

CA INTER | PAPER 5

AUDITING & ETHICS

QUESTION BANK



[QP's, RTP and MTP from May 2022 onwards]

[September 2024 MTP and RTP also included]

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1. NATURE, OBJECTIVE AND SCOPE OF AUDIT

ILLUSTRATIONS

ILLUSTRATION 1.

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

ANSWER:

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

ILLUSTRATION 2.

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

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

ANSWER:

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

ILLUSTRATION 3.

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

ANSWER:

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

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ILLUSTRATION 4.

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

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

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

ANSWER:

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

The auditor has relied upon internal controls. It is very nature of financial reporting that management is responsible for devising suitable internal controls. This is an inherent limitation of audit.

Audit is a type of assurance engagement under which auditor gives an opinion as to whether financial statements give a true and fair view of state of affairs of the concern. However, assurance engagements are not restricted to audit alone. We shall now discuss meaning of assurance engagement and different types of assurance engagements.

ILLUSTRATION 5.

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

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

ANSWER:

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

ILLUSTRATION 6.

CA. P Babu is conducting audit of financial statements of Quick Buy Private Limited. He was not able to obtain external confirmations from certain debtors due to practical difficulties and

peculiar circumstances. However, such a procedure is mandated under one of Standards on Auditing.

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

ANSWER:

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



TEST YOUR KNOWLEDGE

Q.NO.1. “Choosing of appropriate accounting policies in relation to accounting issues is responsibility of management”. Do you agree? Discuss duty of auditor, if any, in relation to accounting policies.

ANSWER:

Q.NO.2. Assurance engagements are not restricted to audit of financial statements alone. Discuss.

ANSWER:

Q.NO.3. An assurance engagement involves a three party relationship. Discuss meaning of three parties in such an engagement.

ANSWER:



Q.NO.4. A Chartered Accountant is specifically asked to check accounts whether fraud exists. State with reasons whether it is an example of reasonable assurance engagement.

ANSWER:

Q.NO.5. An audit does not provide absolute assurance. Discuss how nature of audit procedures itself is one of the reasons due to which audit cannot provide absolute assurance.

ANSWER:

QUESTIONS FROM RTP'S, MTP'S, QP'S

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

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:

Examine with reasons (in short) whether the following statement is correct or Incorrect: The preparation of financial statements involves judgment by management.

(MTP, MAY'22)

ANSWER

Correct: 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.

Question 3:

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

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

(MTP MAY '23)

ANSWER

Correct: As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

Question 4:

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".

(MTP MAY'22)

ANSWER

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 impracticable 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 5:

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 MAY'23)

(PYP MAY '22, RTP NOV '23)

ANSWER

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

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

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

Question 6:

State with reason (in short) whether the following statements are true or false: There is no difference between "audit" and "review." (RTP NOV'22)

ANSWER

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

objective is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement

Question 7:

An audit is distinct from investigation. However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor. Discuss. (RTP MAY '23)

ANSWER

Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and 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 wrongdoing; 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 8:

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

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 wrongdoing; 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 9:

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

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

Question 10:

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

Answer:

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

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

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

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

Question 11:

The auditor should decide whether relevant information is properly disclosed in the financial statements. Explain with reference to scope of audit. (MTP MAY 24)

Answer:

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

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

The management responsible for preparation and presentation of financial statements makes many judgments in this process of preparing and presenting financial statements. For example, choosing of appropriate accounting policies in relation to various accounting issues like choosing method of charging depreciation on fixed assets or choosing appropriate method for valuation of inventories.

The auditor evaluates selection and consistent application of accounting policies by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

Question 12:

KST Limited is engaged in manufacturing business. It appoints CA T to provide it an assurance report on its financial statements prepared on the basis of historical financial information. The characteristic of such an engagement is that it involves gathering of sufficient appropriate evidence on basis of which limited conclusions can be drawn up by practitioner. Identify type of engagement. Which are two other features of such an engagement? (MTP MAY 24)

ANSWER:

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

(1) It provides lower level of assurance than reasonable assurance engagement.

It performs fewer procedures than reasonable assurance engagement.

Question 13:

Nature of financial reporting itself is one of causes of inherent limitations of audit of financial statements. Explain. (MTP MAY 24)

ANSWER:

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

One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls. However, such controls may not have operated to produce reliable financial information due to their own limitations.

Therefore, nature of financial reporting itself is one of causes inherent limitations of audit.

Question 14:

The management of Cool Drinks Limited suspects that some employees of the company may be involved in making fraudulent payments to dummy workers at its various plants in the country. Therefore, they are considering appointment of a firm of auditors to conduct audit involving detailed examination of accounts. However, one senior person among Board members, Mr. P, objects to use of word “audit” in proposed assignment. Comment. Also, discuss how audit is different from investigation. (MTP SEP 24)

ANSWER:

Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and 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, 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 CA Inter (New) | P5 Auditing and Ethics | Comprehensive Question Bank | CA Ram Harsha

auditor to express an opinion.

