the reason and rationale for deletion and the manner of disposal. Obtain the management approval and disposal note authoring disposal of the asset from its active use.
- VII. Verify the process followed for sale of discarded asset, example inviting competitive quotes, tenders and the basis of calculation of sales proceeds. Verify that the management has accurately recorded the deletion of intangible asset (original cost and accumulated amortization up to the date of disposal) and the resultant gain/ loss on disposal in the entity's books of account.

Question 10

While auditing the accounts of ABC Ltd, a member of audit team is not clear about:

- I. the criteria regarding classification of liability into current liability and non-current liability.
- II. Classification of Reserves and Surplus

You being the senior member of audit team guide the member of the audit team about such criteria and classification as per general instructions for preparation of balance sheet as per Schedule III.

Answer 10

A liability shall be classified as current when it satisfies any of the following criteria:

- a. it is expected to be settled in the company's normal operating cycle;
- b. it is held primarily for the purpose of being traded;

- c. it is due to be settled within twelve months after the reporting date; or
- d. the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

Reserves and Surplus shall be classified as:

- a. Capital Reserves;
- b. Capital Redemption Reserve;
- c. Securities Premium;
- d. Debenture Redemption Reserve;
- e. Revaluation Reserve;
- f. Share Options Outstanding Account;
- g. Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);
- h. Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

Note: A reserve specifically represented by earmarked investments shall be termed as a 'fund'.

Note: Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

Question 11

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. Is the statement correct. Explain

Answer 11

The statement is not correct.

The securities premium account may be applied by the Company for the following purposes:

- a. towards the issue of unissued shares of the company to the members of the company fully paid bonus shares;
- b. in writing off the preliminary expenses of the Company;
- c. in writing off the expenses of, or the commission paid or discount allowed on,

- any issue of shares or debentures of the company;
- d. in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
- e. for the purchase of its own shares or other securities under section 68.

Question 12

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.

Answer 12

While checking sales of the client, the auditor has to ensure that all sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted. The auditor can perform the following procedures to ensure the same.

- Trace a few transactions from inception to completion. (Examination in depth)
- E.g: Take few sales transaction, and check from the receipt of sales order to the payment of receivable balance, every underlying document to ensure if it is properly recorded at every stage and measured accurately taking into consideration all the incentives, discounts, if any. The recognition shall be according to the revenue recognition policy of the entity.
- If the client is engaged in export sales, then compliance with AS 11 shall be ensured.
- Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.

Question 13

BNP Ltd has reduced its Share Capital to a greater extent in the year for which you are conducting the audit. State how will you proceed for verifying the reduction of Capital.

Answer 13 Reduction of Capital

For verifying reduction of capital, the auditor needs to undertake the following procedures:

- i. Verify that the meeting of the shareholders held to pass the special resolution was properly convened and that the proposal was circularized in advance to all the shareholders;
- ii. Verify that the Articles of Association authorizes reduction of capital;
- iii. Examine the order of the Tribunal confirming the reduction and verify that a copy of the order and the minutes have been registered and filed with the Registrar of Companies;

- iv. Check the Registrar's Certificate as regards to reduction of capital;
- v. Vouch the accounting entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also check whether the requirements of Schedule III, Part I, have been complied with in relation to presentation;
- vi. Confirm whether the revaluation of assets has been properly disclosed in the Balance Sheet;
- vii. Verify the adjustment made in the members' accounts in the Register of Members and confirm that either the paid up amount shown on the old share certificates has been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled;
- viii. Confirm that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet.
- ix. Verify that the Memorandum of Association of the company has been suitably amended.

Question 14

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

			(C)
	Plant and Machinery (at Cost)		4,00,000
Less:	Depreciation:		
	Up to Previous year	1,40,000	
	For the year	26,000	1,66,000
			2,34,000

- (i) Indicate different assertions in respect of account balances at period end.
- (ii) State specific assertions relating to the above extract of financial statement.

Answer 14

- (i) **Assertions about account balances at the period end:**

- a. Existence – assets, liabilities, and equity interests exist.
- b. Rights and obligations – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- c. Completeness – all assets, liabilities and equity interests that should have been recorded have been recorded.
- d. Valuation and allocation – assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

- (ii) **The specific assertions are as follows:**

1. the firm owns the plant and machinery;
2. the historical cost of plant and machinery is Rs.4 lacs;

3. the plant and machinery physically exists;
4. the asset is being utilised in the business of the company productively;
5. total charge of depreciation on this asset is Rs.1,66,000 to date on which Rs.26,000 relates to the year in respect of which the accounts are drawn up; and
6. the amount of depreciation has been calculated on recognised basis and the calculation is correct.

Question 15

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

Answer 15

The audit procedure generally required to be undertaken by the auditor while auditing Goods sent out on Sale or Return Basis is as under:

- i. Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
- ii. Verify that price of such goods is unloaded from the sales account and the trade receivables record. Check the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.
- iii. Ensure that the goods in respect of which the period of approval has expired at the end of the year, have either been received back or customers' accounts have been debited.
- iv. Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the end of the year lying with the party, has been included in the closing inventory

Question 16

ABC Ltd. wants to buy some equipment on lease and hence is required to sign lease agreement with the supplier of the equipment. What are the important points to be considered in the lease agreement?

Answer 16

The important points to be examined in the lease agreement are:

- i. the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).
- ii. the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.

- iii. whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.
- iv. whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.

Question 17

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

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

Answer 17

Incorrect: Depreciation is a fall in value of asset due to obsolescence, usage and effluxion of time, Therefore, depreciation is charged when the asset is ready for use. Active use of asset is not a mandatory criteria for charge of depreciation.

Question 18

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.

Answer 18

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 the depreciation and amortization expense:

- Obtain the understanding of entity's accounting policy related to depreciation and amortization.
- Ensure the Company's policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act/ applicable accounting standards.
- Whether the depreciation has been calculated after making adjustment of residual value from the cost of the assets.
- Whether depreciation and amortisation charges are valid.
- Whether depreciation and amortisation charges are accurately calculated and recorded.
- Whether all depreciation and amortisation charges are recorded in the appropriate period.

- Ensure the parts (components) of each item of property, plant and equipment that are to be depreciated separately have been properly identified.
- Whether the most appropriate depreciation method for each separately depreciable component has been used.

Question 19

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

Answer 19

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

- Obtain a month-wise and consultant-wise summary.
- In case of monthly retainerhip agreements, verify whether the expenditure for all 12 months has been recorded correctly.
- For non- recurring expenses, select a sample and vouch for the attributes discussed above.
- The auditor should be cautious while vouching for legal expenses as the same may highlight a dispute for which the entity may not have made any provision and the matter may also not have been discussed/ highlighted to the auditor for his specific consideration.

Question 20

A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, etc. as at the end of the reporting period under audit. Explain the audit procedure in this context. (RTP Nov'20)

Answer 20

Direct confirmation procedure

- A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts held in current accounts, deposit accounts, EEFC account, cash credit accounts, restrictive use accounts like dividend, escrow accounts as of the end of the reporting period under audit. This should necessarily be done for all account balances as at the period-end.
- The Company should be asked to investigate and reconcile the discrepancies, if any, including seeking written explanations/ clarifications from the banks/ financial institutions on any unresolved queries.
- The auditor should emphasize for confirmation of 100% of bank account balances. In remote situations, where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include:
- Agreeing the balance to bank statement received by the Company or internet/

online login to account in auditor's personal presence;

- Sending the audit team member to the bank branch along with the entity's personal to obtain balance confirmation from the bank directly.

Question 21

APQ Ltd. deals in real estate and classifies all of its land holding under current assets as inventory. The same is, therefore valued at cost or market value whichever is less. How would you verify profit or loss arising on sale of plots of land by such a dealer? (RTP Nov '21)

Answer 21

Verification of Profit & Loss Arising on sale of Plots by real estate dealer: The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value whichever is less. The amount of profit or loss arising on sale of plots of land by such a dealer should be verified as follows:

- i. Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realised for it.
- ii. This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinized.
- iii. If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.
- iv. Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.
- v. The prices obtained for various plots of land sold should be checked with the plan map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be very feed on a reference to certified copies of sale deeds executed.
- vi. Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.

Question 22

Reserves are amounts appropriated out of profits whereas on the contrary, provisions are amounts charged against revenue. Discuss explaining the difference between the two and also explain clearly revenue reserve and capital reserve. (RTP May '19)

Answer 22

Reserves are amounts appropriated out of profits that are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist as at the date of the Balance Sheet.

On the contrary, provisions are amounts charged against revenue to provide for:

- i. Renewal or diminution in the value of assets; or
- ii. a known liability, the amount whereof could only be estimated and cannot be determined with accuracy; or
- iii. a claim which is disputed.

Amounts contributed or transferred from profits to make good the diminution in value of assets due to the fact that some of them have been lost or destroyed as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions. Provisions are normally charged to the Statement of Profit and Loss before arriving at the amount of profit. Reserves are appropriations out of profits.

Difference between Reserves and Provisions

The difference between the two is that provisions are amounts set aside to meet specific/ identified liabilities or diminution in recoverable value of assets. These must be provided for regardless of whether the Company has earned profit or not.

Reserves on the other hand, represent amounts appropriated out of profits, held for equalising the dividends of the company from one period to another or for financing the expansion of the company or for generally strengthening the company financially.

If we examine the Balance Sheet of a company, at a given time, and deduct the total liabilities to outside trade payables from the value of assets shown therein, the difference between the two figures will represent the net worth of the company based on the book values of assets as on that date. The same shall include the capital contributed by the shareholders as well as total undistributed profit held either to the credit of the Statement of Profit and Loss or to reserves; the reserves again will be segregated as revenue or capital reserves.

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

Examples- to supplement divisible profits in lean years, to finance an extension of business, to augment the working capital of the business or to generally strengthen the company's financial position.

Capital Reserve, on the other hand represents a reserve which does not include any amount regarded as free for distribution through the Statement of Profit and Loss

Examples- share premium, capital redemption reserve.

It may be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve shall also be in the nature of a capital reserve.

A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But the

amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.

Question 23

Explain how you will verify the items given while conducting an audit of an entity:

- a. Recovery of Bad debts written off
- b. Receipt of Insurance claims
- c. Payment of Taxes

Answer 23

a. Recovery of Bad Debts written off: Recovery of bad debts written off is verified with reference to relevant correspondence and proper authorization.

- i. Ascertain the total amount lying as bad debts and verify the relevant correspondence with the trade receivables whose accounts were written off as bad debt.
- ii. Ensure that all recoveries of bad debts have been properly recorded in the books of account.
- iii. Examine notification from the Court or from bankruptcy trustee. Letters from collecting agencies or from account receivables should also be seen.
- iv. Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.
- v. Vouch acknowledgement receipts issued to account receivables or trustees.
- vi. Review the internal control system regarding writing off and recovery of bad debts.

b. Receipt of Insurance Claims: Insurance claims may be in respect of fixed assets or current assets. While vouching the receipts of insurance claims-

- a. The auditor should examine a copy of the insurance claim lodged with the insurance company correspondence with the insurance company and with the insurance agent should also be seen. Counterfoils of the receipts issued to the insurance company should also be seen.
- b. The auditor should also determine the adjustment of the amount received in excess or short of the value of the actual loss as per the insurance policy.
- c. The copy of certificate/report containing full particulars of the amount of loss should also be verified.
- d. The accounting treatment of the amount received should be seen particularly to ensure that revenue is credited with the appropriate

amount and that in respect of claim against asset, the Statement of Profit and Loss is debited with the short fall of the claim admitted against book value, if the claim was lodged in the previous year but no entries were passed, entries in the Statement of Profit and Loss should be appropriately described.

c. Payment of Taxes:

- a. Obtain the computation of taxes prepared by the auditee and verify whether it is as per the Income Tax Act/GST Act/ Rules/ Notifications/ Circulars etc.
- b. Examine relevant records and documents pertaining to payment of advance income tax and self assessment tax.
- c. Payment on account of income-tax and other taxes like GST consequent upon a regular assessment should be verified by reference to the copy of the assessment order, notice of demand and the receipted challan acknowledging the amount paid.
- d. The penal interest charged for non-payment should be debited to the interest account.
- e. Nowadays, electronic payment of taxes is also in trend. Such electronic payment of taxes by way of internet banking facility or credit or debit cards shall also be verified.
- f. The assessee can make electronic payment of taxes also from the account of any other person. Therefore, it should be verified that the challan for making such payment is clearly indicating the PAN No./TAN No./TIN No./GSTIN etc. of the assessee on whose behalf the payment is made.

Question 24

PK Pvt Ltd, based in Moradabad, is engaged in export of brassware goods. The company has huge export receivables as on 31st March 2022. It is also analysed from Export Sales account of the company that large number of small shipments were almost despatched daily during month of March 2022. List out few audit procedures you would adopt as an auditor to verify completeness assertion of export trade receivables. (RTP Nov'22)

Answer 24

Completeness assertion in respect of account balances means that all balances which should have been recorded have been recorded. The auditor needs to satisfy himself about cut off so that there is no understatement or overstatement in account balances of export receivables.

In this context, while verifying completeness assertion of export trade receivables, following audit procedures are required: -

1. Check that in respect of invoices raised in last few days nearing the cut off date, goods have been actually dispatched and not lying with the company.

2. Check stock records, e-way bill, and transporter receipt regarding actual movement of goods. It would provide assurance that export invoices in respect of which revenue was booked have been actually moved out of company's premises.
3. Ensure that all goods invoiced prior to cut off date/year end have been included in export receivables on test check basis.
4. Ensure that no goods despatched after year end have been included in export receivables by tracing entries in export sales, stock records of next year. The same can be verified from e-way bills also.
5. Match invoices to despatch/shipping details. Further match invoices dates to despatch dates to see if sales are being recorded in correct accounting period.
6. Test invoices in receivable report. Select invoices from ageing report of export receivables and compare them with supporting documentation to ensure that these are billed with correct names, dates and amounts.

Question 25

State with reason (in short) whether the following statements are true or false: Internally generated Goodwill can be recognized as an asset. (RTP Nov '23)

Incorrect: As per AS-26, internally generated goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

Question 25

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

An unexplained decrease in GP Ratio may result due to fictitious sales. (RTP Nov '23 & Nov '22)

Incorrect: A fictitious sale will increase the GP Ratio, instead of decreasing it. GP ratio normally comes down if there are unrecorded sales or reversal of fictitious sale entries recorded in the previous year or fictitious purchase or decrease in closing stock.

Question 26

- a. As an auditor, how will you verify the hire purchase transaction in the case of an entity engaged in the business of hire purchase?
- b. A junior accountant of a limited company has not separated transactions of one period from those in the ensuing period. As an Auditor, state the correct procedure to be followed and the areas in which it can be applied. (RTP Nov '23)

Answer 26

- a) Verification of Hire-purchase transactions: While checking the hire-

purchase transaction, the auditor may examine the following:

1. Hire purchase agreement is in writing and is signed by all parties.
2. Hire purchase agreement specifies clearly
 - i. The hire-purchase price of the goods to which the agreement relates;
 - ii. The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;
 - iii. The date on which the agreement shall be deemed to have commenced;
 - iv. The number of instalments by which the hire-purchase price is to be paid, the amount of each of those instalments, and the date, or the mode of determining the date, upon which it is payable, and the person to whom and the place where it is payable; and
 - v. The goods to which the agreement relates, in a manner sufficient to identify them.
3. Ensure that payments are being received regularly as per the agreement.

B Cut-off Arrangement:

1. Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separated from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for this purpose is technically known as "cut-off arrangement".
2. It essentially forms part of the internal control system of the organisation.
3. Accounts, other than sales, purchase and inventory are not usually affected by the continuity of the business and therefore, this arrangement is generally applied only to sales, purchase and inventory.
4. The auditor satisfies by examination and test-checks that the cut-off procedures are adequately followed and ensure that:
 - i. Goods purchased, property in which has already been passed on to the client, have in fact been included in the inventories and that the liability has been provided for in case credit purchase.
 - ii. Goods sold have been excluded from the inventories and credit has been taken for the sales. If the value of sales is to be received, the concerned party has been debited.
5. The auditor may examine a sample of documents, evidencing the movement of inventory into and out of stores, including documents pertaining to period shortly before and after the cut-off date and check whether inventories represented by those documents were included or excluded as appropriate during inventory taking for perfect and correct presentation in the financial statements.

Question 27

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.

Answer 27

- i. For verifying interest income on fixed deposits:
 - Obtain a listing of fixed deposits opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period. Verify the arithmetical accuracy of the interest calculation made by the entity by multiplying the deposit amount with the applicable rate and number of days during the period under audit.
 - For deposits still outstanding as at the period- end, trace the same to the direct confirmation obtained from the respective bank/ financial institution.
 - Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity.
 - Also, obtain a copy of Form 26AS (TDS withholding by the bank/ financial institution) and reconcile the interest reflected therein to the calculation shared by client.
- ii. Dividend Income: For Dividends, verify that the same are recognized in the statement of profit and loss only when the entity's right to receive payment of the dividend is established, provided it is probable that the economic benefits associated with the dividend will flow to the entity and the amount of the dividend can be measured reliably
- iii. Gain/(loss) on sale of investment in mutual funds: Verify that Gain/(loss) on sale of investment in mutual funds is recorded as other income only on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments. For the purpose, obtain the mutual fund statement and trace the gain / loss as recorded in the books of account to the gain/ loss as reflected in the statement.

Disclosure Requirements: Ensure whether the following disclosures as required under Ind AS compliant Schedule III to Companies Act, 2013 have been made:

Whether 'other income' has been classified as:

- Interest income
- Dividend income
- Other non-operating income (net of expenses directly attributable to such income)

Question 28

“Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets.” State any three examples of such occurrence of misappropriation of such assets.

Answer 28

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- i. Inadequate segregation of duties or independent checks.
- ii. Inadequate oversight of senior management expenditures, such as travel and other reimbursements
- iii. Inadequate record keeping with respect to assets.
- iv. Inadequate system of authorization and approval of transactions (for example, in purchasing).
- v. Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
- vi. Lack of complete and timely reconciliations of assets.
- vii. Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.
- viii. Lack of mandatory vacations for employees performing key control functions.
- ix. Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
- x. Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Question 29

ABC limited appointed XYZ & Company, Chartered Accountants, as a Statutory Auditor of the Company for the year 2019-20. CA X, partner of XYZ & Company, was looking after the audit of other income of the company which consists of interest income on fixed deposits. As a Statutory Auditor how would CA X verify interest income on fixed deposits for the year 2019-20?

Answer 29

CA X, partner of XYZ & Company, would carry out the following audit procedure for verifying interest income on fixed deposits of ABC Limited:

1. Obtain a listing of fixed deposits opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period. Verify the arithmetical accuracy of the interest calculation made by the entity by precomputing i.e.
2. For deposits still outstanding as at the period- end, trace the same to the direct

confirmations obtained from the respective bank/ financial institution.

3. Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity.
4. Also, obtain a copy of Form 26AS (TDS withholding by the bank/ financial institution) and reconcile the interest reflected therein to the calculation shared by client.

Question 30

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. Answer 30**

Statutory auditor would perform the following audit procedure for recognition of different items given in the question

1. Interest income on fixed deposits is recognized on a time proportion basis taking into account the amount outstanding and the applicable interest rate.
2. Dividends are recognized in the statement of profit and loss only when:
 - i. the entity's right to receive payment of the dividend is established;
 - ii. it is probable that the economic benefits associated with the dividend will flow to the entity; and
 - iii. the amount of the dividend can be measured reliably.
3. Gain/(loss) on sale of investment in mutual funds is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

Question 31

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.

Answer 31

Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss.

For instance, the cost of importing goods which are subjected to an ad-valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of excise duty/ GST paid.

Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, e.g., commission paid to a manager calculated on the basis of net profits, commission paid to a selling

agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

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

Question 32

State with reasons whether the following statements are correct or incorrect:

A company should disclose in its Annual Report, the shares in the company held by each shareholder holding more than 10 percent shares specifying the number of shares held.

Answer 32

Incorrect: Schedule III to the Companies Act, 2013 requires the company to disclose “shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held” in notes to accounts.

Question 33

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.

Answer 33

Attributes for verifying other expenses like Power and Fuel, Repair etc.:

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

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

- a. Whether the expenditure pertained to current period under audit;
- b. Whether the expenditure qualified as a revenue and not capital expenditure;
- 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.

Question 34

While auditing books of accounts of SOLAR Ltd., you observed that an amount due from a debtor for invoice issued on 31.03.2022 has not been recognized in the books of accounts. As an auditor, you want to ensure that all trade receivable balances that are supposed to be recorded have been recognized in the financial statements. How will you achieve the stated objective?

Answer 34

Audit of Trade Receivable:

All Trade receivable balances that were supposed to be recorded have been recognized in the financial statements. (COMPLETENESS): The auditor needs to satisfy himself of the cut-offs. Without a cut-off, sales could be understated or overstated, hence there is a need to perform the following cut off procedure:

- a. For the invoices issued during the last few days (last 5 days of the reporting year) i.e. cut-off date and which have been included in the debtors; check that the goods should have been dispatched and not lying with the Company;
- b. Ensure that all goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis;
- c. Ensure that no goods dispatched after the year- end have been invoiced and included in debtors for the period under audit.

Question 35

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?

Answer 35

Vouching/Verification of the Sale of Scrap by Auditor would be undertaken as under:

- i. Review the internal control as regards generation, storage and disposal of scrap.
- ii. Check whether the organization is maintaining reasonable record for generation of scrap.
- iii. Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.
- iv. Check the rates at which scrap has been sold and compare the rate with previous year.
- v. Vouch sales with invoices raised, advertisement for tender, rate contract with scrap dealers.
- vi. Ensure that there exists a proper control procedure to identify scrap and good

units and they are not mixed up and sold as scrap.

- vii. Make an overall assessment of the value of realization from scrap as to its reasonableness

Question 36

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

Answer 36

Audit Procedures that CA Q will follow to verify the existence, completeness, and valuation of provisions made are given hereunder:

Existence

1. Obtain a list of all provisions and compare them with balances in the ledger.
2. Inspect the underlying agreements like agreements with customers to assess warranty commitments, any legal and other claims on the entity i.e. litigations.

Valuation

3. Wherever required, obtain the expert's report, calculation and underlying working for the provision amount. For example - for warranty involving complex calculations, some entities get that valued through an actuary.

In such a case, the auditor may request the management to share the actuarial valuation report and in case of any matter under legal dispute, the auditor should request for assessment made by a legal expert in relation to likelihood of a liability devolving on the entity i.e. whether probable or possible or remote as defined above. The auditor should then verify the underlying assumptions used by the expert with the data shared by the management.

Chapter 6

SA 230- Audit Documentation

Question 1

Audit documentation provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor and evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements. Explain stating clearly purpose of audit documentation.

OR

Audit documentation serves a number of purposes. List such purposes

OR

A new team member of GSR & Co., the auditors of Esteem Limited, was of the view that Audit Documentation would not serve any purpose at any stage of Audit. Explain.

OR

CAM is the engagement partner of S Ltd. He has instructed his audit team to maintain proper audit documentation. The audit team members are not sure about the purpose for which the documentation should be made. Explain the various purposes of audit documentation with reference to SA 230.

OR

SA 230, "Audit Documentation" deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. Such audit documentation serves various purposes. Explain. (RTP May '23)

Answer 1

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

Nature of Audit Documentation

Audit documentation provides:

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

Purpose of Audit Documentation

The following are the purpose of Audit documentation:

1. Assisting the engagement team to plan and perform the audit.
2. Assisting members of the engagement team to direct and supervise the

audit work, and to discharge their review responsibilities.

3. Enabling the engagement team to be accountable for its work.
4. Retaining a record of matters of continuing significance to future audits.
5. Enabling the conduct of quality control reviews and inspections.
6. Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

From the above, it can be concluded that Audit documentation serves a number of purposes and hence it would be incorrect to say that audit documentation would not serve any purpose at any stage of audit

Question 2

“Completion Memorandum” is helpful as part of the audit documentation.

Explain. Answer 2

Completion Memorandum or Audit Documentation Summary.

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

- i. the significant matters identified during the audit.
- ii. how they were addressed.

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Question 3

Examine with reasons (in short) whether the following statement is correct or incorrect: Audit notes can serve as a guide in framing Audit programme.

Answer 3

Correct: Audit notes can serve as a guide in framing audit programme in the future as they indicate the weaknesses in the system of the client which specially need to be watched.

Question 4

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

The auditor shall prepare audit documentation on a timely basis.

Answer 4

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

Question 5

Newton Ltd. has made loans and advances on the basis of following securities to various borrowers. As an auditor what type of documents can be verified to ensure that the company holds a legally enforceable security?

- (i) Shares and Debentures
- (ii) Life Insurance Policy
- (iii) Hypothecation of goods. **Answer 5**

Documents to be seen in case of Securities:

Types of Security	Documents etc. to be seen
(i) Shares and debentures	The scrip and the endorsement thereon of the name of the transferee, in the case of transfer.
(ii) Life Insurance Policy.	Assignment of policy in favour of the lender, duly registered with the insurer
(iii) Hypothecation of goods	Deed of hypothecation or other document creating the charge, together with a statement of inventories held at the Balance Sheet date

Question 6

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Explain stating clearly the examples of significant matters (RTP Nov'20).

OR

Judging the significance of a matter requires an objective analysis of the facts and circumstances. Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Explain with the help of examples. (RTP May '19)

Answer 6

Documentation of Significant Matters and Related Significant Professional Judgments
Judging the significance of a matter requires an objective analysis of the facts and circumstances.

Examples of significant matters include:

Matters that give rise to significant risks.

- Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report.

An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results.

Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits, when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

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

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

Question 7

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

The auditor must include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking etc. (RTP Nov '21)

Answer 7

Incorrect: The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete

or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

Question 8

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

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

Answer 8

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

Question 9

State with reason (in short) whether the following statements are true or false: Audit documentation is a substitute for the entity’s accounting records.

Answer 9

Incorrect: The auditor may include copies of the entity’s records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation is not a substitute for the entity’s accounting records.

Question 10

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

An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 30 days after the date of the auditor’s report.

Answer 10

Incorrect: SQC 1 “Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services”, requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor’s report.

Question 11

CA R comes to know some very critical information with regards to the business cycle of an entity for which he has issued the audit report, which become

known to him as an auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report. He wants to perform additional audit procedures to satisfy himself. As an auditor what he shall document, on the matters arising after the date of audit report? (RTP Nov'22)

Answer 11

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

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

Question 12

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor to understand significant matters arising during the audit. Explain the above statement and also give examples of significant matters. (RTP Nov'22)

Answer 12

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:

- Matters that give rise to significant risks.
- Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor's report.

Question 13

Audit Documentation refers to the record of three items. Explain stating clearly the objective and nature of audit documentation. (RTP Nov '23)

Answer 13

Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

The objective of the auditor is to prepare documentation that provides:

- i. A sufficient and appropriate record of the basis for the auditor's report; and
- ii. Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Nature of Audit Documentation Audit documentation provides:

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

Question 14

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis. Explain in detail.

Answer 14

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

- SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files.
- An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.
- Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross-referencing working papers.
- Signing off on completion checklists relating to the file assembly process
- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

- After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.
- SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

Question 15

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

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

Answer 15

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

Question 16

State with reasons whether the following statements are correct or incorrect:

The auditor shall assemble the audit documentation in the audit file and complete the administrative process of assembling the final audit file before the date of the auditor's report

Answer 16

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

SA 560- Subsequent Events

Question 1

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

Answer 1

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

- (a) Discuss the matter with management and, where appropriate, those charged with governance.
- (b) Determine whether the financial statements need amendment and If so,
- (c) Inquire how management intends to address the matter in the financial statements.

Question 2

SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Explain those events and also define subsequent events.

Answer 2

SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements.

Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:

- (a) Those that provide evidence of conditions that existed at the date of the financial statements; and
- (b) Those that provide evidence of conditions that arose after the date of the financial statements.

SA 700 explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor

becomes aware and that occurred up to that date.

Subsequent events refer to events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

Question 3

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. Explain.

Answer 3

Audit Procedure Regarding Events Occurring Between the Date of The Financial Statements and The Date of the Auditor's Report

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.

The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment which shall include the following:

- (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- (c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- (d) Reading the entity's latest subsequent interim financial statements, if any.

Question 4

"The auditors should consider the effect of subsequent events on the financial statement and on auditor's report"– Comment according to SA 560.

Answer 4

Effect of Subsequent Events: SA 560 "Subsequent Events", establishes standards on the auditor's responsibility regarding subsequent events.

According to it, 'subsequent events' refer to those events which occur between the date of financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. It lays down the standard that the auditor should consider the effect of subsequent events on the financial statements and on the auditor's report.

The auditor should obtain sufficient appropriate evidence that all events upto the date of the auditor's report requiring adjustment or disclosure have been identified and to identify such events, the auditor should-

- i. obtain an understanding of any procedures management has established to ensure that subsequent events are identified.
- ii. inquire of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

Examples of inquiries of management on specific matters are:

- Whether new commitments, borrowings or guarantees have been entered into.
 - Whether sales or acquisitions of assets have occurred or are planned.
 - Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
 - Whether there have been any developments regarding contingencies.
 - Whether there have been any developments regarding risk areas and contingencies.
 - Whether any unusual accounting adjustments have been made or are contemplated.
 - Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
 - Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
 - Whether any events have occurred that are relevant to the recoverability of assets.
- iii. Read minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
 - iv. Read the entity's latest subsequent interim financial statements, if any.
 - v. Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.
 - vi. Inquire, or extend previous oral or written inquiries, of the entity's legal

SA 570- Going Concern

Question 1

When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor has determined that management of XYZ Ltd has already performed a preliminary assessment of the entity's ability to continue as a going concern. Explain how would auditor of XYZ Ltd proceed in the above case.

Also explain how would the auditor proceed if such an assessment has not yet been performed by the management. (RTP May '21)

Answer 1

When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:

- i. If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or
- ii. If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

Question 2

As described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. Explain stating the auditor's responsibilities with regard to going concern (RTP May '21).

Answer 2

The auditor's responsibilities are:

1. to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and
2. to conclude, based on the audit evidence obtained, whether a material

uncertainty exists about the entity's ability to continue as a going concern. However, as described in SA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Question 3

Give examples of financial events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. (RTP Nov '21)

Answer 3

The following are examples of **Financial** events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern:

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.

Question 4

Management's assessment of the entity's ability to continue as a going concern involves making a judgement about inherently uncertain future outcomes of events or conditions. What are relevant factors to that judgement?

Answer 4

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.

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SA 580- Written Representations

Question 1

Explain the objectives of the auditor regarding written representations.

Answer 1

The objectives of the auditor regarding written representation:

(i) To obtain written representations

To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

(ii) To support other evidence

To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and

(iii) To respond appropriately

To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

Question 2

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

Written representations are requested from those responsible for the preparation and presentation of the financial statements.

Answer 2

Correct: Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation. However, management (rather than those charged with governance) is often the responsible party.

Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements.

Question 3

Akash & Associates are the statutory auditors of Deluxe Ltd. for the FY 2020 -21. During the course of audit, CA Akash, the engagement partner requested the management of the company to provide written representation with respect to valuation of a transaction. The management, however does not provide the same to CA Akash. What course of action should CA Akash follow in such situation?

Answer 3

If management of Deluxe Ltd. does not provide one or more of the requested written representations,

CA Akash should:

- (a) Discuss the matter with management;
- (b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
- (c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705.

Question 4

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

When inventory under the custody and control of a third party is material to the financial statements, the auditor can obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by taking written representation from management. (MTP 2 Marks April '23)

Answer 4

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

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

Question 5

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

Explain stating clearly objectives of the auditor regarding written

representation. (RTP May '20)

Answer 5

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

Written representations are requested from those responsible for the preparation and presentation of the financial statements.

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

The objectives of the auditor regarding written representation

The objectives of the auditor are:

- (a) **To obtain written representations**-To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
- (b) **To support other evidence** -To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and
- (c) **To respond appropriately**-To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

Question 6

Written representations are to be provided by the management to the auditor when requested. Explain (RTP Nov '23)

Answer 6

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

Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other

equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements.

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

- i. discuss the matter with management;
- ii. re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
- iii. take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor shall disclaim an opinion on the financial statements if management does not provide the written representations.

Question 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?

Answer 7

Other Written Representation: Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations.

The written representations draw on the agreed acknowledgement and understanding of management of its responsibilities by requesting confirmation that it has fulfilled them. The auditor, CA K of B Ltd, may also ask management of B Ltd to reconfirm its acknowledgement and understanding of those responsibilities in written representations. This is particularly appropriate when:

- i. Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
- ii. The terms of the audit engagement were prepared in a previous year;
- iii. There is any indication that management misunderstands those responsibilities; or
- iv. Changes in circumstances make it appropriate to do so.

SA 260- Communication with Those Charged with Governance

Question 1

State the significant difficulties encountered during audit with reference to SA- 260 (communication with those charged with governance).

Answer 1

Significant Difficulties Encountered During the Audit: As per SA 260 "Communication with Those Charged with Governance", significant difficulties encountered during the audit may include such matters as:

- Significant delays in management providing required information.
- An unnecessarily brief time within which to complete the audit.
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- The unavailability of expected information.
- Restrictions imposed on the auditor by management.
- Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

SA 700 : Forming an Opinion and Reporting on Financial Statements

Question 1

Examine with reasons (in short) whether the following statements are correct or incorrect: The auditor shall express an adverse opinion when:

- (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive

Answer 1

Incorrect: The auditor shall express a qualified opinion when:

- (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
- (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Question 2

G & Associates are the Statutory Auditors of R Ltd., a company engaged in the business of manufacturing of blankets. The auditor has completed the audit and is in the process of forming an opinion on the financial statements for the

F.Y. 2022-2023. CA L, the engagement partner, wants to conclude that whether the financial statements as a whole are free from material misstatements, whether due to fraud or error. What factors he should consider to reach that conclusion?

Answer 2

Factors to be considered to form an opinion: The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

- (a) The auditor's conclusion, in accordance with SA 330, whether sufficient appropriate audit evidence has been obtained

- (b) The auditor's conclusion, in accordance with SA 450, whether uncorrected misstatements are material, individually or in aggregate.
- (c) The evaluations required
 - i. The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.
 - ii. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Question 3

The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Explain

Responsibilities for the Financial Statements: The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements."

SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

This section of the auditor's report shall describe management's responsibility for:

- (a) **Preparing the financial statements** in accordance with the applicable financial reporting framework, **and for such internal control** as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; [because of the possible effects of fraud on other aspects of the audit, materiality does not apply to management's acknowledgement regarding its responsibility for the design, implementation, and maintenance of internal control (or for establishing and maintaining effective internal control over financial reporting) to prevent and detect fraud.] and
- (b) **Assessing the entity's ability to continue as a going concern** and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include

a description of when the use of the going concern basis of accounting is appropriate.

Question 4

The auditor evaluated, in respect of T Ltd., whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. Auditor's evaluation included consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. Advise the qualitative aspects of the entity's accounting practices.

Answer 4

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:
 - i. The selective correction of misstatements brought to management's attention during the audit

Example

- Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
 - The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives.
- ii. Possible management bias in the making of accounting estimates.
 4. SA 540 addresses possible management bias in making accounting estimates.

Indicators of possible management bias do not constitute misstatements for

purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

Question 5

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

An Audit report is an opinion drawn on the entity's financial statements to make sure that the records are true and correct representation of the transactions they claim to represent. (RTP May '20)

Answer 5

Incorrect: The purpose of an audit is to enhance the degree of confidence of intended users of the financial statements. The aforesaid purpose is achieved by the expression of an independent reporting by the auditor as to whether the financial statements exhibit a true and fair view of the affairs of the entity.