The scope of audit is general and broad whereas scope of investigation is specific and narrow.

In the given situation, management of company suspects that some of its employees may be involved in making fraudulent payments on account of dummy workers at its different plants in the country. Such an assignment is in the nature of “investigation”.

Therefore, Mr. P is right in objecting the use of word “audit” in the proposed assignment.

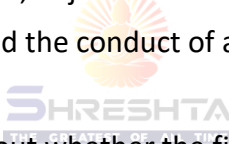
Question 15:

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

GR & Associates have been appointed as its statutory auditors for financial year 2022-23. J and K are newly appointed audit assistants in the firm and are part of engagement team constituted for purpose of audit of M Motors Ltd. However, they are confused about what such an audit tends to achieve. They perceive audit as a guarantee against possible errors or frauds in financial statements. Do you agree with perception of both the assistants? In this context, outline objectives of an independent audit conducted in accordance with Standards on Auditing. (RTP MAY 24)

Answer:

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

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

An analysis of above brings out following points clearly: -

- (1)** Auditor’s objective is to obtain a reasonable assurance whether financial statements as a whole are free from material misstatement whether due to fraud or error.

Reasonable assurance is to be distinguished from absolute assurance. Absolute assurance is a complete assurance or a guarantee that financial statements are free from material misstatements. However, reasonable assurance is not a complete guarantee. Although it is a high-level of assurance but it is not complete assurance.

Audit of financial statements is carried out by the auditor with professional competence and skills in accordance with Standards on Auditing. Audit procedures are applied in accordance with SAs, audit evidence is obtained and evaluated. On the basis of that, conclusions are drawn and opinion is formed. It leads to high level of assurance which is called as reasonable assurance but

it is not absolute assurance.

- (2) Misstatements in financial statements can occur due to fraud or error or both. The auditor seeks to obtain reasonable assurance whether financial statements as a whole are free from material misstatements caused by fraud or error. He has to see effect of misstatements on financial statements as a whole, in totality.
 - (3) Obtaining reasonable assurance that financial statements as a whole are free from material misstatements enables the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
 - (4) The opinion is reported and communicated in accordance with audit findings through a written report as required by Standards on Auditing.
- Therefore, perception of both assistants is not proper. Auditor of financial statements does not seek to provide guarantee that financial statements are free from material misstatements caused by frauds or errors. He obtains reasonable assurance.

Question 16:

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 24)

Answer:

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

“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.

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

Standards on Auditing have been issued on wide spectrum of issues in the field of auditing including (but not limited to) overall objectives of independent auditor, audit documentation, planning an audit of financial statements, identifying and assessing risk of material misstatement, audit evidence, audit sampling, going concern and forming an opinion and reporting on financial statements.

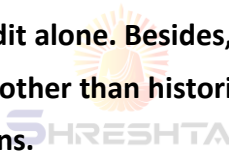
Some examples of Standards on Auditing are:

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

Examples of Standards on Review engagements are

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

Question 17:

Kriti, a CA student, has joined articles in a reputed audit firm. She considers audit engagement to be an “assurance engagement”. Her understanding is that audit engagement is the only kind of assurance engagement in which practitioner gives a written assurance report in appropriate form. However, her friend Somaya, does not agree with her. She is of the view that assurance engagements are not restricted to audit alone. Besides, Somaya also thinks that assurance engagements can also relate to matters other than historical financial information. Whose view appears to be correct? State with reasons.  (RTP SEP 24)

ANSWER:

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

There are also assurance engagements which relate to matters other than historical financial information like providing assurance on matters involving prospective financial information and providing assurance on internal controls in an entity. In assurance reports involving prospective financial information, the practitioner obtains sufficient appropriate evidence to the effect that management's assumptions on which the prospective financial information is based are not unreasonable, the prospective financial information is properly prepared on the basis of the assumptions, and it is properly presented, and all material assumptions are adequately disclosed. In the given case, Kriti is of the view that audit engagement is the only kind of assurance engagement in which practitioner gives a written assurance report in appropriate form whereas is of the view that assurance engagements are not restricted to audit alone. Thus, view of Somaya is

correct.



2. ETHICS AND TERMS OF AUDIT ENGAGEMENTS

ILLUSTRATIONS

ILLUSTRATION 1.

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

ANSWER:

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

ILLUSTRATION 2.

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

ANSWER:

"Integrity" requires that a professional accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information contains a materially false or misleading statement; contains statements or information provided negligently or omits or obscures required information where such omission or obscurity would be misleading.

In the given case, a false certificate is knowingly issued showing misstated original cost of machinery. Therefore, fundamental principle of "integrity" is violated.

ILLUSTRATION 3.

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

ANSWER:

When threats to independence exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level. Holding of shares involves financial interest in the company and is in nature of self-interest threat. He has come to hold shares due to nomination made by his distant relative before accepting the appointment. Considering above, he should take steps to eliminate the threat by selling shares

immediately before accepting appointment. Holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence.