Thus, an Audit report is an opinion drawn on the entity's financial statements to make sure that the records are true and fair representation of the transactions they claim to represent.

Question 6

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section.

OR

While drafting auditor's report of LK Ltd., what are the matters to be included by auditor in Opinion Section paragraph? (RTP Nov'22)

Answer 6

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

- (a) Identify the entity whose financial statements have been audited;
- (b) State that the financial statements have been audited;
- (c) Identify the title of each statement comprising the financial statements;
- (d) Refer to the notes, including the summary of significant accounting policies; and
- (e) Specify the date of, or period covered by, each financial statement comprising the financial statement.

Question 7

The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally. Explain (RTP May '21)

Answer 7

The requirements of SA 700 are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. This SA promotes consistency in the auditor's report but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. Consistency in the auditor's report, when the audit has been conducted in accordance with SAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

Question 8

State with reason (in short) whether the following statements are true or false For auditor's opinion, reasonable assurance is an absolute level of assurance.

Answer 8

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

Question 9

What an auditor should state in the "Basis for opinion" section of auditor's report? When the auditor modifies the opinion on the financial statements, explain the amendments he should make in this section

Answer 14

An auditor should state in "Basis for Opinion" section of Auditor's Report as under:

Basis for Opinion:

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

- i. States that the audit was conducted in accordance with Standards on Auditing;
- ii. Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
- iii. Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit

and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.

- iv. States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Amendments an Auditor should make:

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

- i. Amend the heading "Basis for Opinion" required by para of SA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and
- ii. Within this section, include a description of the matter giving rise to the modification.

Question 10

State with reason (in short) whether the following statements are true or false: In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments

Answer 10

Correct: In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated.

Question 11

State with reasons whether the following statements are correct or incorrect. The Location of the description of the auditor's responsibilities for the audit of the financial statements is always within the body of the auditor's report.

Answer 11

Incorrect: The description of the auditor's responsibilities for the audit of the financial statement shall be always shown as below –

- Within the body of the auditor's report
- Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix or
- By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority, where law, regulation or national auditing standards expressly permit the auditor to do so

Question 12

State with reasons whether the following statements are correct or incorrect:

Where a firm is appointed as the auditor of a company, the report is signed only in the personal name of the partner signing the report.

Answer 12

Incorrect: Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm. The partner/ proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

SA 705- Modifications to the Opinion in the Independent Auditor's Report

Question 1

While conducting audit of VED Ltd., you as an auditor are not only prevented in completing certain audit procedures but also are not able to obtain audit evidence even by performing alternative procedures. How you will deal with this situation?

Answer 1

As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", if, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

1. If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
2. If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
 - (i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or
 - (ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

If the auditor withdraws, before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

Question 2

Distinguish between an adverse opinion and a qualified opinion. Also draft an opinion paragraph for both types of opinion.

Answer 2

An auditor shall express an adverse opinion, when the auditor having obtained sufficient and appropriate audit evidence, concludes that misstatements, individually or in aggregate are both material and pervasive.

Whereas, when the auditor, having obtained sufficient and appropriate audit evidence, concludes that misstatements are material but not pervasive, shall express a qualified opinion.

SA705 – “Modifications to the Opinion in the Independent Auditor’s Report” deals with the form and content of both types of report. The following are the draft of the opinion paragraphs of the reports.

(i) Adverse Opinion

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the “Holding Company”) and its subsidiaries (the Holding Company and its subsidiaries together referred to as “the Group”), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2023, the consolidated statement of profit and Loss, (consolidated statement of changes in equity) and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the “consolidated financial statements”). In our opinion and to the best of our information and according to the explanations given to us, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 2023, of its consolidated profit/loss, (consolidated position of changes in equity) and the consolidated cash flows for the year then ended.

(ii) Qualified Opinion

We have audited the standalone financial statements of ABC Company Limited (“the Company”), which comprise the balance sheet as at March 31, 2023, and the statement of Profit and Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company’s branches located at (location of branches)) . In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2023 and profit/loss,

(changes in equity) and its cash flows for the year ended on that date.

Question 3

What an auditor should state in “Basis for opinion” section of auditor’s report and when the auditor modifies the opinion on the financial statements, what amendments he should make in this section?

Answer 3

An auditor should state in “Basis for Opinion” section of Auditor’s Report as under:
Basis for Opinion:

The auditor’s report shall include a section, directly following the Opinion section, with the heading “Basis for Opinion”, that:

- (i) States that the audit was conducted in accordance with Standards on Auditing;
- (ii) Refers to the section of the auditor’s report that describes the auditor’s responsibilities under the SAs;
- (iii) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor’s other ethical responsibilities in accordance with these requirements.
- (iv) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor’s opinion.

Amendments an Auditor should make:

When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SA 700 (Revised):

- (i) Amend the heading “Basis for Opinion” required by para of SA 700 (Revised) to “Basis for Qualified Opinion,” “Basis for Adverse Opinion,” or “Basis for Disclaimer of Opinion,” as appropriate; and
- (ii) Within this section, include a description of the matter giving rise to the modification.

Question 4

Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2020 - 21 the company transferred its accounts to computerized system (SAP) from manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such the statutory auditors of the company were not able to extract correct data and reports from the system. Such data was not available manually also. Further, the employees and the management of the company were not

supportive in providing the requisite information to the audit team. The auditor believes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive.

Explain the kind of audit report that the statutory auditor of the company should issue in this case.

Answer 4

The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements. In the present case Delightful Ltd, the statutory auditor of the company is unable to extract correct data and reports from the SAP system for conduct of audit. Also, such data and reports are not available manually. Moreover, the auditor believes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive. As such, the statutory auditor of Delightful Ltd. should give a disclaimer of opinion.

Question 5

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

An auditor should issue disclaimer of opinion when there is difference of opinion between him and the management on a particular point

Incorrect: The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

In case of difference of opinion, either the auditor will issue qualified report or adverse report and not disclaimer of opinion.

Question 6

Elucidate the circumstances when a modification to the Auditor's opinion is required. Also state the factors for making the decision regarding which type of modified opinion is appropriate.

Answer 6

Circumstances When a Modification to the Auditor's Opinion Is Required

The auditor shall modify the opinion in the auditor's report in the following circumstances:

1. The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
2. The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

The decision regarding which type of modified opinion is appropriate depends upon:

- (a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and
- (b) The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

SA 706- Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

Question 1

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

Other matter paragraph is paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Answer 1

Incorrect: Emphasis of Matter paragraph is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Question 2

State clearly the objective of the Auditor as per SA 706. Also define emphasis of matter paragraph and other matter paragraph.

Answer 2

As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

- (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or
- (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Other Matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Question 3

The inclusion of an Emphasis of Matter paragraph in the Auditor's Report affects the auditor's opinion.

Answer 3

Incorrect: When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall indicate that the auditor's opinion is not modified in respect of the matter emphasized. Such a paragraph shall refer only to information presented or disclosed in the financial statements. The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion.

Question 4

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

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall include an Emphasis of Matter paragraph in the auditor's report.

Answer 4

Incorrect: If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.

Question 5

If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, what is required to be stated by the auditor in an Other Matter paragraph

Answer 5

If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

- (i) That the financial statements of the prior period were audited by a predecessor auditor;
- (ii) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and
- (iii) The date of that report, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

Question 6

What is meant by Emphasis of Matter Paragraph? Give some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph.

OR

Mention the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph. (MTP 3 Marks Nov '21, RTP Nov'22)

Answer 6

Examples of circumstances to include Emphasis of Matter Paragraph: As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are;

- (a) An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- (b) A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- (c) Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- (d) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Question 7

Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?

Answer 7

Emphasis of Matter paragraph: A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (i) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
- (ii) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
- (iii) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Question 8

D Ltd. is a company engaged in publishing business magazines. CA P is the statutory auditor of the company. The company takes property in the barter deal from its real estate customers against publication of their advertisements. The properties obtained during the year through such barter deals have been considered in the books of accounts on the basis of possession letter only and have been included in PPE in the financial statements. Considering this matter of such importance that is

fundamental to the users understanding, CA P has decided to communicate the same in his report. CA P seeks your guidance in reporting this matter in his audit report.

Answer 8

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

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

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

The draft of the same is as under:

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

Alternative Solution:

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

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

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

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

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

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

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

SA 701- Communicating Key Audit Matters in the Independent Auditor's Report

Question 1

As an auditor of listed company, what are the matters that the auditor should keep in mind while determining "Key Audit Matters". (MTP 3 Marks Oct '21, RTP Nov'21)

Answer 1

Determining Key Audit Matters: As per SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report", the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

- (i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.
- (ii) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- (iii) The effect on the audit of significant events or transactions that occurred during the period. The auditor shall determine which of the matters determined in accordance with above were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

Question 2

Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not considered as a substitute or alternative for a number of important items. What are those items?

Answer 2

As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

- (i) A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
- (ii) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA

705, “Modifications to the Opinion in the Independent Auditor’s Report”;

- (iii) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity’s ability to continue as a going concern; or
- (iv) A separate opinion on individual matters.

Question 3

Communicating key audit matters in the auditor’s report is a separate opinion on individual matters.

Answer 3

Incorrect: Communicating key audit matters in the auditor’s report are in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor’s report is not a separate opinion on individual matters.

Alternative solution

Incorrect: Communicating key audit matters in the auditor’s report is not a separate opinion on individual matters. The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor’s report under the heading “Key Audit Matters”.

SA 710- Comparative Information—Corresponding Figures and Comparative Financial Statements

Question 1

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in some circumstances. Explain those circumstances.

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?

Answer 1

When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances.

1. **If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion** and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:
 - (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
 - (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.
2. **If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements** on which an unmodified opinion has been previously issued, the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and, if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified.
3. **Prior Period Financial Statements Not Audited-** If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the

current period's financial statements.

Question 2

NG Ltd. appointed CA N as the statutory auditor for the F.Y. 2021 -2022. Previous year's auditor gave a qualified opinion on the Comparative Financial Statements for the year ended 31.03.2021. What will be the reporting responsibility casted on CA N when he forms an opinion and prepares audit report on the Comparative Financial Statements for the F.Y. 2021-2022?

Answer 2

Prior Period Financial Statements Audited by a Predecessor Auditor: As per SA 710, if the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, CA. N, the auditor of NG Limited shall state in an Other Matter paragraph:

- (a) That the financial statements of the prior period were audited by a predecessor auditor;
- (b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and
- (c) The date of that report, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

Audit of Branch Office Accounts 143(8)

Question 1

When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole. Explain.

Answer 1

Using the Work of another Auditor: When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India has dealt with these issues in **SA 600, "Using the Work of another Auditor"**. It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

- (a) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as are as requiring special consideration, procedures for the identification of inter -component transactions that may require disclosure and the time-table for completion of audit; and
- (b) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor.

This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

Joint Audit

Question 1

The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Explain stating the advantages of the joint audit.

Answer 1

Joint Audit: The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage.

In specific terms the **advantages** that flow may be the following:

- (i) Sharing of expertise.
- (ii) Advantage of mutual consultation.
- (iii) Lower workload.
- (iv) Better quality of performance.
- (v) Improved service to the client.
- (vi) Displacement of the auditor of the company taken over in a takeover often obviated.
- (vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- (viii) Lower staff development costs.
- (ix) Lower costs to carry out the work.
- (x) A sense of healthy competition towards a better performance.

Question 2

Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard.

Answer 2

Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:

- (a) identify division of audit areas and common audit areas;
- (b) ascertain the reporting objectives of the engagement;
- (c) consider and communicate among all joint auditors the factors that are significant
- (d) in directing the engagement team's efforts;
- (e) consider the results of preliminary engagement activities, or similar engagements performed earlier.
- (f) ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

Question 3

Examine with reasons whether the following statements are correct or incorrect.

Joint auditor is always bound by the views of majority of the joint auditors regarding matters to be covered in report.

Answer 3

Incorrect- Where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s). Therefore, joint auditor is not bound by the views of the majority of the joint auditors regarding the matters to be covered in the audit report.

Question 4

HMB Limited's business has grown from one state of India to various countries of the world. Since the business has increased manifold, the management decided to appoint joint auditors for conducting the statutory audit of the company. They appointed three CA firms for it. For which audit work the joint auditors will be jointly & severally responsible?

Answer 4

Joint Audit of Financial Statements:

As per SA 299, "Joint Audit of Financial Statements", all the joint auditors shall be jointly and severally responsible for:

- (i) the audit work which is not divided among the joint auditors and is carried out by all joint auditors;

- (ii) decisions taken by all the joint auditors under audit planning in respect of common audit areas;
- (iii) matters which are brought to the notice of the joint auditors by any one of them and there is an agreement among the joint auditors on such matters;
- (iv) examining that the financial statements of the entity comply with the requirements of the relevant statutes;
- (v) presentation and disclosure of the financial statements as required by the applicable financial reporting framework;
- (vi) ensuring that the audit report complies with the requirements of the relevant statutes, applicable Standards on Auditing and other relevant pronouncements issued by ICAI.

Reporting Requirements under Companies Act

Question 1

During the audit of PQR Ltd. you as an auditor requested officers of the company to have access to secretarial records and correspondence which they refused to provide. Comment.

Answer 1

Right of Access to secretarial records and correspondence:

1. Section 143(1) of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books of account and vouchers of the company kept at Registered or Head Office, branches and subsidiaries in the case of a Holding Company for conducting the audit.
2. Further, he is also entitled to require from the officers of the company such information and explanations which he considers necessary for the proper performance of his duties as Auditor. Therefore, he has a statutory right to inspect the secretarial records and correspondence.
3. In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company. It is, therefore, essential for the auditor to refer to the secretarial records and correspondence which also includes Minute book. In the absence of the same, the auditor may not be able to vouch/verify certain transactions of the company.
4. The refusal to provide access to secretarial records and correspondence shall constitute limitation of scope as far as the auditor's duties are concerned.
5. The auditor may examine whether by performing alternative procedures, the auditor can substantiate the assertions or else he shall have to either qualify the report or give a disclaimer of opinion.

Question 2

The auditor has to make inquiries on certain matters under section 143(1) of Companies Act, 2013. Discuss those matters.

Answer 2

The auditor has to make inquiries on following matters under section 143(1) of Companies Act, 2013:-

- (a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;
- (b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

- (c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
- (d) whether loans and advances made by the company have been shown as deposits;
- (e) whether personal expenses have been charged to revenue account;
- (f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

Question 3

The auditor's reporting on internal financial control will be applicable with

respect to interim financial statements. Discuss Answer 3

Clause (i) of Sub-section 3 of Section 143 of the Act requires the auditors' report to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

It may be noted that auditor's reporting on internal financial controls is a requirement specified in the Act and, therefore, will apply only in case of reporting on financial statements prepared under the Act and reported under Section 143.

Accordingly, reporting on internal financial controls will not be applicable with respect to interim financial statements, such as quarterly or half-yearly financial statements, unless such reporting is required under any other law or regulation.

In view of above, the given statement is incorrect.

Question 4

The auditor shall make a report to the members of the company on the accounts examined by him. Explain with reference to relevant provisions of the Companies Act, 2013.

Answer 4

Right to report to the members of the company on the accounts examined by him – The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made there under or under any order made under this section and to the best of his information and

knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

Question 5

CA E was appointed statutory auditor of XYZ Private Limited in AGM held in the month of August, 2023 for the first time for audit of financial statements of the company from year 2023-24 onwards. Since he is new to the company, he wants to be sure about integrity of accounting records. In this regard, he wants to ensure that software used by company for maintenance of its books of accounts is capable of tracking user activities and changes made to entries in books of accounts, if any, during the course of year.

What CA E is looking for in the given situation? Discuss the reporting requirements for CA E in this matter to be included in audit report to be issued under the Companies Act, 2013.

Answer 5

In the given situation, the auditor is looking for a feature of "audit trail" in software used by company for maintenance of books of accounts. Under section 143(3) of Companies Act, 2013, it has to be reported by the auditor as under: -

Whether the company has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.

Question 6

Discuss significance of a company auditor's right/power to obtain information and explanation from officers of the company. (RTP Nov '21)

Answer 6

The right of the auditor to obtain from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor is a wide and important power. In the absence of such power, the auditor would not be able to obtain details of amount collected by the directors, etc. from any other company, firm or person as well as of any benefits in kind derived by the directors from the company, which may not be known from an examination of the books. It is for the auditor to decide the matters in respect of which information and explanations are required by him.

Therefore, such a right/power is quite significant for discharge of duty of an auditor of a company to report to the members of the company on accounts examined by him.

Question 7

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.

Answer 7

Section 143(1) of the Act provides that the auditor of a company, at all times, shall have a right of access to the books of account and vouchers of the company, whether kept at the registered office of the company or at any other place and he is entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor.

- (a) The right of access is not limited to those books and records maintained at the registered or head office so that in the case of a company with branches, the right also extends to the branch records, if the auditor considers it necessary to have access thereto as per Section 143(8).
- (b) In the given case where CA D was appointed as Statutory Auditor of Head office of RJ Ltd and CA M was appointed to conduct Statutory Audit of Branch office of RJ Ltd., CA D wanted to visit Mumbai Branch to verify the inventory records at Mumbai but management of RJ Ltd did not allow CA D to verify the inventory records at its Mumbai Branch on the ground that branch audit was already being undertaken by another CA M.
- (c) Keeping in view the above provisions of the Companies Act and facts of the case, it can be concluded that CA D has a right to visit the branch for verifying inventory records at Mumbai even if the branch accounts are audited by another auditor CA M, if he considers it necessary to do so for the performance of his duties as an auditor.