ILLUSTRATION 4.

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

ANSWER:

Undue dependence on fees of a client constitutes a threat as there is fear of losing the client. Such threats are referred to as self-interest threats.

ILLUSTRATION 5.

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

ANSWER:

In this case, Chartered Accountant is already rendering accounting and book keeping services to an NGO. If he accepts audit, he would be involved in reviewing own work. Therefore, the same constitutes “self-review” threat.

ILLUSTRATION 6.

The auditors of a company have only relied upon management representation letter regarding treatment of certain tax matters under appeal by the company. The auditors have not carried out any other audit procedures to justify management’s treatment of the said tax matters under appeal in the financial statements. What is lacking on part of auditors in such a situation?

ANSWER:

In the given case, auditors have relied only upon management representation letter regarding treatment of certain tax matters under appeal by the company. No other audit procedures to verify management’s treatment of such matters under appeal have been performed by auditors. It shows lack of “professional skepticism” on part of auditors.

ILLUSTRATION 7.

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

ANSWER:

Engagement letter includes reference to expected form and content of audit report. It merely states that auditor would provide opinion in this form. However, engagement letter also includes statement that the form and content of report may need to be amended in the light of audit

findings. Therefore, if in light of audit findings, auditor needs to give a modified opinion, he shall do so.

ILLUSTRATION 8.

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

ANSWER:

It is necessary for management to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. It is a necessary precondition for an audit in accordance with SA 210.

If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:

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

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

ILLUSTRATION 9.

CA PK Nair is offered appointment as auditor of a company engaged in providing tourism services. While making due diligence of the proposed client, he comes to know that there have been raids on premises of the company and residences of its directors by National Investigation Agency (NIA) on suspicion of links with terror outfits. It has been followed up with searches by Enforcement Directorate hunting for illicit money trail. There is a strong suspicion of tourism services provided by company being façade of terror funds. Should proposed offer be accepted by him?

ANSWER:

Integrity of principal owners has to be considered before accepting an audit engagement in accordance with SA 220. In this regard, SA 220 states requirements on lines of SQC 1. SQC 1 clearly states that in cases where there are indications that the client might be involved in money

laundering or other criminal activities, appointment should not be accepted.

In the instant case, there have been raids of NIA on suspected links with terror outfits which is a criminal activity. Further, raids by Enforcement Directorate also point towards money laundering. Therefore, proposed offer should not be accepted.

ILLUSTRATION 10.

CA Arpita has joined a mid-sized CA firm recently. She finds that partners remain too busy and the firm is proposing to accept audit work in areas in which it has no experience or capabilities. The firm is proposing to accept audit of some entities engaged in emerging “fin-tech” sector. Such audits may be requiring extensive use of technology and data analytics. However, the said firm has no such capabilities and trained personnel. Discuss, whether, firm should accept such audits with reason.

ANSWER:

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

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



TEST YOUR KNOWLEDGE

Q.NO.1. Briefly outline how principles-based approach differs from rules-based approach to ethics.

ANSWER:

Q.NO.2. How application of professional skepticism throughout audit is helpful in reducing audit risk?

ANSWER:

Q.NO.3. A Chartered accountant is conducting audit of a client for last two years. Before proceeding to start audit for next year, he notices that there is substantial change in management. Besides, client has ventured into areas of business activity which were not present at time of accepting initial audit engagement. Discuss responsibility of auditor in this regard in context of SA 210.

ANSWER:



Q.NO.4. How does SQC 1 ensure that independence in engagements is not breached by an audit firm?

ANSWER:

Q.NO.5. An engagement partner takes overall responsibility for maintaining audit quality in an audit engagement in accordance with SA 220. What are his objectives in taking and emphasizing such responsibility?

ANSWER:

QUESTIONS FROM RTP'S, MTP'S, QP'S

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, MTP NOV'23)

ANSWER

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 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

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 IESBA Code establishes the following as the fundamental principles 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.

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 3:

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). (RTP MAY'22)

ANSWER

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 4:

Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats. Explain the guiding principles in this regard. (RTP May'23)

ANSWER

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 5:

Examine with reasons (in short) whether the following statements are correct or Incorrect: Confidentiality requires an auditor to be straight forward and honest in all professional and business relationships. (MTP NOV'22)

ANSWER

Incorrect: Integrity requires an auditor to be straight forward and honest in all professional and business relationships. It implies fair dealing and truthfulness. Confidentiality principle requires an auditor to respect the confidentiality of information acquired as a result of professional or business relationships.

Question 6:

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. (MTP MAY'23)

ANSWER

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 7:

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

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:

1. 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."

2. Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.