Question 8

During the course of audit of PQR Ltd, the statutory auditor CA G came across payments made to various creditors aggregating to ` 75 lakhs. On verifying the same it is found that the accounts manager had accounted for fake invoices of credit purchases for ` 25 lakhs in the books of account in the name of one bogus creditor Mr. X.

Discuss the duties of auditor with reference to the provisions of Companies

**Act,
2013 and also the disclosure requirements in the Board's Report.**

Answer 8

The auditor shall report under clause (xi) of the CARO, 2020 that:

Whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated;

Reporting to the Audit Committee or Board: Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than ` 1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub- rule (1) [i.e. less than ` 1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:

- (i) Nature of Fraud with description;
- (ii) Approximate amount involved; and
- (iii) Parties involved.

Question 1

Discuss the reporting requirements under CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares

Answer 1

The following are the disclosure requirements as per CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.

- (a) whether moneys raised by way of initial public offer or further public offer (including debt instruments) during the year were applied for the purposes for which those are raised, if not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported;
- (b) whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of noncompliance;

Question 2

Discuss which class of companies are specifically exempt from the applicability of CARO 2016 (CARO 2020).

Answer 2

CARO 2016 (CARO 2020) specifically exempts the following class of companies:

- (i) A banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;
- (ii) An insurance company as defined under the Insurance Act, 1938;
- (iii) A company licensed to operate under section 8 of the Companies Act;
- (iv) A One Person Company as defined under clause (62) of section 2 of the Companies Act;
- (v) A small company as defined under clause (85) of section 2 of the Companies Act; and
- (vi) A private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial

institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crores during the financial year as per the financial statements.

Question 3

M Ltd. has given certain loans to related parties and also has accepted certain deposits. As an auditor, how will you include the above items in paragraph 3 of CARO, 2016 (CARO 2020)

Answer 3

Clause (iii) of paragraph 3 of CARO, 2016 (CARO 2020) states

Whether the company has granted any loans, secured or unsecured to companies, firms, Limited Liability 2013. If so,

- (i) As follows-
 - (a) **Aggregate amount during the year, outstanding at the balance sheet date with respect to such loans and advances to subsidiaries, joint ventures and associates.**
 - (b) **Aggregate amount during the year, outstanding at the balance sheet date with respect to such loans and advances to parties other than subsidiaries, joint ventures and associates.**
- (ii) Whether the terms and conditions of the grant of such loans are not prejudicial to the company's interest;
- (iii) Whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular;
- (iv) if the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest;
- (v) Specify the amount of any Renew or Extension or Fresh Loan granted to settle the overdues of existing loans given to same parties.
- (vi) Reporting of any loan granted which are repayable on demand or without specifying any terms or period of payment.

Further, Clause (v) of paragraph 3 of CARO, 2016 (CARO 2020) states in case the company has accepted deposits,

- (i) whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any: other relevant provisions of the Companies Act, 2013 and the rules framed there under, where applicable, have been complied with? If not, the nature of such contraventions be stated;
- (ii) If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?

In the given situation, M Ltd. has given certain loans to related parties and also has accepted certain deposits. Thus, the auditor is required to report the same as per clause (iii) and (v) of Paragraph 3 of CARO, 2016 (CARO 2020).

Question 4

Provision of CARO, 2016 (CARO 2020) is not applicable to ABC Pvt. Ltd., a subsidiary of XYZ Ltd. (a public company) having fully paid up Capital and Reserves & Surplus of Rs. 50 lakhs, Secured loan from bank of Rs. 90 Lakhs and Turnover of Rs. 5 Crore, for the financial year 2018-19.

Answer

The CARO specifically **exempts** a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees 1 crore as on the balance sheet date and which does not have total borrowings exceeding rupees 1 crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees 10 crore during the financial year as per the financial statements. From the above, it is clear that ABC Pvt. Ltd. is a subsidiary of XYZ Ltd. and hence not exempt from CARO, 2016 (**CARO 2020**) although it is satisfying the conditions that allow exemption to private limited company which is not a subsidiary or holding company of a public company.

Question 5

State the matters to be included in auditor's report as per CARO, 2020 regarding

"Default in repayment of loan or borrowing to a financial institution, bank etc."

Answer 5

The auditor is required to report as per clause (ix) of paragraph 3 of CARO 2020

- (a) whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported as per the format below:-

Nature of borrowing, including debt securities	Name of lender	Amount not paid On due date	Whether principal or interest	No. of days delay or unpaid	Remarks, if any
	lender wise details to be provided in case of defaults to banks, financial institutions and Government.				

- (a) whether the company is a declared wilful defaulter by any bank or financial institution or other lender;
- (b) whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported;
- (c) whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated;
- (d) whether the company has taken any funds from any entity or person on account of or to meet the obligations of its subsidiaries, associates or joint ventures, if so, details thereof with nature of such transactions and the amount in each case;
- (e) whether the company has raised loans during the year on the pledge of securities held in its subsidiaries, joint ventures or associate companies, if so, give details thereof and also report if the company has defaulted in repayment of such loans raised;

Question 6

State the matters to be included in auditor's report as per CARO, 2020 regarding

- Verification of inventory and working capital limits. Answer 6

Matters to be included in Auditor's report as per CARO 2020:

(i) Clause (ii) of Para 3 of CARO, 2020, requires the auditor to report

- (a) whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;
- (b) whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

Question 7

Discuss the reporting requirements as per CARO, 2020, regarding:

- (i) **disputed and undisputed statutory dues**
- (ii) **internal audit system of the company Answer 7**

Matters to be included as per CARO, 2020:

Undisputed and Disputed Statutory dues Clause (vii)

- (a) whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income tax, sales- tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;
- (b) where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned (a mere representation to the concerned Department shall not be treated as a dispute).

Internal audit system Clause (xiv)

- (a) whether the company has an internal audit system commensurate with the size and nature of its business;
- (b) whether the reports of the Internal Auditors for the period under audit were considered by the statutory report.

Question 8

State with reason (in short) whether the following statements are true or false: According to Para 3(1)(d) of CARO, 2020, an auditor needs to report whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the

year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the

amount of change, if change is 5% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets.

Answer 8

Incorrect: According to Para 3(1)(d) of CARO, 2020, an auditor needs to report whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible asset.

Question 9

Explain the Reporting requirements the auditor should ensure under CARO 2020 related to PPE and Intangible assets.

Answer 9

Reporting for PPE and Intangible assets - Clause (i) of Para 3 of CARO ,2020, requires the auditor to include a statement in the auditor's report on the

following matters, namely -

- (a) (A) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of Property, Plant and Equipment;
- (B) whether the company is maintaining proper records showing full particulars of intangible assets;
- (b) whether these Property, Plant and Equipment have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- (c) whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company, if not, provide the details thereof in the format below:-

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

- (d) whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets;
- (e) whether any proceedings have been initiated or are pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, if so, whether the company has appropriately disclosed the details in its financial statements.

Question 10

State the matters to be included in the auditor's report as per CARO, 2020 regarding:

- (i) **Nidhi Company.**
- (ii) **Transactions with related parties.**

As per clause (xii) of CARO, 2020, the following matters are required to be included in the auditor's report relating to Nidhi Company

- (a) whether the Nidhi Company has complied with the Net Owned Funds to

Deposits in the ratio of 1:20 to meet out the liability.

- (b) whether the Nidhi Company is maintaining ten per cent. unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability;
- (c) whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof;

As per clause (xiii) of CARO, 2020, the following matter is required to be included in the auditor's report relating to transactions with the related parties:

whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards;

Question 11

The auditor's requirement to report under clause (X) of paragraph 3 of the Companies (Auditor's Report) Order, 2016 is restricted to frauds noticed or reported during the year. Explain what auditors may consider for reporting under this clause?

Answer 13

The auditor is required to report under clause (x) **(Clause xi)** of paragraph 3 of Companies (Auditor's Report) Order, 2016 **(CARO 2020)**,

Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:

- (i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified, the fraud by the company or on the company by its officers or employees are only covered.
- (ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.
- (iii) While reporting under this clause
 - (a) report whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;
 - (b) Whether any report under sub-section (12) of section 143 of the Companies Act, 2013 has been filed by the auditors in Form ADT-4.
 - (c) Whether auditor has considered whistle-blower complaints, if any

Question 14

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

Answer 14

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

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

Applying the above to the given case, G Pvt. Ltd., its paid-up capital and reserves are Rs.95 Lakh (C 120 Lakh - Rs.25 Lakh), borrowings from a Bank and financial institution are (C 55 Lakh + Rs.55 Lakh) i.e., Rs.1.10 Crore, turnover {including discontinuing operations (C 850 lakh + Rs.250 Lakh)} Rs.1100 Lakh i.e., Rs.11 Crore.

Since its borrowings and turnover are exceeding the specified limit and therefore it is not exempt from the applicability of CARO, 2020.

Question 15

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 15

Reporting Requirements under CARO 2020 for raising funds: As per clause (x)(b) of Para 3 of CARO, 2020, the auditor of a company has to report whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been

used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance.

In the present case, TS Ltd. has raised funds by issuing fully convertible debentures for expansion and diversification of the business. However, the company used the funds for repayment of long-term loans and advances instead of utilization of the same for the purpose for which the funds were raised i.e. expansion and diversification of business.

Here, the auditor should report the fact in his report that the funds were used for the purpose other than the purpose for which the funds were raised, as per clause (x)(b) of Para 3 of CARO, 2020.

Special Features of Audit of Different Type of Entities

Question 1

An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations

Answer 1

Receipt of Donations:

- (i) **Internal Control System:** Existence of internal control system particularly with reference to division of responsibilities in respect of authorised collection of donations, custody of receipt books and safe custody of money.
- (ii) **Custody of Receipt Books:** Existence of system regarding issue of receipt books, whether unused receipt books are returned and the same are verified physically including checking of number of receipt books and sequence of numbering therein.
- (iii) **Receipt of Cheques:** Receipt Book should have carbon copy for duplicate receipt and signed by a responsible official. All details relating to date of cheque, bank's name, date, amount, etc. should be clearly stated.
- (iv) **Bank Reconciliation:** Reconciliation of bank statements with reference to all cash deposits not only with reference to date and amount but also with reference to receipt book.
- (v) **Cash Receipts:** Register of cash donations to be vouched more extensively. If addresses are available of donors who had given cash, the same may be cross-checked by asking entity to post thank you letters mentioning amount, date and receipt number.
- (vi) **Foreign Contributions,** if any, to receive special attention to compliance with applicable laws and regulations.

Remittance of Donations to Different NGOs:

- (i) **Mode of Sending Remittance:** All remittances are through account payee cheques. Remittances through Demand Draft would also need to be scrutinised thoroughly with reference to recipient.
- (ii) **Confirming Receipt of Remittance:** All remittances are supported by receipts and acknowledgements.
- (iii) **Identity:** Recipient NGO is a genuine entity. Verify address, 80G Registration Number, etc.
- (iv) **Direct Confirmation Procedure:** Send confirmation letters to entities to

whom donations have been paid.

- (v) **Donation Utilisation:** Utilisation of donations for providing relief to Tsunami victims and not for any other purpose.
- (vi) **System of NGOs' Selection:** System for selecting NGO to whom donations have been sent.

Question 2

You have been appointed auditor of Dr. Prem Ratan Hospital. Discuss any eight important points that would attract your attention while audit. (MTP 4 Marks Oct '21)

OR

You have been appointed auditor of M/s. BLK Hospital. Discuss important points that would attract your attention while audit.

OR

A multi-specialty 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-specialty hospital.

Answer 2

Audit of Hospital: The special steps involved in such an audit are stated below-

1. **Register of Patients:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.
2. **Collection of Cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.
3. **Income from Investments, Rent etc.:** See 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.
4. **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 authorization.
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.

Question 3

BPL Ltd. is running a "RAGHU PALACE CINEMA." Your firm of Chartered Accountants has been appointed to get its accounts audited. Assistant appointed on the job to conduct audit asks the audit in charge as to how to go about conducting an audit and seeks your guidance on it. Keeping in view the above you are required to explain to the assistant special steps (any five) involved in the Audit of Cinema.

OR

You are auditing the Books of accounts of Karla Multiplex which runs 15 Film shows everyday. One of the major issues which are of concern to you as an auditor is the Agreement entered into the Multiplex owners with the Film Distributors. State what points would you check as an auditor in this respect.

Answer 3

The special steps involved in the audit of Cinema are stated below-

1. Verify the internal control mechanism-
 - a. that entrance to the cinema-hall during show is only through printed tickets;
 - b. that they are serially numbered and bound into books;
 - c. that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;

- d. that for advance booking a separate series of tickets is issued; and
 - e. that the inventory of tickets is kept in the custody of a responsible official.
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 and vouch and verify the entertainment tax returns filed each month.
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.
6. Verify the charges collected for advertisement slides and shorts by reference to the Register of Slides and Shorts Exhibited kept at the cinema as well with the agreements, entered into with advertisers in this regard.
7. Vouch the expenditure incurred on advertisement, repairs and maintenance. No part of such expenditure should be capitalized.
8. Confirm that depreciation on machinery and furniture has been charged at an appropriate rate.
9. Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.
10. Examine unadjusted balance out of advance paid to the distributors against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.
11. The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, etc. as in the case of club.

Question 4

LLP need not file a "Statement of Accounts and Solvency".

Answer 4

Incorrect: A LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. A "Statement of Accounts and Solvency" in prescribed form shall be filed by every LLP with the Registrar every year.

Question 5

Cine screen Multiplex Ltd. is operating cinemas in different locations in Mumbai and has appointed you as an internal auditor. What are the areas that need to be verified in relation to receipts from sale of Tickets?

OR

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 2021-2022. However, one of the team members is of the view that the internal control mechanism of the company should also be verified. Can you guide the audit team about the areas that will be covered in verifying the internal control mechanism?

Answer 5

Audit of Cinema: The special steps involved in its audit are stated below-

- (i) Verify that entrance to the cinema-hall during show is only through printed tickets;
- (ii) Verify that they are serially numbered and bound into books;
- (iii) Verify that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;
- (iv) Verify that for advance booking a separate series of tickets is issued;
- (v) Verify that the inventory of tickets is kept in the custody of a responsible official.
- (vi) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.
- (vii) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.
- (viii) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class.
- (ix) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

Question 6

The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. Explain.

Answer 6

Compile and submit Accounts of Union and States - The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. The Comptroller and Auditor General shall, from the accounts compiled by him or [by the Government or any other person responsible in that behalf] prepare in each accounts (including, in the case of accounts compiled by him, appropriation accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union Territory having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

The C&AG Act of 1971 has provisions for relieving him of this responsibility to give information and render assistance to the Union and States: The Comptroller and Auditor General shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

Question 10

GSR & Co. has been appointed as an auditor of Tagore School. Engagement team wants to verify Fees from students in detail. Advise the audit procedure to be followed by the engagement team.

Explain and also state the role of auditor with respect to the following in case of a school: The fees from the students.

Answer 6

Fee from Students :-

1. Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.
2. Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
3. Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
4. Check admission fees with admission slips signed by the head of the

institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.

5. See that free studentship and concessions have been granted by a person authorised to do so, having regard to the Rules prepared by the Managing Committee.
6. Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
7. Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

Question 7

The audit programme of NGO should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted. Explain.

Answer 7

The audit programme should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted.

1. **Corpus Fund:** The contributions / grants received towards corpus be vouched with special reference to the letters from the donor(s). The interest income be checked with Investment Register and Physical Investments in hand.
2. **Reserves:** Vouch transfers from projects / programmes with donors letters and board resolutions of NGO. Also check transfer of gross value of asset sold from capital reserve to general reserve and adjustments during the year.
3. **Ear-marked Funds:** Check requirements of donors institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.
4. **Project / Agency Balances:** Vouch disbursements and expenditure as per agreements with donors for each of the balances.
5. **Loans:** Vouch loans with loan agreements, counterfoil of receipt issued.
6. **Fixed Assets:** Vouch all acquisitions / sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/ agreements for the grant. In the case of immovable property check title, etc.
7. **Investments:** Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis - investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.
8. **Cash in Hand:** Physically verify the cash in hand and imprest balances, at the close of the year and whether it tallies with the books of account.
9. **Bank Balance:** Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.

10. **Inventory:** Verify inventory in hand and obtain certificate from the management for the quantities and valuation of the same.
11. **Programme and Project Expenses:** Verify agreement with donor/ contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.
12. **Establishment Expenses:** Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

Question 8

Briefly explain the provisions for qualification and appointment of Auditors under the Multi-State Co- operative Societies Act, 2002.

Answer 8

Qualification of Auditors -Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of Multi-State co-operative society.

However, the following persons are not eligible for appointment as auditors of a Multi-State co- operative society-

- (i) A body corporate.
- (ii) An officer or employee of the Multi-State co-operative society.
- (iii) A person who is a member or who is in the employment, of an officer or employee of the Multi- State co-operative society.
- (iv) A person who is indebted to the Multi-State co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the Multi- State co-operative society for an amount exceeding one thousand rupees.

If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be deemed to have vacated his office as such. **Appointment of Auditors** - Section 70 of the Multi-State Co-operative Societies Act, 2002 provides that the first auditor or auditors of a Multi-State co-operative society shall be appointed by the board within one month of the date of registration of such society and the auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. If the board fails to exercise its powers under this sub-section, the Multi-State co-operative society in the general meeting may appoint the first auditor or auditors.

The subsequent auditor or auditors are appointed by Multi-State co-operative society, at each annual general meeting. The auditor or auditors so appointed shall hold office from the conclusion of that meeting until the conclusion of the

next annual general meeting.

Question 9

All Non-Governmental Organisations (NGOs) registered under the Companies Act, 2013 are allowed to maintain accounts either on accrual basis or cash basis.

Answer 9

Incorrect: NGOs registered under the Companies Act, 2013 must maintain their books of account under the accrual basis as required by the provisions of section 128 of the said Act. If the accounts are not maintained on accrual basis, it would amount to non-compliance of the provision of the Companies Act, 2013. The NGOs which are not registered under the Companies Act, 2013 are allowed to maintain accounts either an accrual basis or cash basis.