Question 8:

CA Tripad (engagement partner) based at New Delhi is external auditor of Lap of Nature, a firm, since last three years. The firm is engaged in business of providing tourism services including holiday packages to its club members. It has also provided auditor including his team members free holiday for a week every year in one of its premium resorts in Ooty in the State of Tamil Nadu. The company has also booked free air travel for engagement team members during all these years. Discuss why Chartered Accountant is not acting ethically. How are familiarity threats created in above situation? (MTP MAY 24)

ANSWER:

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

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

Question 9:

Professional Behaviour is one of the fundamental principles governing professional ethics. Explain its meaning. Also, give example of a situation where a Chartered Accountant fails to follow this principle. (MTP MAY 24)

ANSWER:

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

Example

A Chartered Accountant has conducted audit of accounts of an entity for a particular year. ICAI has issued a letter to him relating to certain matters concerning audit. He didn't even bother to reply to the letter despite reminders. Failure to reply to professional body smacks of lack of courtesy and professional responsibility. In the given case, Chartered accountant has not followed principle of Professional Behaviour.

SA 210- AGREEING THE TERMS OF AUDIT ENGAGEMENTS

Question 1:

CA Inter (New) | P5 Auditing and Ethics | Comprehensive Question Bank | CA Ram Harsha

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. (MTP NOV'22)

ANSWER

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 the audit; and
 - Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.



Question 2:

"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.

(RTP NOV '23, MTP MAR'22)

ANSWER

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 3:

An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so. Explain the circumstances which may contribute towards a request from the client for the auditor to change the engagement. (RTP NOV'22)

ANSWER

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

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

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

Question 4:

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? (PYP NOV'22)

ANSWER

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-

- i. a change in circumstances affecting the need for the service,
- ii. a misunderstanding as to the nature of an audit or related service originally requested.
- iii. a restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

Question 5:

The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed terms of the audit engagement shall be recorded in an audit *engagement letter* or other suitable form of written agreement. Who gives engagement letter to whom and what is included in such a letter? (MTP MAY 24)

ANSWER:

The audit engagement letter is sent by the auditor to his client. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent. Such a letter includes:

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

Question 6:

CA H has been offered audit of financial statements of a society engaged in promoting social causes, such as setting up of drug de-addiction centres for misguided youth and rehabilitating such young people by helping them find avenues of gainful employment. However, CA H failed to send audit engagement letter to the society's governing body and proceeded to conduct the audit. In the absence of this letter, the governing body is of the view that purpose of such an audit is to provide absolute assurance against probable errors and frauds in the financial statements. Does it constitute violation of fundamental principles governing professional ethics? State reasons for the same. (MTP SEP 24)

ANSWER:

As per SA 210, "Agreeing the Terms of Audit Engagements", the auditor shall agree the terms of the

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

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

Question 7:

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

(RTP MAY 24)

ANSWER:

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

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

(A) Establishing whether the preconditions for an audit are present and

(B) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

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

In the given situation, CA X is insisting only upon obtaining agreement of management regarding

acknowledgment of its responsibility for internal control to enable preparation of financial statements that are free from material misstatements in accordance with SA 210. Design, implementation and maintenance of internal control to ensure preparation of reliable financial statements that are free from material misstatements is management's responsibility. He is insisting on obtaining agreement of management regarding acknowledgment of its responsibility. Therefore, CA X's view is proper. In case management does not provide such agreement acknowledging its responsibility, the auditor shall not accept proposed audit engagement unless required by law or regulation.

SQC 1- QUALITY CONTROL FOR FIRMS WHICH PERFORM AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION AND OTHER ASSURANCE AND RELATED SERVICE ENGAGEMENTS

Question 1:

Discuss the following:

The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Explain the purpose of monitoring compliance with quality control policies and procedures. (MTP NOV'22)

ANSWER

The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- a. Adherence to professional standards and regulatory and legal requirements;
- b. Whether the quality control system has been appropriately designed and effectively implemented; and
- c. Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.
- d. Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

Question 2:

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

Historical financial information relates to financial information based on assumptions about the occurrence of future events and possible actions by an entity. (MTP NOV'23, PYP Nov 22)

ANSWER

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

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.

(RTP NOV'22)

ANSWER

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:

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.

(MTP MAY'23)

ANSWER

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.

Question 5:

SQC 1 dwells upon engagement quality control review (EQCR) as part of system of quality control in a firm. Why is such a review required? For which type of engagements EQCR is mandatory?

(MTP MAY 24)

What should be approach of firm for engagements for which EQCR is not mandatory?

ANSWER:

Significant judgments made in an engagement should be reviewed by an engagement quality control reviewer for taking an objective view before the report is issued. Engagement quality control review is mandatory for all audits of financial statements of **listed entities**.

In respect of other engagements, firm should devise criteria to determine cases requiring performance of engagement quality control review.

Question 6:

SQC 1 requires assumption of leadership responsibilities for quality within firm. Are such leadership responsibilities required for audit engagements only? Who assumes such leadership responsibilities within firm? How it is important for audit quality?

(MTP SEP 24)

ANSWER:

SQC 1 requires firms to establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Therefore, such leadership responsibilities are required for all engagements and not for audit engagements only. Such policies and procedures should require the firm's chief executive officer or the firm's managing partners to assume ultimate responsibility for the firm's system of quality control. The example set by firm's leadership encourages an inner culture that recognizes high quality audit work. Further, persons assigned operational responsibilities for the firm's quality control system by the firm's chief executive officer or managing partners should have sufficient and appropriate experience, ability and the necessary authority to

assume that responsibility.

Question 7:

ABC & Associates, an audit firm, has been approached by a prospective company client that has been in business for about 10 years to conduct an audit of its financial statements. Before accepting the audit engagement, the firm wants to assess the integrity of prospective client. With regard to the assessment of integrity, which matters should be considered by the audit firm?

(RTP SEP 24)

ANSWER:

With regard to the integrity of a client, matters that ABC & Associates should consider include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.

Indications that the client might be involved in money laundering or other criminal activities.



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.

(RTP MAY '23)

ANSWER

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

- a. The importance to audit quality of:
 - i. Performing work that complies with professional standards and regulatory and legal requirements;

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

Engagement partner defined

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

Question 2:

An engagement partner takes overall responsibility for maintaining audit quality in an audit engagement in accordance with SA 220. What are his objectives in taking and emphasizing such responsibility? (MTP MAY 24)

ANSWER:

Leadership responsibility of an engagement partner is to take responsibility for the overall quality on each audit engagement. 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 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.

The fact that quality is essential in performing audit engagements.

Question 3:

"SA 220 is premised on the basis that the firm is subject to SQC 1". What do you understand by given statement in context of audit quality? (RTP MAY 24)

ANSWER:

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

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

Therefore, SA 220 is premised on the basis that the firm is subject to SQC 1. Within the context of the

firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement.

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



3. AUDIT REPORT

ILLUSTRATIONS

ILLUSTRATION 1.

Maithili Thakur, a CA student, was perusing audit report of a company. Her eyes fell on an 18-digit alpha numeric number stated at end of audit report below the signatures of auditor and membership number. Make her understand objective and significance of such a randomly generated number. Is it required to be stated in case of audit reports only?

ANSWER:

The 18-digit alpha numeric number noticed by her at end of audit report is Unique Document Identification number (UDIN). It is a system generated unique number. Its basic objective is to curb the malpractices of non-CAs impersonating themselves as CAs. It helps in securing reports and documents issued by practising CAs.

It is required to be stated in case of audit reports and certificates.

ILLUSTRATION 2.

CA. Maya Memani has conducted audit of a company. She has asked Sana, a CA student undergoing training in her office, to prepare draft audit report. Sana was part of engagement team conducting the audit. She has been further told to prepare draft report expressing unmodified opinion. After drafting para comprising unmodified opinion, Sana feels no need to provide basis for opinion. Discuss why her thinking is not proper.

ANSWER:

Basis for Opinion” is one of basic elements of an audit report in accordance with SA-700. Even in cases where unmodified opinion is expressed by auditor, “Basis for opinion” has to be provided by auditor. Basis for opinion section provides context about auditor’s opinion.

Therefore, Sana’s thinking is not proper.

ILLUSTRATION 3.

CA. Sarasbhai Patel, while conducting audit of an entity, feels that there is an atmosphere of non-cooperation all around. He has not been provided with necessary support for attending inventory count process of entity as at year end. Besides, CFO is not providing him present addresses of customers as well as suppliers for sending external confirmations. Even mail ids have not been provided on the pretext of business confidentiality.

He was not able to verify revenues of entity due to lack of complete details. For verifying expenses, he has been asking for bills on a sample basis, but staff has been making lame excuses. The matter was brought to knowledge of higher echelons of management, but of no avail. The auditor feels that there could be misstatements and their possible effects would be material and affecting many aspects of financial statements.

Assuming it is not possible to withdraw from engagement, what type of opinion should be
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expressed by auditor?

ANSWER:

In the given case, auditor has not been able to obtain sufficient appropriate audit evidence relating to inventories, debtors, creditors, revenues and expenses. The matter has brought to knowledge of management but no result has been achieved. Besides, auditor opines that there could be misstatements and their possible effects could be both material and pervasive.

In such circumstances, he should make disclaimer of opinion in accordance with SA 705.

ILLUSTRATION 4.

CA. Dicky Yadav is auditor of a company having four branches. The four branches are audited by another auditor CA. Yamini Jain. The reports in respect of accounts of branches examined by her have already been sent to company auditor. During the course of audit, CA Dicky Yadav asks the branch auditor to share with her summary of audit procedures and findings in respect of accounts of branches examined. CA. Yamini Jain feels it as encroachment of her domain. Discuss the issue.

ANSWER:

As per SA 600 - "Using the Work of Another Auditor", the principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which maybe in the form of a completed questionnaire or check-list. Such review of audit procedures and findings can be undertaken if principal auditor feels that it is necessary to apply such procedures to obtain sufficient appropriate audit evidence. It is not an encroachment of another auditor's domain.

ILLUSTRATION 5.