Question 10

“Public moneys should not be utilised for the benefit of a particular person or section of the community”. List out the exceptions to this rule while audit against propriety.

Answer 10

Exceptions to the rule – Audit Against Propriety: Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

- (i) the amount of expenditure involved is insignificant; or
- (ii) a claim for the amount could be enforced in a Court of law; or
- (iii) the expenditure is in pursuance of a recognised policy or custom; and
- (iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

Question 11

- (i) **List out the types of Revenue Grants received by local bodies from the State. (MTP 2 Marks Nov '21)**
- (ii) **PQR Ltd., a government company, constructed a building in conformity with rules and regulations for installing a telephone exchange but not used for the same purpose resulting in the infructuous expenditure.**

Considering the above case, explain the type of expenditure audit to be performed to curb the situation.

Answer 11

- (i) **Revenue grants received by Local Bodies:**

Local bodies may receive different types of grants from the state

administration. Broadly the revenue grants are of three types:

1. **General purpose grants:** These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.
2. **Specific purpose grants:** These grants which are tied to the provision of certain services or performance of certain tasks.
3. **Statutory and compensatory grants:** These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

(ii) **Propriety audit:** According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Further, it may so happen that a transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned but may still be highly wasteful.

In the given situation, PQR Ltd. being a government company, constructed a building in conformity with rules and regulations for installing a telephone exchange but not used for the same purpose resulting in an infructuous expenditure.

Thus, propriety audit should be done for PQR Ltd. to bring out improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations to the notice of the proper authorities of wastefulness in public administration.

Question 12

Audit of government expenditure is one of the major components of government audit conducted by the office of R s . & AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Explain those standards.

OR

The audit of government expenditure is one of the major components of government audit. Explain the basic standards set for such audit of expenditure.

OR

An audit of Expenditure is one of the major components of Government Audit. In the context of 'Government Expenditure Audit', write in brief, what do you understand by:

- I. **Audit against Rules and Orders**
- II. **Audit of Sanctions**
- III. **Audit against Provision of Funds**
- IV. **Propriety Audit**
- V. **Performance Audit.**

Government Expenditure Audit: Audit of government expenditure is one of the

major components of government audit conducted by the office of C&AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorized by competent authority fixing the limits within which expenditure can be incurred. Briefly, these standards are explained below:

- (i) **Audit against Rules & Orders:** The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority.
- (ii) **Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorizing such expenditure.
- (iii) **Audit against Provision of Funds:** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made.
- (iv) **Propriety Audit:** It is required to be seen that the expenditure is incurred with due regard to broad and general principles of financial propriety. The auditor aims to bring out cases of improper, avoidable, or in fructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Audit aims to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions.
- (v) **Performance Audit:** This involves that the various programmers, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Efficiency- cum- performance audit, wherever used, is an objective examination of the financial and operational performance of an organization, programmer, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

Question 13

The Constitution of India contains no specific provisions regarding the appointment, salary and duties and powers of the C&AG. Moreover, the constitution does not guarantee the independence of the C&AG of India.

Answer 13

Incorrect: The Constitution of India contains specific provisions regarding the appointment, salary and duties and powers of the C&AG. The constitution guarantees the independence of the C&AG of India by prescribing that he shall be appointed by the President of India and shall not be removed from office except on the ground of proven mis-behaviour or incapacity.

Question 14

In carrying out audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertained to

the bank, there is no unrecorded income and the income is recorded at appropriate amount. Explain the Audit Approach and Procedures regarding following points in the above context :

- (i) **RBI's Directions**
- (ii) **Materiality**
- (iii) **Revenue Certainty**
- (iv) **Revenue Uncertainty**

Answer 14

Audit Approach and Procedures

- **Auditor's Concern:** In carrying out audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions, which took place during the relevant period and pertained to the bank, there is no unrecorded income and the income is recorded at appropriate amount.
- **RBI's Directions:** RBI has advised that in respect of any income which exceeds one percent of the total income of the bank if the income is reckoned on a gross basis or one percent of the net profit before taxes if the income is reckoned net of costs, should be considered on accrual as per Accounting Standard 9.
- **Materiality:** If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify their report in that situation.
- **Revenue Certainty:** Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In modern day banking, the entries for interest income on advances are automatically generated through a batch process in the CBS system.
- **Revenue Uncertainty:** In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also.

Question 15

Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is,

however, not the function of audit to prescribe what such rules, regulations and orders shall be. Analyse and Explain

Answer 15

Audit against Rules & Orders - Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories:

- (i) Rules and orders regulating the powers to incur and sanction expenditure from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);
- (ii) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and
- (iii) Rules and orders regulating the conditions of service, pay and allowances, and pensions government servants.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

they are not inconsistent with any provisions of the Constitution or any laws made thereunder;

- (a) they are consistent with the essential requirements of audit and accounts as determined by the C&AG;
- (b) they do not come in conflict with the orders of, or rules made by, any higher authority; and
- (c) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C&AG.

Question 16

What are the special steps involved in conducting the audit of an Educational Institution?

Answer 16

The Special Steps Involved in the Audit of an Educational Institution are the following:

- (i) Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.
- (ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.
- (iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.
- (iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
- (v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
- (vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.
- (vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.
- (viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.
- (ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.
- (x) Verify rental income from landed property with the rent rolls, etc.
- (xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
- (xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.

- (xiii) Report any old heavy arrears on account of fees, dormitory rents, etc, to the Managing Committee.
- (xiv) Confirm that caution money and other deposits paid by students on admission have been shown as liability in the balance sheet and not transferred to revenue.
- (xv) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.
- (xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.
- (xvii) Vouch donations, if any, with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.
- (xviii) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.
- (xix) Vouch in the usual manner all establishment expenses and enquire into any unduly heavy expenditure under any head.
- (xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.
- (xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
- (xxii) Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. These should be checked by reference to Inventory Register and values applied to various items should be test checked.
- (xxiii) Confirm that the refund of taxes deducted from the income from investment (interest on securities, etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.
- (xxiv) Verify the annual statements of accounts and while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of Staff, etc.

Question 17

State the points which merit consideration in the audit of a CLUB w.r.t its members.

Answer 17

The 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 and counterfoils issued to them, on a reference to minutes of the Managing Committee.
- 2. **Member 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. **Subscription Arrears/in Advance:** Ensure that –
 - **arrears** of subscriptions for the previous year have been correctly brought over,
 - **arrears** for the year under audit and subscriptions received in advance have been correctly adjusted.
 - Subscriptions received in advance should have been properly accounted for.
- 4. **Arithmetical accuracy:** Check totals of various columns of the Register of members and tally them across.
- 5. **Register of Members:** 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. **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.

Question 18

As an auditor, explain the areas of consideration while auditing the element of ROOM SALES during the audit of a 5-Star Hotel.

Answer 18

Following points merit consideration while auditing the element of ROOM SALES during the audit of a Hotel:-

1. The charge for room sales is normally posted to guest bills by the receptionist/ front office or in the case of large hotels by the night auditor.
2. The source of these entries is the guest register and audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period.
3. Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been

properly authorised.

4. In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room. This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill.
5. Ensure compliance with the provisions of FEMA and RBI if receipts are in foreign currency. Ensure application of proper Conversion rate.
6. Special emphasis to be laid on receipts through Credit Cards.
7. The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.

Question 20

As an Auditor of NGO, how do you check/verify at least four receipts of income during the year?

Answer 20

The receipt of income of NGO may be checked on the following lines:

- (i) **Contributions and Grants for projects and programmes:** Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.
- (ii) **Receipts from fund raising programmes:** Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.
- (iii) **Membership Fees:** Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.
 - (i) **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.
 - (ii) **Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.

Question 21

Central Govt. holds 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.

Answer 21

Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi-State co-operative society. Under section 77 of the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:

- (i) that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles; or
- (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.

Thus, in the given case since Central Govt is holding 55% shares and financial position of Kisan Credit co- operative society is in danger, Central government can direct for special audit.

Question 22

Before commencing the Audit of Local Bodies, a Chartered Accountant employee in firm of XYZ & Co., firm of Chartered Accountants seeks assistance of Mr. X, partner, in preparation of audit programme for local bodies. How Mr. X should advise to him in this connection?

Answer 22

Audit Programme for local bodies

- (i) The Local Fund Audit Wing of the State Government is generally in-charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure his appointment.
- (ii) The auditor while auditing the local bodies should report on the fairness of the contents and presentation of financial statements, the strengths and weaknesses of system of financial control, the adherence to legal and/or administrative requirements; whether value is being fully received on money spent. His objective should be to detect errors and fraud and misuse of resources.
- (iii) The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.

- (iv) He should ensure that all types of sanctions, either special or general, accorded by the competent authority.
- (v) He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.
- (vi) The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

Question 23

You have been appointed as an auditor of ABC Hotel, a three-star hotel, for Financial Year 2022-23. As an auditor, what are the special points that need to be considered in verifying the Inventories in the nature of food and beverages?

Answer 23

Verification of inventories in the nature of food and beverages:

The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores' areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed. Therefore, following points may be noted in this regard:

- (i) All movement and transfer of inventories must be properly documented.
- (ii) Areas where inventories are kept must be kept locked and the key retained by the departmental manager.
- (iii) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.
- (iv) Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.
- (v) The auditor should ensure that all inventories are valued at the year end and that he should himself be present at the year-end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories.

Question 24

Explain in detail the duties of Comptroller and Auditor General of India

Answer 24

Duties of C&AG: The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under-

- (i) **Compile and submit Accounts of Union and States** - The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices

under his control by treasuries, offices or departments responsible for the keeping of such account.

(ii) **General Provisions Relating to Audit - It shall be the duty of the C&AG –**

- (a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;
- (b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;
- (c) to audit and report on all trading, manufacturing profit and loss accounts and balance- sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) **Audit of Receipts and Expenditure** - Where anybody or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

(iv) **Audit of Grants or Loans** - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organization, the Comptroller and Auditor General shall scrutinize the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

(v) **Audit of Receipts of Union or States** - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated

Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.

(vi) **Audit of Accounts of Stores and Inventory** - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

(vii) **Audit of Government Companies and Corporations** - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The comptroller and Auditor - General of India shall appoint the auditor under sub-section (5) or sub- section

(7) of section 139 (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

Question 25

- (a) **As per Multi-State Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance- sheet or profit and loss account. Explain**
- (b) **Explain the powers and duties of auditors under the Multi-State Co-operative Societies Act, 2002.**

Answer 25

- (a) As per sub-section (3) & (4) of section 73 of Multi- state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co- operative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:
- (a) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and
- (b) In the case of the profit and loss account, of the profit or loss for its financial year. The auditor's report shall also state:
- (i) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.
- (ii) Whether, in his opinion, proper books of account have been kept by the Multi- State co- operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from

branches or offices of the Multi-State co-operative society not visited by him.

- (iii) Whether the report on the accounts of any branch office audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.
- (iv) Whether the Multi-State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.

Where any of the matters referred to in sub-section (3) or (4) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

- (c) Section 73 of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors. According to this, every auditor of a Multi-State co-operative society shall have a right of access at all times to the books accounts and vouchers of the Multi-State co-operative society, whether kept at the head office of the Multi-State co-operative society or elsewhere, and shall be entitled to require from the officers or other employees of the Multi-State co-operative society such information and explanation as the auditor may think necessary for the performance of his duties as an auditor.

As per section 73(2), the auditor shall make following inquiries:

- (a) Whether loans and advances made by the Multi-State co-operative society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi-State co-operative society or its members,
- (b) Whether transactions of the Multi-State co-operative society which are represented merely by book entries are not prejudicial to the interests of the Multi-State co-operative society,
- (c) Whether personal expenses have been charged to revenue account, and
- (d) Where it is Stated in the books and papers of the Multi-State co-operative society that any shares have been allotted for cash, whether cash has actually, been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet as correct regular and not misleading.

Question 26

Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanor to its logical end. Explain (RTP May '21)

Answer 26

Government audit is neither equipped nor intended to function as an investigating

agency, to pursue every irregularity or misdemeanor to its logical end. The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration. In India, the function of Government Audit is discharged by the independent statutory authority of the **Comptroller and Auditor General** through the agency of the **Indian Audit and Accounts Department**. Audit is a necessary function to ensure accountability of the executive to Parliament, and within the executives of the spending agencies to the sanctioning or controlling authorities. The purpose or objectives of audit need to be tested at the touchstone of public accountability. The Comptroller and Auditor General (C&AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.

Question 27

While planning the audit of an NGO, the auditor may focus on Knowledge of the NGO's work, its mission and vision, Updating knowledge of relevant statutes especially with regard to recent amendments, circulars etc. Explain the other relevant points the auditor needs to focus while planning the audit of NGO.

Answer 27

While planning the audit, the auditor may concentrate on the following:

- (i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operates.
- (ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 1976, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.
- (iii) Reviewing the legal form of the Organization and its Memorandum of Association, Articles of Association, Rules and Regulations.
- (iv) Reviewing the NGO's Organization chart, then Financial and Administrative Manuals, Project and Programmed Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
- (v) Examination of minutes of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.
- (vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
- (vii) Setting of materiality levels for audit purposes.
- (viii) The nature and timing of reports or other communications.
- (ix) The involvement of experts and their reports.
- (x) Review the previous year's Audit Report.

Question 28

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

If LLP (Limited Liability Partnership Firm) is appointed as an auditor of a company, every partner of a firm shall be authorized to act as an auditor.

Answer 28

Incorrect: As per section 141(2) of the Companies Act, 2013, where a firm including a limited liability partnership (LLP) is appointed as an auditor of a company, only the partners who are Chartered Accountants shall be authorized to act and sign on behalf of the firm.

Question 29

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

The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971

Answer 29

Incorrect The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013.

Question 30

No inspection under Section 79 of Multi-State Co-operative Societies Act, 2002 shall be made unless a notice has been given to the multi-state co-operative society. Explain stating clearly when and how such inspection can be made. Also state the powers available with the Central Registrar in this regard along with provisions relating to communication of the inspection report under the said section. (RTP May '22)

Answer 30

(a) Inspection of Multi-State Co-operative societies under Section 79

1. **When:** The Central Registrar may, on a request from
 - (i) federal co-operative to which a Multi-State Co-operative society is affiliated or a creditor or
 - (ii) not less than one-third of the members of the board or
 - (iii) not less than one-fifth of the total number of members of a Multi-State co-operative society
2. **How:** By general or special order in writing in this behalf inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into the constitution, working and financial

condition of a Multi-State co-operative society.

3. **Opportunity of Being heard:** No inspection shall be made unless a notice of not less than fifteen days has been given to the multi-state co-operative society.
4. **Powers available:** The Central Registrar or the person authorized by him shall have the following powers:
 - (a) **Powers** He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, take them into custody and shall have power to verify the cash balance of the society and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary.
 - (b) Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.
5. **Inspection Report:** A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection.

Question 31

State six important advantages of audit of accounts of a Partnership firm. (RTP Nov '23)

Answer 31

Advantages of Audit of Accounts of a Partnership: On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows:

- 1) Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated. On this consideration, it is usually provided in and accepted by the partners, shall be binding upon them, unless some manifest error is brought to light within a specified period subsequent to the accounts having been signed.
- 2) On the retirement or death of a partner, audited accounts, which have been accepted by the partners, constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.
- 3) The accounts of a partnership, which have been audited, are generally accepted by the Income Tax Department as the basis for computing the assessable income of the partners.
- 4) Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as

evidence of the profitability of the concern and its financial position.

- 5) Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.
- 6) An audit is an effective safeguard against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

Question 32

State the objectives of audit of Local Bodies. Answer 32

Objective of Audit of Local Bodies: The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. The municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit. The important objectives of audit are:

- (i) reporting on the fairness of the content and presentation of financial statements;
- (ii) reporting upon the strengths and weaknesses of systems of financial control;
- (iii) reporting on the adherence to legal and/or administrative requirements;
- (iv) reporting upon whether value is being fully received on money spent; and
- (v) detection and prevention of error, fraud and misuse of resources

Question 33

In the case of audit of a charitable institution, what attentions should be paid by the auditor regarding audit of expenditure items?

OR

CA B is appointed as the auditor of a Public Charitable Trust. Guide him the focus area of attention relating to the vouching and verification of expenditure of charitable institution.

Answer 33

Audit of Expenditure of Charitable Institution:

- (i) Vouching payment of grants also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and that no trustee, director or member of the management committee has benefited there from either directly or indirectly.
- (ii) Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test basis.
- (iii) Check payment along with supporting documents in regard to salary and

other expenses. Verify that all payments are made after proper sanction by appropriate authority.

- (iv) Ascertaining that any funds contributed for a special purpose have been utilized for the purpose.
- (v) Verifying the cash and bank balances/payments.

Question 34

Explain the different types of revenue grants which local bodies may receive.

Answer 34

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.

Question 35

You have been appointed as an auditor of VJM Schools. Discuss the points which merit your consideration as an auditor while verifying Assets and Liabilities of VJM Schools.

Answer 35

Verification of Assets & Liabilities of VJM Schools:

1. Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.
2. Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet and not transferred to revenue, unless they are not refundable.
3. See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus. Ascertain that the system ordering inspection on receipt and issue of provisions, food stuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
4. Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.

Question 36

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?

Answer 36

Audit of a Hospital:

A. Receipts from treatment of patients

- a. **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.
- b. **Collection of Cash from patients:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patient's bills.

B. Donations from donors to treat the patients: Ascertain those legacies and donation received for a specific purpose have been applied in the manner agreed upon.

C. Capital Expenditure Incurred: Verify the Capital Expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee.

D. Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income tax .

This involves

- (i) vouching the Income-tax refund with the correspondence with the Income-tax Department; and
- (ii) checking the calculation of the repayment of claims/refund claim.