CA. Ravi Patnaik is conducting audit of a company for which reporting requirements under CARO, 2020 are applicable. He finds that cash credit facilities amounting to Rs.4 crores were released to the company by branch of a bank for meeting its working capital requirements. He finds that out of above funds, Rs.1 crore have been used by company for installing effluent treatment plant to meet State pollution control Board requirements.

Is there any reporting obligation upon him under CARO, 2020?

ANSWER:

Clause (ix) (d) of CARO, 2020 whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated.

In the given situation, funds have been raised for meeting working capital requirements for Rs. 4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings. Out of above, Rs.1 crore have been used by the company for investment in effluent treatment plant which is ostensibly for a long-term purpose.

Hence, the matter needs to be reported in accordance with requirements of Clause (ix) (d) of CARO, 2020.

ILLUSTRATION 6.

The company has dispensed with the practice of taking inventory of their inventories at the year-end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations. Explain reporting requirement under CARO, 2020.

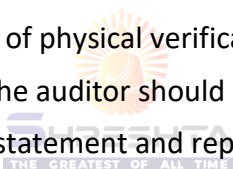
ANSWER:

Reporting for Physical Verification of Inventory:

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;

In the given case, the above requirement of physical verification of inventory by the management has not been taken place and therefore the auditor should point out the same under CARO, 2020. He may consider the impact on financial statement and report accordingly.



ADDITIONAL ILLUSTRATIONS

ILLUSTRATION 1.

M/s Smart & Associates are the statutory auditors of Hotmeals Ltd. for the FY 2021-

22. How will the auditor address the audit report issued on the financial statements for the FY 2021-22? Also give a title to the report.

ANSWER:

INDEPENDENT AUDITOR'S REPORT

To the Members of Hotmeals Ltd.

ILLUSTRATION 2.

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

ANSWER:

INDEPENDENT AUDITOR'S REPORT

ILLUSTRATION 3.

M/s Amitabh & Associates are the statutory auditors of Ringston Ltd. which is a company engaged in the business of manufacture of pen drives. The auditor has started drafting the audit report for the FY 2021-22. CA Amitabh, the engagement partner is of the view that the financial statements of Ringston Ltd. represent a true and fair view. Give the draft of the opinion paragraph of the audit report.

ANSWER:

Opinion

We have audited the financial statements of Ringston Limited which comprise the Balance Sheet as at 31.03.2022 and the statement of Profit and Loss Account and the notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the company as at 31.03.2022 and the Profit & Loss for the year ending on that date.

ILLUSTRATION 4.

M/s Kite Rite & Associates are the statutory auditors of Prime Deluxe Limited, for the FY 2021-22. At the time of finalising the audit report, one of the engagement team members, Mr. Robin, asked the engagement partner, CA Kite as to what all should be included in the Basis of Opinion Paragraph. The engagement partner CA Kite, explained the team in detail and asked Mr. Robin to draft such section for the auditor's report of Prime Deluxe Limited. Help Mr. Robin to draft the

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Basis for opinion section.

ANSWER:

Basis for Opinion

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

ILLUSTRATION 5.

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

ANSWER:

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity) and cash flows of the Company in accordance with the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgements and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error. In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so. Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

ILLUSTRATION 6.

M/s Ajay Vijay & Associates are the statutory auditors of Sarovar Ltd. for the FY 2021-22. The company is engaged in the business of manufacture of water bottles. At the time of finalising the auditor's report, one of the audit team members asked CA Ajay, the engagement partner to advise as to how the auditor's responsibilities can be shown in an appendix to the auditor's report. Draft the auditor's responsibility paragraph so as to advise the audit team member.

ANSWER:

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with SAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor's report. This description, which is located at [indicate page number or other specific reference to the location of the description], forms part of our auditor's report.

ILLUSTRATION 7.



M/s TUV & Associates are the statutory auditors of Venus Ltd. for the FY 2021-22.

At the time of finalising the auditor's report, one of the audit team members asked the engagement partner, CA Tarun, to explain as to how the auditor's report will be signed. Help CA Tarun in explaining the same.

ANSWER:

The following is the correct way of signing an audit report.

M/s TUV & Associates

Chartered Accountants

(Firm's Registration No.)

Signature

(Name of the Member Signing the Audit Report)

(Designation)

(Membership No. XXXXX)

Place of Signature:

UDIN:

20037320AAAAAH1111

Date:

ILLUSTRATION 8.

Super Duper Ltd. is a company engaged in the manufacture of office furniture. M/s Young Old & Associates are the statutory auditors of the company for the FY 2021-

22. During the year under audit, the engagement partner CA Young noticed that the company has not bifurcated its loans into long term and short term. CA Young understands that such misstatement is not pervasive though the same is material.

Explain the type of opinion that should be given by M/s Young Old & Associates in this case.

ANSWER:

M/s Young Old & Associates should give a qualified opinion as the effect of the misstatement on account of the non-bifurcation of loans into long term and short term loans, is material but not pervasive.

ILLUSTRATION 9.

M/s Taj Raj & Associates are the statutory auditors of Porex Ltd. engaged in the manufacture of premium watches, for the FY 2021-22. During the course of audit, CA Taj, the engagement partner found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Both the facts are not reflected in the financial statements for the year ending 31.03.2022. Accordingly, CA Taj is of the view that the impact of both the situations on the financial statements is material and pervasive and thus, the financial statements represent a distorted view of the state of affairs of the company. Explain the reporting requirements of CA Taj.



ANSWER:

The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

In the case Porex Ltd., CA Taj found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Such situations are not reflected in the financial statements of the company despite having a material and pervasive impact on the financial statements. As such, CA Taj should give an adverse opinion.

Further, CA Taj should also consider the reporting responsibilities under CARO 2020 and section 143(12) of the Companies Act, 2013.

ILLUSTRATION 10.

Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2021-22 the company transferred its accounts to computerised system (SAP) from manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such the statutory auditors of the company were not able to extract correct data and reports from the system. Such data was not

available manually also. Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. Explain the kind of audit report that the statutory auditor of the company should issue in this case.

ANSWER:

When the statutory auditor of the company is unable to obtain sufficient and appropriate audit evidence, the auditor should give disclaimer of opinion as per SA 705.

In the present case, the statutory auditor of the company is unable to extract correct data and reports from the SAP system for conduct of audit. Also, such data and reports are not available manually. As such, the statutory auditor of Delightful Ltd. should give a disclaimer of opinion.

ILLUSTRATION 11.

M/s Daisy & Associates are the statutory auditors of Zebra Ltd. for the FY 2021-22. CA Daisy, the engagement partner wants to verify the cash in hand as on 31.03.2022. The cash balance of the company as on 31.03.2022 is Rs. 1,00,000/- and the turnover of the company for the year is Rs. 6 crores. The management of the company informs CA Daisy that such cash verification is not possible as the cashier is on leave for his marriage and no other employee of the company is available as all are busy in year ending activities. Explain the relevant provisions to deal with such a situation.

ANSWER:

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers is likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

In the present case CA Daisy, the statutory auditor is unable to verify the cash in hand of Zebra Ltd. as on 31.03.2022. The same is due to a limitation imposed by the management of Zebra Ltd. which is due to the non availability of the cashier. In such situation, CA Daisy should perform alternate procedures to verify the cash on hand of the company. Further, CA Daisy should consider the impact on the auditor's report and may consider issuing a qualified opinion in this case.

ILLUSTRATION 12.

M/s Sun Moon & Associates are the statutory auditors of Venus Ltd. for the FY 2021-22. Owing to the pervasive nature of material misstatements in the financial statements of the company, CA Moon, the engagement partner decided to give an adverse opinion. Explain the responsibility of CA Moon with respect to communication with those charged with governance.

ANSWER:

CA Moon, being the statutory auditor of Venus Ltd. should communicate with those charged with governance about the circumstances that led to the expected modification i.e. an adverse opinion. Further the wording of such modification also needs to be discussed.

ILLUSTRATION 13.

Lomaxe Ltd. is a company engaged in the business of manufacture of candles. CA Kamalnath is the statutory auditor of the company for the FY 2021-22. During the year under audit, there was a fire in the company's factory as a result of which, some of the company's plant and machinery was destroyed. The same was disclosed by the company in the notes to accounts annexed to the financial statements for the year ending 31.03.2022. CA Kamalnath decided to communicate this matter in the auditor's report as he is of the view that the matter is of such importance that it is fundamental to the user's understanding of the financial statements. Help CA Kamalnath to deal with this situation in the auditor's report.

ANSWER:

In the present case there is a need to add Emphasis on Matter Paragraph in the Auditor's Report.

The draft of the same is as under:

Emphasis of Matter – Effects of Fire in Company's Factory

We draw attention to Note Y of the financial statements, which describes the effects of a fire in the Company's factory. Our opinion is not modified in respect of this matter



TEST YOUR KNOWLEDGE

Q.NO.1. “The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.” Explain

ANSWER:

Q.NO.2. “The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity’s accounting practices, including indicators of possible bias in management’s judgements.” Discuss stating clearly qualitative aspects of the entity’s accounting practices

ANSWER:

Q.NO.3. Discuss the factors affecting the decision of the auditor regarding which type of modified opinion is appropriate.

ANSWER:



Q.NO.4. Discuss the objective of the auditor as per Standard on Auditing (SA) 705 “Modifications to The Opinion in The Independent Auditor’s Report”.

ANSWER:

Q.NO.5. In considering the qualitative aspects of the entity’s accounting practices, the auditor may become aware of possible bias in management’s judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required.

ANSWER:

In considering the qualitative aspects of the entity’s accounting practices, the auditor may become aware of possible bias in management’s judgements. The auditor may conclude that lack of

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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 judgement and involvement of audit executives.

- ii. Possible management bias in the making of accounting estimates.