Question 37

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?

Answer 37

Definition of Municipality & Expenditure incurred by it: Definition: A Municipality can be defined as a unit of local self-government in an urban area. By the term 'local self-government' is ordinarily understood the administration of a locality – a village, a town, a city or any other area smaller than a state – by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.

Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads:

- (a) general administration and revenue collection,
- (b) public health,
- (c) public safety,
- (d) education,
- (e) public works, and
- (f) others such as interest payments, etc.

Question 38

Ban LLP is formed during the year 2021-22. 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?

Answer 38

Books of Accounts Ban LLP is required to maintain: An LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. LLPs are required to maintain books of accounts which shall contain-

1. Particulars of all sums of money received and expended by the LLP and the matters in respect of which the receipt and expenditure takes place,
2. A record of the assets and liabilities of the LLP,
3. Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,
4. Any other particulars which the partners may decide.

Question 39

In the case of Co-operative societies, contribution to Education fund is a charge on profits and not an appropriation.

Answer 39

Correct: Some of the State Acts provide that every society shall contribute annually towards the Education Fund of the State Federal Society, at the appropriate rate as per the class of the society. Therefore, contribution to Education Fund is a charge on profits and not an appropriation.

Question 40

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.

Answer 40

Performance audit - The scope of the audit has been extended to cover efficiency, economy and effectiveness audit or performance audit, or full scope audit.

Efficiency audit looks into whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them, i.e., the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner.

Economy audit looks into whether the government has acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy.

Effectiveness audit is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives.

Efficiency- cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.

Chapter 10

Audit of Banks

Question 1

The engagement team of FRN & Co.- Auditors of Bank of Baroda held discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.

The discussion between the members of the engagement team and the audit engagement partner are being done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit.

Analyse and Advise the matters to be discussed in the engagement team discussion.

Answer 1

The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference. The discussion provides:

- An opportunity for more experienced engagement team members, including the audit engagement partner, to share their insights based on their knowledge of the bank and its environment.
- An opportunity for engagement team members to exchange information about the bank's business risks.
- An understanding amongst the engagement team members about effect of the results of the risk assessment procedures on other aspects of the audit, including decisions about the nature, timing, and extent of further audit procedures.

The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's financial statements to material misstatements. These discussions are ordinarily done at the planning stage of an audit

The engagement team discussion ordinarily includes a discussion of the following matters:

- Errors that may be more likely to occur;
- Errors which have been identified in prior years;
- Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
- Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;
- Need to maintain professional skepticism throughout the audit engagement;
- Need to alert for information or other conditions that indicates that a

material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

Question 2

In the case of a nationalised bank, the auditor is required to make a report to the Central Government. The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalised bank. Explain what would the auditor state in his report.

Answer 2

In the case of a nationalised bank, the auditor is required to make a report to the Central Government in which he has to state the following:

- (a) whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;
- (b) whether or not the transactions of the bank, which have come to his notice, have been within the powers of that bank;
- (c) whether or not the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit;
- (d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and
- (e) any other matter which he considers should be brought to the notice of the Central Government.

The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalized bank.

Question 3

Your firm of Chartered Accountants has been appointed as the Auditor of two branches of OBC which are located in the Industrial area. Considering that the location of the branches of bank in industrial area, these would be "advances oriented branches and audit of advances would require the major attention of the auditors. Advise how would you proceed to obtain evidence in respect of audit of advances.

Answer 4

- (a) **Audit of Advances:** Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors. In carrying out audit of advances, the auditor is primarily

concerned with obtaining evidence about the following:

- (a) Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
 - (b) Advances represent amount due to the bank.
 - (c) Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
 - (d) There are no unrecorded advances.
 - (e) The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
 - (f) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
 - (g) Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.
- (b) The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:
- examining the validity of the recorded amounts;
 - examining loan documentation;
 - reviewing the operation of the accounts;
 - examining the existence, enforceability and valuation of the security;
 - checking compliance with RBI norms including appropriate classification and provisioning; and
 - carrying out appropriate analytical procedures.

Question 4

There are different types of banks prevailing in India. Explain giving examples of such banks.

Answer 4

There are different types of banking institutions prevailing in India which are as follows:

Commercial Banks	Regional Rural Banks
Co-operative Banks.	Payment Banks.
Development Banks (more commonly known as 'Term-Lending Institutions').	Small Finance Banks.

- 1) **Commercial banks** are the most wide spread banking institutions in India, that provide a number of products and services to general public and other segments of economy. Two of its main functions are:-
 - a. accepting deposits and
 - b. granting advances.
- 2) **Regional Rural Banks** known as **RRBs** are the banks that have been set up in rural areas in different states of the country to cater to the basic banking and financial needs of the rural communities. **Examples are:-** Punjab Gramin Bank , Tripura Gramin Bank , Allahabad UP Gramin Bank , Andhra Pradesh Grameen Vikas Bank, etc.
- 3) **Co-operative Banks** function like Commercial Banks only but are set up on the basis of Cooperative Principles and registered under the Cooperative Societies Act of the respective state or the Multistate Cooperative Societies Act and usually cater to the needs of the agricultural and rural sectors. **Examples are :-** The Gujarat State Co-operative Bank Ltd. , Chhatisgarh Rajya Sahakari Bank Maryadit , etc.
- 4) **Payments Banks** are a new type of banks which have been recently introduced by RBI. They are allowed to accept restricted deposits but they cannot issue loans and credit cards. However, customers can open Current & Savings accounts and also avail the facility of ATM cum Debit cards , Internet-banking & Mobilebanking. **Examples are:-** Airtel Payments Bank , India Post Payments Bank, Paytm Payments Bank, etc.
- 5) **Development Banks** had been conceptualized to provide funds for infrastructural facilities important for the economic growth of the country.

Examples are:- Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI) , etc.
- 6) **Small Finance Banks** have been set up by RBI to make available basic financial and banking facilities to the unserved and **unorganised** sectors like small marginal farmers, small & micro business units, etc. **Examples are:-** Equity as Small Finance Bank , AU Small Finance Bank , etc.

Question 5

In case of a Bank, explain the meaning of Funded loans. Also give examples.

Answer 5

Funded loans are those loans where there is an actual transfer of funds from the bank to the borrower.

Advances comprise of funded amounts by way of:

- Term loans
- Cash credits, Overdrafts, Demand Loans
- Bills Discounted and Purchased

- Participation on Risk Sharing basis
- Interest-bearing Staff Loans

Question 6

Banks ask Security or Collateral while lending to assure that the Borrower will return the money to bank in prescribed time. Explain stating clearly the concept of Primary and Collateral Security. Also give examples of most common types of securities accepted by banks.

OR

Mr. A approaches a bank for financial assistance for his upcoming project. The Bank Branch Manager, after verifying the proposal, is agreeable to financing Mr. A, but asks for the security to be offered to the bank. Discuss the nature of securities required to be offered to the bank.

Answer 6

Banks ask Security or Collateral while lending to assure that the Borrower will return the money to bank in prescribed time else the Banks have legal authority to sell the collateral to recover its money.

Nature of Security

- A. Primary security** refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.
- B. Collateral security** is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following:

- Personal Security of Guarantor
- Goods/Stocks/Debtors/Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property
- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Banker's General Lien
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments

Question 6

"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 nationalized bank stating clearly the provision percent required.

Answer 6

Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Further, asset classification would be borrower-wise and not facility-wise. All facilities including investments in securities would be termed as NPA.

There are different provisioning requirements as regards to categories of NPA such as Sub- standard assets, Doubtful assets and loss assets which are given below:

Categories of Non-Performing Assets:	Provision required
♦ Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months.	15%
♦ Doubtful Assets: Would be one, which has remained in the substandard category for a period of 12 months.	Secured+ Unsecured
♦ Sub-categories: Doubtful up to 1 Year (D1) Doubtful 1 to 3 Years (D2) Doubtful more than 3 Years (D3)	25% + 100% 40% + 100% 100% + 100%
♦ Loss Assets: Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Question 7

Explain “Advances under Consortium” in the context of Prudential Norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances.

Answer 10

Advances under Consortium: Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

The banks participating in the consortium, therefore, need to arrange to get their

share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

Question 8

When is an agricultural advance considered as non performing as per the RBI guidelines?

Answer 8

As per the guidelines, Agricultural Advances are of two types:

- 1) Agricultural Advances for “long duration” crops; and
- 2) Agricultural Advances for “short duration” crops.

The “long duration” crops would be crops with crop season longer than one year and crops, which are not “long duration” crops would be treated as “short duration” crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers’ Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons; and
- A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

Question 9

Explain hypothecation and assignment as the modes of creation of security with respect to advance granted by a bank.

Answer 9 Hypothecation:

The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

Neither ownership nor possession is transferred to the bank. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank. The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

Assignment:

Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favor of another person. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life

insurance policies are accepted by banks as security by way of assignment. An assignment gives the assignee absolute right over the moneys/debts assigned to him.

Question 10

The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. Explain this statement

Answer 10

The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, inter alia, the following:

- The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
- All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- The compliance with the terms of sanction and end use of funds should be ensured.
- Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
- If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
- All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
- In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
- Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- The accounts should be kept within both the drawing power and the sanctioned limit.
- All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.

- The operation of each advance account should be reviewed at least once a year and at more frequent intervals in the case of large advances.

Question 11

When are following considered as non performing as per the RBI guidelines?

- Government guaranteed advances**
- Advances to staff**

Answer 11

Government Guaranteed advances:

- Central Govt. guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets, but regarded as NPA for Income Recognition purpose
- The situation would be different if the advance is guaranteed by State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

Advances to Staff

Interest-bearing staff advances as a banker should be included as part of advances portfolio of the bank. In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards. Such loans/ advances should be classified as NPA only when there is a default in repayment of installment of principal or payment of interest on the respective due dates. The staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets.

Question 12

Explain pledge and set off as the modes of creation of security with respect to advance granted by a bank.

Answer 12

Pledge: A pledge involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods. The pledge of goods constitutes a specific (or fixed) charge.

Set-off: Set-off is a statutory right of a creditor to adjust, wholly or partly, the debit balance in the debtor's account against any credit balance lying in another account of the debtor. The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same).

For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

Question 13

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

Classification as NPA should be based on the availability of security and asset classification would be facility wise and not borrower wise.

Answer 13

Incorrect: Classification as NPA should be based on the record of recovery. Availability of security or net worth of borrower/guarantor is not to be taken into account for purpose of treating an advance as NPA or otherwise. Asset classification would be borrower-wise and not facility-wise.

Question 14

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

Banks recognize income on Non-Performing Assets on accrual basis. Answer 14

Incorrect: Income from non-performing assets (NPA) is not recognised on accrual basis due to its uncertainty but is booked as income only when it is actually received.

Question 15

CA X is acting as concurrent auditor of a branch of KLT Bank (a nationalized bank) located in Delhi during the year 2022-23. The assignment started from 1st October 2022 and is for a period of one year. By virtue of this assignment, he is required to issue monthly reports on different aspects of the functioning of branch including deposits, advances and housekeeping to controlling authorities of Bank. At the end of March, 2023, he has got an offer to conduct statutory audit of two branches of KLT Bank located in the State of Rajasthan for the year 2022-

23. Can he accept the above offer? Discuss. Answer 15

In the given situation, CA X has undertaken concurrent audit assignment of KLT Bank which is in the nature of internal assignments.

In accordance with RBI guidelines, statutory audit assignments should not be undertaken by auditors while being associated with internal assignments in bank during the same year like concurrent audits (Internal audits of banks conducted monthly during the year).

As CA X is associated with KLT Bank as concurrent auditor, he should not accept statutory audit assignment of same bank even though it relates to different branches of the bank.

Question 16

While conducting statutory audit of branch of a nationalized bank, it is noticed by CA Z that credit facilities granted to a borrower consisting solely of term loan have been classified as "Sub-standard Asset" during the year 2022-23 due to failure of borrower to pay EMIs on time. Such EMIs were outstanding for more than 90 days and account was, therefore, classified as "Sub-Standard Asset". CA Z has also agreed to above asset classification made by branch management.

What are CA Z's responsibilities regarding verification of compliance with income recognition norms by branch in respect of above credit facilities? (MTP 3 Marks Oct'23)

Answer 16

RBI norms stipulate that if any advance account becomes NPA as at close of any year, the entire interest accrued or credited to income account in past periods should be reversed or provided for, if the same is not realized.

Further, in respect of NPAs, fees, commission and other similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

In the given case, account has turned Sub-standard asset which is a type of NPA. Therefore, auditor should make compliance of above norms relating to income recognition.

Question 17

In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realized. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also. Analyse and Explain.

Answer 17 Reversal of Income:

If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realized. This will apply to Government guaranteed accounts also. In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected. Further, in case of banks which have wrongly recognized income in the past should reverse the interest if it was recognized as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired

whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

Question 18

State with reason (in short) whether the following statements are true or false: The policy of income recognition, in case of a Bank, should be subjective

Answer 18

Incorrect: The policy of income recognition should be objective and based on record of recovery rather than on any subjective considerations. Income from non-performing assets (NPA) is not recognized on accrual basis but is booked as income only when it is actually received

Question 20

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

The assignment is the creation of an equitable charge which is created in favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower

Answer 20

Incorrect: The hypothecation is the creation of an equitable charge (i.e., a charge created not by an express enactment but by equity and reason), which is created in favor of the lending bank by execution of hypothecation agreement in respect of the moveable securities belonging to the borrower.

Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favor of another person.

Question 21

Your firm of auditors, SRG & Co., has been appointed as Statutory Central Auditors of Reliable Bank. Explain the reporting requirements of the Statutory Central Auditors (SCAs) in addition to their main audit report.

Answer 21

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

- (i) Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(I) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.
- (ii) Long Form Audit Report. (LFAR)

- (iii) Report on compliance with SLR requirements.
- (iv) Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
- (v) Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
- (vi) Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.
- (vii) Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jelani Committee on internal control and inspection/credit system.
- (viii) Report on instances of adverse credit-deposit ratio in the rural areas.

Question 22

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

A loan granted for short duration crops will be treated as NPA, if the installment of principal or interest thereon remains overdue for one crop season.

Answer 22

Incorrect: A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

Question 23

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

It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the RBI and agreed upon by the concerned statutory auditors. Special consideration need not be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

Answer 23

Incorrect: It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

Question 24

CA. Puranjay is appointed as statutory branch auditor of two branches of a nationalized bank for year 2021-22. During the course of audit, he came across the following:

While verifying advances of one semi-urban branch, he noticed substantial number of accounts categorized as SMA (Special mention accounts). In this context, explain the nature and significance of SMA. (RTP Nov'22)

Answer 24

Special Mention accounts (SMA) are those accounts which are resulting signs of incipient stress leading to the possibility that borrowers may default on debt obligations. These are in the nature of warning system to alert the banks about probable NPAs so that remedial action can be taken before accounts actually turn NPAs. Therefore, their significance lies in the fact that proper and timely identification of SMAs can help in preventing turning potential NPAs into actual NPAs.

Question 26

TEP Industries Private Limited, a company engaged in obtaining rice from paddy, is enjoying a cash credit facility against hypothecation of paid stocks and book debts (eligible up to 90 days only) from LMV Bank for 4.00 crore. The letter sanctioning the above credit facility stipulates margin @ 25% on stocks and @ 40% on eligible book debts up to 90 days.

While preparing stock statement as on 30.6.23, accountant of the company calculates value of stocks for Rs. 5 crore (including Rs. 1 crore of rice which was lying in a low lying godown and was completely damaged during recent floods caused by river Yamuna). Debtors outstanding as on 30.6.23 are Rs. 3 crore (including Rs. 50 lacs outstanding for last 6 months). Trade creditors outstanding as on date are

Rs. 2 crore. He calculates DP as on 30.6.23 for Rs. 3.30 crore. Is he correct? Justify with your workings. What does drawing power calculated by you signify to the borrower company? (RTP Nov '23)

Answer 26

The calculation of DP is as under

Value of stocks as on 30.6.23	5.00 crore
Less: value of damaged stocks	1.00 crore
Value of stocks considered as on 30.6.23	4.00 crore
Less: Trade creditors	2.00 crore
Paid stocks	2.00 crore
Less: Margin @ 25%	0.50 crore
Drawing power for stocks [A]	1.50 crore
Value of Trade debtors	3.00 crore

Less: Debtors outstanding for more than 90 days	0.50 crore
	2.50 crore
Less: Margin @ 40%	1.00 crore
Drawing power for Book debts [B]	1.50 crore
Total drawing power [A+ B]	3.00 crore

Accountant's DP calculation is not correct. The drawing power of Rs.3.00 crore signifies that company can utilize funds to the tune of Rs. 3.00 crore only against sanctioned cash credit limit of Rs.4.00 crore.

Question 27

You are appointed as an auditor of Banking Co., and hold discussions with engagement team. List out matters which you would discuss at the planning stage of an audit to gain better understanding of the bank and its environment.

Answer 27

The engagement team discussion ordinarily includes a discussion of the following matters:

- (i) Errors that may be more likely to occur;
- (ii) Errors which have been identified in prior years;
- (iii) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
- (iv) Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;
- (v) Need to maintain professional skepticism throughout the audit engagement;
- (vi) Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

Question 28

Compute the Drawing Power for Cash Credit A/c of S Limited for the month of March 2022 with following information:

(Amount in C)

Stock	50,000
Debtors (Including Debtor of Rs.5,000 for an invoice dated 17.11.2021)	45,000
Sundry creditors	15,000
Sanctioned Limit	45,000
Margin on stock is 20% and on debtors is 50%. Note: Debtors older than 3 months are ineligible for calculation of DP.	

Answer 28

Computation of Drawing Power:

Computation of Drawing Power for CC A/c of S Ltd.

Particulars of current assets		Amount (C)	DP Amt (C)
(A) Stocks:			
Stocks at realizable value		50,000	
Less: Unpaid stocks:			
- Sundry creditors	15000	15000	
Paid for stocks		35000	
Margin @ 20%		7000	28000
(B) Debtors:			
Total Debtors		45000	
Less: Ineligible debtors		5000	
Eligible debtors		40000	
Margin @ 50%		20000	20000
Total Drawing Power			48000

The sanctioned limit given in the Question is Rs. 45000 whereas drawing power as per the above working is Rs. 48000. So, drawing power would be restricted to sanctioned limit i.e. 45000

Question 29

“Ramjilal & Co. had been allotted the branch audit of a nationalized bank for the year ended 31st March, 2018. In the audit planning, the partner of Ramjilal & Co., observed that the allotted branches are predominantly based in rural areas and major portion of the advances were for agricultural purpose.”

Now he needs your assistance on the following points so as to incorporate them in the audit plan:

- (i) **for determination of NPA norms for agricultural advances**
- (ii) **for accounts where there is erosion in the value of security/frauds committed by the borrowers.**

Answer 29

- (i) **NPA norms for Agricultural Advances:** As per the guidelines, Agricultural Advances are of two types, (1) Agricultural Advances for “long duration” crops and (2) Agricultural Advances for “short duration” crops.

The “long duration” crops would be crops with crop season longer than one year and crops, which are not “long duration” crops would be treated as “short duration” crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers’ Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons and,
 - A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.
 - Accounts where there is erosion in the value of security / frauds committed by borrowers
- (ii) Not prudent to follow stages of asset classification. It should be straightaway classified as doubtful or loss asset as appropriate.
- (i) Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.
 - (ii) If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset. It may be either written off or fully provided for by the bank.

Question 30

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?

Answer 30

Provisioning of Non-performing Assets: CA R should verify that the classification of NPAs into sub-standard assets, doubtful assets and loss assets is done depending upon prudential norms as per the RBI Guidelines. Further he should also ensure that provision is being made for the same in accordance with the given table:

Categories of Non-Performing Assets:	Provision required
♦ Substandard Assets: Would be one, which has remained NPA for a period less than or equal to 12 months.	15%

♦ Doubtful Assets: Would be one, which has remained in the substandard category for a period of 12 months.	Secured+ Unsecured
♦ Sub-categories: Doubtful up to 1 Year (D1) Doubtful 1 to 3 Years (D2) Doubtful more than 3 Years (D3)	25% + 100% 40% + 100% 100% + 100%
♦ Loss Assets: Would be one, where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly.	100%

Alternative Answer 1:

Aspects to be verified by CA R to check correct provisioning of NPAs: CA R should verify following aspects while checking whether correct provisioning of NPAs is being made by bank: -

1. It should be verified whether classification of NPAs is in accordance with RBI guidelines. Such guidelines require classification of NPAs into sub- standard assets, doubtful assets and loss assets depending upon different criteria. Each classification requires different percentage of provisions. Therefore, proper classification of NPAs would ensure that provisioning is correct.
2. It should be verified that doubtful assets have been further properly classified in D1, D2 and D3 categories. These three different categories require provision of 25%, 40% and 100% respectively of secured portions of outstanding amount.
3. It should be verified that secured and unsecured portion in doubtful assets have been arrived at properly. Unsecured portion of liability entails provision of 100%. Therefore, it is important to verify that break-up of doubtful assets into secured and unsecured portions is proper.
4. As different kinds of loans and advances are handled by the bank, it should be ensured that loan classification according to its purpose is properly made in the system. NPA norms vary for cash credit accounts, term loans, bills purchased and agricultural loans. Any wrong classification can lead to incorrect provisioning. For example, if an agricultural loan is wrongly classified, it would lead to incorrect provisions.

Alternative Answer 2:

Aspects to be verified by CA R to check correct provisioning of NPAs:

1. For audit of Provisions, the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled.

2. The auditor should obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets.
3. The auditor may verify the loan classification on a sample basis.
4. The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.

Question 31

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)?

Answer 31

Meaning of Drawing Power generally addressed as “DP” is an important concept for Cash Credit (CC) facility availed from banks and financial institutions. Drawing power is the limit up to which a firm or company can withdraw from the working capital limit sanctioned.

Different from Sanctioned Limit: The Sanctioned limit is the total exposure that a bank can take on a particular client for facilities like cash credit, overdraft, export packing credit, non-funded exposures etc. On the other hand, Drawing Power refers to the amount calculated based on primary security less margin as on a particular date.

Computation of DP: It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

Ethics

Question 1

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

OR

Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. Explain giving examples.

Answer 1

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

Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the SAs.
- Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:
- Overlooking unusual circumstances.
- Over generalising when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Professional skepticism is necessary to the critical assessment of audit evidence. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required

to consider the reliability of information to be used as audit evidence. In cases of doubt about the reliability of information or indications of possible fraud, the SAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.

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

Question 2

The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements. The Code establishes the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements. Explain

OR

Explain the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements in accordance with Code of Ethics issued by ICAI.

Answer 2

Ethical Requirements Relating to an Audit of Financial Statements: The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements :

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

Question 3

The IESBA Code establishes the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements. Discuss and also explain the meaning of ethics. (RTP May '22)

Answer 3

The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

First, broadly understand what are ethics? "Ethics" are the principles of conduct governing an individual or group. Professions like law, medicine have their code of ethics. Auditing profession is no exception. Rather, in profession of auditing, importance of ethics is manifold.

The IESBACodeestablishes thefollowing as thefundamentalprinciples of professional ethics relevant to the auditor when conducting an audit of financial statements. We shall understand broad meaning and intent of these fundamental principles as under:-

a. Integrity

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

b. Objectivity

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

c. Professional competence and due care

It requires that auditor attains and maintains professional knowledge and skill at the level required to render competent professional service based on current technical and professional standards and legislation and also to act diligently and in accordance with technical and professional standards. Diligence includes responsibility to act carefully, thoroughly and on a timely basis in accordance with requirements of an assignment.

C. Confidentiality

Confidentiality principle requires an auditor to respect the confidentiality of information acquired as a result of professional or business relationships.

d. Professional behaviour

It requires an auditor to comply with relevant laws and regulations and avoid any conduct that he knows or should know might discredit the profession.

Question 4

The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded as being incompatible with integrity and objectivity. Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be

taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist requiring the application of different safeguards. Explain stating clearly the five types of threats as contained in Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC).

OR

The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. Explain

Answer 4

The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded as being incompatible with integrity and objectivity. Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist requiring the application of different safeguards.

Threats to Independence

The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

1. **Self-interest threats**, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement, (iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the audit engagement.
2. **Self-review threats**, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement (Non audit services include any professional services provided to an entity by an auditor, other than audit or review of the financial statements. These include management services, internal audit, investment advisory service, design and implementation of information technology systems etc.), or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.
3. **Advocacy threats**, which occur when the auditor promotes, or is perceived to

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

4. **Familiarity threats** are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways: (i) close relative of the audit team working in a senior position in the client company, (ii) former partner of the audit firm being a director or senior employee of the client, (iii) long association between specific auditors and their specific client counterparts, and (iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.
5. **Intimidation threats**, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

Question 5

Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. Explain.

Answer 5

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

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

Question 6

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

It is necessary for the auditor to maintain professional skepticism throughout the audit.

Answer 6

Correct. As per SA 200, "Overall Objectives of the Independent Auditor and the

Conduct of an Audit in Accordance with Standards on Auditing”, professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. Thus, it is necessary for the auditor to maintain professional skepticism throughout the audit.

Question 7

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

OR

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

OR

Discuss few guiding principles which are behind safeguards to eliminate threats to auditor’s independence. (RTP Nov ’21)

Answer 7

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

The following are the guiding principles in this regard: -

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

Question 8

There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance. Explain.

Answer 8

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

"Independence is: (i) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

Independence in appearance – the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised."

Question 9

Examine with reasons (in short) whether the following statements are correct or incorrect. Advocacy threat, is the threat which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.

Answer 9

Incorrect: Self-interest threat is the threat which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Further, Advocacy threat is the threat which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe

that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.

Question 10

Write a note on "Self-review threats"

Answer 10

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

Question 11

Professional integrity and independence are considered essential characteristics of all the professions. There are two interlinked perspectives of independence of auditors, one, independence of mind and two, independence in appearance. Explain. (RTP May '23)

Answer 11

Professional integrity and independence are considered essential characteristics of all the professions but are more so in the case of accountancy profession. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.

It is not possible to define "independence" precisely. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules themselves cannot create or ensure the existence of independence. Independence is a condition of mind as well as personal character. It should not be confused with the superficial and visible standards of independence which are sometimes imposed by law.

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

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

Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

Question 12

"Independence of mind and independence in appearance are interlinked perspectives of Independence of auditors." Explain.

Answer 12

- (a) Independence" implies that the judgment of a person is not subordinate to the wishes or direction of another person who might have engaged him. The auditor should be independent of the entity subject to the audit. There are two interlinked perspective of independence of auditors, one independence of mind and two, independence in appearance. The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term "Independence" as comprising both-
- (b) Independence of mind – the state of mind that permits the provision of an

opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and

- (c) Independence in appearance – the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised." Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

Question 13

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

Answer 13

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

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

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

SA 210- Agreeing the Terms of Audit Engagements

Question 1

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

Engagement partner refers to the partner or other person in the firm who is responsible for the audit engagement.

Answer 1

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

Question 2

Examine with reasons (in short) whether the following statement is correct or incorrect: The terms of audit engagement can restrict the scope of an audit.

Answer 2

Incorrect: The scope of an audit of financial statements will be determined by the auditor for having regard to the terms of the engagement, the requirement of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.

Question 3

Preconditions for an audit have not been defined in SA 210 "Agreeing the Terms of Audit Engagements."

Answer 3

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

Question 4

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

decide not to send a new audit engagement letter or other written agreement each period. Explain the factors an auditor considers to be appropriate to revise the terms of the audit engagement or to remind the entity of existing terms.

Answer 4

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

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms;

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

Question 5

Discuss preconditions for an audit as per SA 210. Explain how would an auditor proceed to establish the presence of pre-conditions for an audit.

Answer 5

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

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

- (a) Determine whether the financial reporting framework is acceptable; and
- (b) Obtain the agreement of management that it acknowledges and understands its responsibility:
 - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework;

- (ii) For the internal control as management considers necessary; and
 - To provide the auditor with: Access to all information such as records, documentation and other matters;
 - Additional information that the auditor may request from management for the purpose of audit; and
 - Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Question 6

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

Answer 6

Acceptance of a Change in Engagement: An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so. A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications. If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to-

- (i) the original engagement; or
- (ii) any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report. The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in

an engagement letter or other suitable form of written agreement. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall-

- (i) Withdraw from the audit engagement where possible under applicable law or regulation; and
- (ii) Determine whether there is any obligation, either contractual or

otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Question 7

Examine with reasons whether the following statements are correct or incorrect.

Even if law or regulation prescribes sufficient details of the terms of the audit engagement the auditor should record them in a written agreement

Answer 7

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

Question 8

CA P is appointed as an auditor of XYZ Limited for the F.Y. 2021 -22. The management of XYZ Limited has requested the auditor to change the terms of original engagement as the company has diversified its business and few new products have been introduced by the company. Can CA P agree to the request made by the management? Under which circumstances can the client make a request to the auditor for a change in the terms of engagement?

Answer 8

Acceptance of a Change in Engagement:

The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, a significant change in nature or size of the entity's business is one of the factors which may make it appropriate to revise the terms of the audit engagement.

In the given situation, XYZ Limited has diversified its business and few new products have also been introduced by the Company which is indicative of significant change in nature or size of the entity's business. In view of above, CA. P can agree to the request made by the management to change the terms of the audit engagement. Therefore, request of Management to change the terms of audit engagement is appropriate.

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

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

SQC 1- Quality Control for Firms Which Perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Service Engagements

Question 1

The firm's system of quality control should include policies and procedures addressing each and every element of system of quality control. State those elements.

Answer 1

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

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

Question 2

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. Discuss

Answer 2

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. SQC 1 "Quality Control for Firms that perform Audits and Review of Historical Financial Information, and other Assurance and related services", requires firms to establish policies and procedures for the timely completion of the assembly of audit files. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature.

Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross referencing working papers.
- Signing off on completion checklists relating to the file assembly process.

- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

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

Question 3

The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles. Explain stating clearly personnel issues addressed by such policies and procedures.

Answer 3

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

Such policies and procedures address the following personnel issues:

- (a) Recruitment.
- (b) Performance evaluation.
- (c) Capabilities.
- (d) Competence.
- (e) Career development.
- (f) Promotion;
- (g) Compensation; and
- (h) Estimation of personnel needs.

Addressing these issues enables the firm to ascertain the number and characteristics of the individuals required for the firm's engagements. The firm's recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm's work.

Question 4

CA Raj, an engagement partner wants to take decision, regarding acceptance and continuance of an audit engagement. Which information's, he

should obtain before accepting an engagement?

Answer 4

SQC 1 requires the firm to obtain information before accepting an engagement. Information such as the following assists the engagement partner in determining whether the decisions regarding the acceptance and continuance of audit engagements are appropriate:

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

Question 5

The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances. Explain.

Answer 5

The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances. Through its policies and procedures, the firm seeks to establish consistency in the quality of engagement performance. This is often accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter - specific guidance materials. Matters addressed include the following:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- Processes for complying with applicable engagement standards.
- Processes of engagement supervision, staff training and coaching.
- Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- Appropriate documentation of the work performed and of the timing and extent of the review.
- Processes to keep all policies and procedures current.

SA 220- Quality Control for an Audit of Financial Statements

Question 1

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

Answer 1

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

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

Engagement partner defined

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

Question 2

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

Answer 2

Information which assist the Auditor in accepting and continuing of relationship with Client: As per SA 220, “Quality Control for an Audit of Financial

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

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

Case study based MCQs. Case Scenarios

Case Scenario (MTP May 20)

- M/s TPR & Associates have been appointed as the auditors of Octopus Ltd. for the Financial Year 2019-20
- During the course of audit, the auditor notices that there is significant change in the number of debtors of the company. The auditor decided to check the debtors account in detail.
- Further the company has made various provisions like the provisions for taxation, provision for bad & doubtful debts.
- Also during the current Financial Year, the auditor attended the physical verification of the inventory being carried out by the management.
- The auditor notices that there is no substantial change in the bifurcation of amount of items representing the liabilities side of the balance sheet of Octopus Ltd. Still the auditor understands that he needs to check the liability side in detail.
- Further the company has also recognised various income like interest income and dividend income which auditor understands need to be checked in detail.
- The auditor is of the understanding that certain matters need to be reported under Companies Auditors Report Order (CARO).

Based on the above facts, answer the following

1. is a possible obligation that arises from the past events and whose existence will be confirmed only by the occurrence/ non occurrence of one or more uncertain future events not wholly within the control of the entity:-
 - (a) Provision
 - (b) Reserve
 - (c) Contingent Liability
 - (d) Liability
2. Which of the following is not correct with respect to the inventory held by Octopus Limited:-
 - (a) All inventory units held by the company should have been recorded and recognized in the financial statements.
 - (b) Any inventory held by a third party on behalf of the company should not be included as part of the inventory balance.
 - (c) Inventory should be recognized at cost or net realizable value whichever

Answer: (c)

is lower.

- (d) Inventory balance as at the year end does not include any element of next year

Answer: (b)

3. If the management of Octopus Ltd. refuses to allow the auditor, to send the confirmation request to the debtors, the auditor should:-

- (a) Withdraw from the engagement.
- (b) Not listen at all to any requests of the management.
- (c) Consider the management's request for refusal and assess its validity and decide the nature, timing, extent of his audit procedures accordingly.
- (d) Agree to management request and proceed with audit of other items of the financial statements.

Answer: (c)

4. Which of the following statements is not true so far as the liabilities of a company are concerned:-

- (a) Liabilities are the financial obligations of a company including owner's funds.
- (b) Liabilities include borrowing, trade payable and other current liabilities and provisions.
- (c) Verification of liabilities is an important as that of assets.
- (d) All of the above.

Answer : (a)

5. **Statement 1:** Confirmations as well as undelivered letters should be given/ returned to the auditor and not to the client

Statement 2: When no reply is received, the auditor should perform alternate procedures regarding the balances: -

- (a) Only statement 1 is correct
- (b) Only statement 2 is correct
- (c) Both 1 & 2 are correct
- (d) Both 1 & 2 are incorrect

Answer: (c)

Case Scenario 2.

ABC Ltd. is a company dealing in products namely chocolate and coffee. ABC Ltd. approached audit firm XYZ & Associates for the statutory audit of its financial statements for the year ended 31.03.2019. The Gross turnover of the company is Rs.105 crores, out of which turnover from one of its product namely coffee is of Rs.95 crores during the immediate preceding Financial Year.

During the course of Audit, XYZ & Associates found certain delay in the payment of the Employees Provident Fund by ABC Ltd. They understand that the same

need to be reported under the relevant provisions of Companies (Auditors Report) Order 2016.

During the FY 2018-2019, Mrs. X wife of CA Mr. X who is partner in XYZ & Associates acquires certain shares of ABC Ltd. The audit firm is of the opinion that this may call for a disqualification for the firm for being working as the auditor of the company under the relevant provisions of the Companies Act 2013.

Further, ABC Ltd. also approached the auditors to provide them the Investment Banking service to which the auditors denied as per the provisions of Companies Act 2013.

During the course of audit, XYZ & Associates has reason to believe that an offence of fraud involving some amount has been committed in the ABC Ltd. by its General Manager. The auditors understand that there is a requirement for reporting of fraud by the auditors under the Companies Act and the relevant rules.

Based on the above facts, answer the following: -

1. After the appointment of XYZ & Associates, ABC Ltd. should inform the auditor and file a notice of such appointment with registrar within: -

- (a) 60 days
- (b) 30 days
- (c) 15 days
- (d) 20 days

Answer: (c)

2. If Mrs. X acquires security exceeding the prescribed limit in the ABC Ltd., then XYZ & Associates shall take corrective actions within... days. What is the prescribed limit: -

- (a) 100 days, Market Value Rs 1,00,000
- (b) 60 days, Face value Rs 1,00,000
- (c) 90 days, Face value Rs 1,00,000
- (d) 15 days, market value Rs 1,00,000

Answer: (b)

3. Under which section reporting of fraud by an auditor to the Central Government is required and what is the amount of fraud: -

- (a) Section 143(12), 1 crore & above
- (b) Section 139(12), 1 crore & above
- (c) Section 143(12), 2 crores & above
- (d) None of the above

Answer: (a)

4. What is the requirement for ABC Ltd as per the relevant provisions regarding maintenance of cost records: -
- (a) Maintenance of cost records is mandatory, in form CRA 1.
 - (b) Maintenance of cost records is mandatory, in form CRA 2.
 - (c) Maintenance of cost records is mandatory, in any general format.
 - (d) No requirement of maintenance of cost records.

Answer : (a)

5. Under relevant clause of CARO,2020, XYZ & Associates is required to report the extent of arrears of Employees Provident Fund as at the balance sheet date:
- (a) Exceeding 9 months.
 - (b) Exceeding 3 months
 - (c) Exceeding 6 months
 - (d) Exceeding 12 months

Answer :(c)

Case Scenario 3

Mr. Laxman is appointed as statutory auditor of Best Limited for the Financial Year ended 31st March, 2020.

During the course of audit, it was found that few doubtful transactions had been committed by finance manager who retired in March, 2020.

The fraud was going on since last 4-5 years and the total amount misappropriated is approximately Rs.75 lacs.

Balance sheet of Best Ltd. reflected a cash balance of Rs.7 crores. The company has taken a loan of Rs.2 crores from the bank despite of the huge cash balance with the company.

Also, Companies Act bestows some duties on auditors to report matters to Central Government in case of fraud.

On the basis of above facts answer below questions in relation to Mr. Laxman's role and duties while conducting statutory audit of Best Limited.

1. Mr. Laxman shall obtain That the financial statements are free from fraud and misstatement.
- (a) Absolute assurance
 - (b) Reasonable assurance
 - (c) Management assurance
 - (d) Chief financial officer assurance

Answer:(b)

2. Mr. Laxman suspects that cash payments were inflated. Out of the below which could be probable reason for such inflated cash payments.

- (a) Not accounting for cash sales completely
- (b) Making payments against purchase vouchers
- (c) Making payments against inflated vouchers
- (d) Teeming and Lading .

Answer: (c)

3. As per Section 143 (12) of Companies Act, 2013 & Rule 13 of CAAR, 2014; Mr. Laxman 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 audit committee constituted under section 177 and also to the Board within such time and in such manner as prescribed.
- (d) report the matter to the Board within such time and in such manner as prescribed.

Answer: (a)

4. 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.

Answer: (a)

5. As an auditor what conclusion can Mr Laxman draw looking at the huge cash reserve of the company and corresponding bank loan?

- (a) Report this matter to the Central Government u/s 143(12) as there is a possibility of fraud
- (b) Obtain sufficient and appropriate audit evidence of existence of fraud
- (c) Report the matter under CARO, 2020
- (d) There is nothing to report as it's a normal financial decision.

Answer: (b)

Case Scenario (MTP Oct '21)

RRM & Associates have been appointed as the statutory auditors of UVW Ltd. for the FY 2019-2020. The engagement partner is CA Raj and his engagement team consists of 2 article assistants. CA Raj briefed his audit team regarding the factors affecting the sample selection and the sample size. The team was also told that the tolerable error should be zero and sample size should be selected accordingly. CA Raj gave a detailed audit programme to his team. The audit programme with respect to the checking of accounts receivable and accounts payable consists of checking the accounts on sample basis. CA Raj asked the engagement team to divide the accounts receivables and account payable balances into separate groups and to take sample from each of them.

During the course of audit, the audit team noticed that certain internal control system with respect to the accounts receivable were not in place at few instances during the FY 2019 -20.

Also while checking the payment transactions on sample basis, the engagement team noticed that on 9th and 10th of every month, the miscellaneous expense vouchers were not signed by the authorised personnel. The engagement team discussed the implications of the same on their audit procedures to be performed in this regard.

Based on the above facts, answer the following: -

1. Which of the following factors should not be considered by CA Raj in deciding the extent of checking while making the sample plan in case of UVW Ltd.?
 - a. The size of UVW Ltd.
 - b. The state of the internal control system of UVW Ltd.
 - c. The tolerable error range decided in case of UVW Ltd.
 - d. The competence of the engagement team.

Answer: (d)

2. With respect to the weakness in internal control system of accounts receivable during the FY 2019 -20, the audit team: -
 - a. Should consider a larger sample size or 100% examination of accounts receivables.
 - b. Should consider a smaller sample size of accounts receivables.
 - c. Should not consider applying sampling techniques.
 - d. Should give a disclaimer of opinion.

Answer: (a)

3. Statement 1: While conducting an audit, it is obligatory for the auditor to apply sampling. Statement 2: There may be sometimes where test checking or sampling may not be suitable.

- (a) Only statement 1 is true
- (b) Only statement 2 is true
- (c) Both the statements are true
- (d) None of the statements is true

Answer: (b)

4. With respect to selecting sample for accounts receivable and accounts payable which method of selecting of sample is advised by CA Raj to the engagement team?

- (a) Stratified Sampling method
- (b) Monetary Unit Sampling method
- (c) Haphazard Sampling method
- (d) Interval Sampling

Answer: (a)

5. With respect to the deviation identified by the auditor occurring on 9th and 10th of every month, what course of action should the audit firm adopt?

- (a) RRM & Associates should ignore such deviation as it exists only on a very few instances during the entire year under audit.
- (b) RRM & Associates should extend its audit procedures to such deviated transactions.
- (c) RRM & Associates shall investigate the nature and causes of such deviations as such deviations may be intentional and may indicate the possibility of fraud.
- (d) Both b & c.

Answer: (d)

Case Scenario (MTP April '21)

- Mars Ltd is a public company having a turnover exceeding Rs 50 crores in the last 3 financial years including the current financial year which is FY 2019-20
- The company comes under the class of companies specified under item (A) Regulated Sectors.
- M/s XYZ & Associates have been appointed as the auditors of Mars Ltd for FY 2019-20.
- Mars Ltd has a branch office in Dubai for which a separate auditor has been appointed.
- M/s XYZ & Associates understand that they need to communicate with the another auditor appointed for the branch office in Dubai.
- Further Mars Ltd has taken a loan from a nationalized bank in 2015 amounting to Rs 1 crore payable in 8 equal instalments of Rs. 12.50 lakhs each starting from 31st March 2016 onwards. It has repaid its 4

instalments, however the company has defaulted in the current financial year. Mars Ltd has sought re- scheduling of loan from the bank.

- The auditors, XYZ & Associates understand that they have certain reporting requirements under Companies (Auditor's Report) Order, 2016.
- Further, the auditors also attended the physical verification of inventory conducted by the management at the year end.

Based on the above facts, answer the following:-

1) With respect to the forms specified by companies (Cost Records & Audit) Rule 2014, which of the following is incorrect combination:-

- (a) Form CRA 1- Maintenance of cost records by the Company.
- (b) Form CRA 2- Intimation of appointment of another cost auditor to Central Government.
- (c) Form CRA 3- Submission of Cost Audit Report to the Board of Directors of the company.
- (d) Form CRA 4- Submission of Cost Audit Report by the company to the Registrar

Answer: (d)

2. Within how many days of the receipt of the copy of Cost Audit Report. Mars Ltd is required to forward the report to the Central Government:-

- (a) 30 days
- (b) 60 days
- (c) 15 days
- (d) 90days

Answer: (a)

4. Whether reporting about maintenance of cost records required by Companies (Auditors Report) Order, 2016. If yes, then under which clause and which is the relevant section under the Companies Act 2013: -

- (a) Yes, Clause vi, Section 148(1)
- (b) No, - , Section 148(1)
- (c) Yes, clause v, Section 143(1)
- (d) No, - , section 143(1)

Answer: (a)

5. With respect to the branch office of Mars Ltd In Dubai, what is the duty of M/s XYZ & Associates:-

- (a) M/s XYZ & Associates might discuss with the branch auditor the audit procedures applied by the branch auditor.
- (b) M/s XYZ & Associates may also visit the branch auditor.
- (c) M/s XYZ & Associates cannot advise the other auditor of accounting, auditing/ reporting requirement as the other auditor is well versed with

such provisions.

(d) Both a & b

Answer: (d)

6. Which of the following is incorrect:

- (a) Sa 200 overall objectives of independent Auditor.
- (b) **SA 230** Audit documentation
- (c) Sa 299 Joint audit financial statement
- (d) Sa 600 subsequent Events (

Answer: (d)

Case Scenario (MTP Oct '21)

RM & Associates have been appointed as Auditors of Techblocks Consulting Ltd. for the year 2020-

21. CA R and CA M were the Engagement partners. Para 1

The Firm has freshly appointed 2 Article Clerks who had no practical knowledge in the area of Auditing. They had to work to tight hard-headed factual issues and were baffling to understand the various terms and their objectives in the field of Auditing.

Para 2

To make sure that the Article Clerk do not misplace or mis-handle the Working Papers, CA M also described the relevance of Audit File and clarified that working papers are the property of Auditor. Such Audit file should be preserved for a period of seven years.

Para 3

CA R while scrutinizing Books of Accounts suspected some fictitious sales as a result of which he anticipated inflated Debtors. Management was reluctant to give the details. As CA R could not gather more evidence from the Management, he sought to obtain details from the third party.

Para 4

On further perusal of Opening Balances, it is essential to perceive that Accounting Policies have been consistently applied in the current period's financial statements and whether any changes have been properly accounted for and disclosed. CA M assigned this duty to his article clerk. The Article clerk explained to CA M about how he had observed that Accounting policies were not consistently applied in relation to opening balances in accordance with the financial reporting framework or a change is not properly accounted or not adequately disclosed.

Para 5

Subsequently, the Auditors gathered from the Management that there was a fire in the Factory premises after the Balance Sheet date, as a result of which the company suffered loss of Inventories. It did not provide any conditions on the Balance Sheet date. SA 560 deals with such type of transaction.

(1) The Auditor explained his Audit team the purpose of Audit Documentation. Which of the following is incorrect with respect to the purpose of Audit Documentation?

- (a) It enables the conduct of quality control reviews and inspections in accordance with SQC- 1.
- (b) It helps in preparation of Financial Statements.
- (c) It retains a record of matters of continuing significance to future audits.
- (d) It enables the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Answer: (b)

(2) An auditor strictly ensured that the audit team should document assemble all the working papers in Audit file. The completion of assembling the Audit File is an administrative process and should be done in :

- (a) It should be within 30 days from the date of Audit Report.
- (b) It should be within 60 days from the completion of Audit.
- (c) It should not be more than 60 days from the date of Audit Report.
- (d) It should be before 90 days from the completion of Audit.

Answer: (c)

(3) With reference to para 3 of case scenario, this is case of obtaining External confirmation by the Auditor. Which of the following is in appropriate with regard to external confirmation?

- a. External Confirmations are restricted to Account balances only.
- b. It is also used in a case to obtain Audit evidence about the absence of certain conditions say, Side Agreement.
- c. It can be also effective in obtaining Audit evidence about verification of Inventories held by third parties at bonded warehouses for processing or on consignment.
- d. External Confirmation is also functional in case of Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the Balance Sheet date.

Answer: (a)

(4) With reference to para 4, in such a situation CA M shall express a :

- a. A Disclaimer Opinion
- b. A qualified opinion
- c. A qualified opinion or an adverse opinion in accordance with SA 705
- d. An un modified opinion.

Answer : (c)

(5) In respect to subject matter mentioned in Para 5, what procedures should Auditor perform to identify such events?

Statement 1: Obtain an understanding of any procedures management has established as well as Inquiry with Management and those charged with governance procedures for identification of such subsequent events.

Statement 2: Inspection of Minutes of the meetings of the entity's owners, management and those charged with governance that have been held after the date of the financial statements and matters discussed at any such meetings for which minutes are not yet available.

Statement 3: The Auditor should not read the entity's latest subsequent interim financial statement, if any.

- (a) Only statement 1 is correct
- (b) Only statement 2 is correct
- (c) Both statement 1 and 2 are correct\
- (d) Only statement 3 is correct (2 marks oct 21)

Answer: c.

Case Scenario (MTP March 22)(RTP Nov '22)

SAM & Company, a Chartered Accountant firm, is in the process of finalizing the audit of **Health is Wealth Limited** which is a Company listed on the Bombay Stock Exchange. Since the past decade, **Health is Wealth Limited** has made its presence felt in over 10 countries, including India, making it a leader in the global fitness industry. It runs a chain of fitness centres that offers energetic group workouts and multiple workout formats to choose from. It also offers the best equipment, knowledgeable staff and personal advice in a welcoming environment.

SAM & Company being a very reputed firm, was appointed for the statutory audit of **Health is Wealth Limited**. The Engagement Partner CA A and her team of 8 members have conducted the audit in an efficient and effective manner. The senior manager in the team, CA K is of the opinion that they have obtained sufficient appropriate audit evidence, which concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements. One of the article clerks, Mr N, is a fresher and this audit is his first experience as an auditor in a limited company. He is a sharp boy and has grasped all the concepts and techniques very well. However, the term "pervasive" confused him so CA K patiently explained to Mr. N the pervasive effects on the financial statements as per the auditor's judgement. Mr. N understood the term well and thanked CA K for clearing all his doubts.

CA A disagreed with CA K that they have obtained sufficient appropriate audit evidence, which concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements. So, the entire team held various meetings and discussions, and finally reached to a conclusion. They concluded that they have obtained reasonable assurance that

the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion took into account:

- a. Whether sufficient appropriate audit evidence had been obtained;
- b. Whether uncorrected misstatements were material, individually or in aggregate;
- c. The evaluations.

The Auditor's Report was prepared in writing and it was decided that an unmodified opinion would be expressed. The first section of the auditor's report included the auditor's opinion, and had the heading "Opinion". Following the Opinion section, was a section with the heading "Basis for Opinion". When expressing an unmodified opinion on financial statements, the auditor's opinion used the following phrase,

"In our opinion, the accompanying financial statements give a true and fair view of [...] in accordance with [the applicable financial reporting framework]."

During the audit, the audit team had observed that there was uncertainty in Health is Wealth Limited relating to the future outcome of a regulatory action. So, a paragraph was included in the auditor's report that referred to this matter which was appropriately disclosed in the financial statements and that, in the auditor's judgment, was of such importance that it was fundamental to users' understanding of the financial statements

CA A also determined whether the financial statements included the comparative information required by the applicable financial reporting framework and whether such information was appropriately classified. One team member, Mr R was curious to know whether the auditor's opinion referred to the corresponding figures or not, whenever the corresponding figures are presented. CA A explained the circumstances to Mr R in which, when the corresponding figures are presented, auditor's opinion referred to the corresponding figures.

Based on the above information, answer the following questions: (2 Marks)

- (1) CA K explained to Mr. N the pervasive effects on the financial statements in the auditor's judgement.

Pervasive effects on the financial statements are those that, in the auditor's judgement:

- (i) Are not confined to specific elements, accounts or items of the financial statements;
- (ii) If so confined, represent or could represent a substantial proportion of the financial statements; or
- (iii) In relation to disclosures, are fundamental to users' understanding of the financial statements.

Which of the following is correct?

- (a) (i), (iii)

- (b) (ii),(iii)
- (c) (i), (ii)
- (d) (i), (ii) and (iii)

Answer 1 (d)

(2) When expressing an unmodified opinion on financial statements, SAM & Company used the following phrase:

“In our opinion, the accompanying financial statements give a true and fair view of [...] in accordance with [the applicable financial reporting framework].”

Which is the other phrase which is regarded as being equivalent to the above phrase and could also be used by SAM & Company?

- (a) In our opinion, the accompanying financial statements give a true and correct view of [...] in accordance with [the applicable financial reporting framework];
- (b) In our opinion, the accompanying financial statements present correctly, in all material respects, [...] in accordance with [the applicable financial reporting framework];
- (c) In our opinion, the accompanying financial statements present fairly, in all material respects, [...] in accordance with [the applicable financial reporting framework];
- (d) In our opinion, the accompanying financial statements give a correct and fair view of [...] in accordance with [the applicable financial reporting framework].

Answer 2 (c)

1. Which of the following statements is not included in the section with the heading “Basis for Opinion” in the Auditor’s Report?

- (a) Audit was conducted in accordance with the Accounting Standards.
- (b) Auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor’s other ethical responsibilities in accordance with these requirements.
- (c) Description of the auditor’s responsibilities under the SAs.
- (d) States whether the auditor believes that the audit evidence the auditor has obtained, is sufficient and appropriate to provide a basis for the auditor’s opinion.

Answer 3 (a)

5. A paragraph was included in the Auditor’s Report of Health is Wealth Limited that referred to a matter which was appropriately disclosed in the financial statements that, in the auditor’s judgment, was of such importance that it was

fundamental to users' understanding of the financial statements. What is this section of the Auditor's Report called?

- (a) Other Matters.
- (b) Emphasis of Matters.
- (c) Key Audit Matters.
- (d) Auditor's Responsibilities for the Audit of the Financial Statements.

Answer 4 (b)

6. CA A explained the circumstances to Mr. R in which, when the corresponding figures are presented, auditor's opinion referred to the corresponding figures. Which of these circumstances did he mention to Mr. R?

- (a) If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which a modified opinion has been previously issued.
- (b) 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 resolved.
- (c) Prior Period Financial Statements are audited by another auditor.
- (d) Prior Period Financial Statements not audited.

Answer 5 (d)