Q.NO.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.

ANSWER:



Q.NO.7. Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?

ANSWER:

Q.NO.8. "An auditor is required to make specific evaluations while forming an opinion in an audit report." State those evaluations.

ANSWER:

Q.NO.9. The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Explain

ANSWER:

Q.NO.10. Communicating Key Audit Matter is not a substitute for disclosure in the Financial Statements rather Communicating key audit matters in the auditor's report is in the context of the Auditor having formed an opinion on the financial statements as a whole. Analyse.

ANSWER:

Q.NO.11. The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section.

ANSWER:

Q.NO.12. Distinguish between an adverse opinion and a qualified opinion. Also draft an opinion paragraph for both types of opinion.

ANSWER:

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.

Adverse Opinion:

We have audited the accompanying consolidated financial statements of ABC Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2021, the consolidated statement of profit and Loss, (consolidated statement of changes in equity) and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "consolidated financial statements"). In our opinion and to the best of our information and according to the explanations given to us, because of the significance of the matter discussed in the Basis for Adverse

Opinion section of our report, the accompanying consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 2021, of its consolidated profit/loss, (consolidated position of changes in equity) and the consolidated cash flows for the year then ended.

Qualified Opinion:

We have audited the standalone financial statements of ABC Company Limited ("the Company"), which comprise the balance sheet as at March 31, 2021, and the statement of Profit and Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches)). In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at March 31st, 2021 and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

Q.NO.13. ABC Ltd is a company incorporated in India. It has branches within and outside India. Explain who can be appointed as an auditor of these branches within and outside India. Also explain to whom branch auditor is required to report.

ANSWER:

Q.NO.14. Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard.

ANSWER:

Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should:

- a. Identify division of audit areas and common audit areas;
- b. Ascertain the reporting objectives of the engagement;
- c. Consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;
- d. Consider the results of preliminary engagement activities, or similar engagements performed earlier.
- e. Ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

Q.NO.15. 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:

Q.NO.16. Discuss the reporting requirements under CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.

ANSWER:

The following are the disclosure requirements as per CARO 2020, with respect to the moneys raised by the company by way of initial public offer or further public offer and where the company has made any preferential allotment or private placement of shares.

- a. whether moneys raised by way of initial public offer or further publicoffer (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;

QUESTIONS FROM RTP'S, MTP'S, QP'S

SA 700- FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS

Question 1:

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?

(MTP NOV'23)

ANSWER

Factors to be considered to form an opinion: The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial

reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

- 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 2:

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

(MTP MAY'23, RTP MAY '23)

ANSWER

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 3:

While drafting auditor's report of LK Ltd., what are the matter to be included by auditor in Opinion Section paragraph? (RTP Nov'22)

ANSWER

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

- Identify the entity whose financial statements have been audited;
- State that the financial statements have been audited;
- Identify the title of each statement comprising the financial statements;
- Refer to the notes, including the summary of significant accounting policies; and
- Specify the date of, or period covered by, each financial statement comprising the financial statements.

Question 4:

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700. Explain (RTP MAY '22)

ANSWER

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700 (Revised) to include only the following:

A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;

A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

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

Question 5:

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.

(RTP NOV'22 & NOV '23)

ANSWER

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 6:

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. Explain stating clearly specific evaluations made by the auditor. (RTP MAY '22, MTP MARCH '23)

ANSWER

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements.

In particular, the auditor shall evaluate whether:

- a. The financial statements adequately disclose the significant accounting policies selected and applied;
- b. The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- c. The accounting estimates made by management are reasonable;
- d. The information presented in the financial statements is relevant, reliable, comparable, and understandable;
- e. The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
- f. The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Further, when the financial statements are prepared in accordance with a fair presentation framework, the evaluation mentioned above shall also include an evaluation by the auditor as to whether the financial statements achieve fair presentation which shall include consideration of:

- i. The overall presentation, structure and content of the financial statements; and
- ii. Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

Question 7:

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be

materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required. (RTP MAY '23)

ANSWER

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. 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 judgement and involvement of audit executives.

- ii. Possible management bias in the making of accounting estimates.

Question 8:

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? (RTP NOV '23, MTP NOV '23)



ANSWER

An auditor should state in "Basis for Opinion" section of Auditor's Report as under:

Basis for Opinion:

The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:

- 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 9:

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. (PYP NOV 22)

ANSWER

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.

Alternative Solution:

As per section 145 of the Companies Act, 2013, the person appointed as an auditor of the company shall sign the auditor's report or sign or certify any other document of the company. Whereas if a firm 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.

The partner 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.

Question 10:

Mention any four financial events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as going concern. (MTP MAY 24)

ANSWER:

Financial events or conditions that may cast significant doubt on the entity's ability to continue as going concern:

- (i) Net liability or net current liability position.
- (ii) Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short term borrowings to finance long term assets.
- (iii) Indications of withdrawal of financial support by trade payables.
- (iv) Negative operating cash flows indicated by historical or prospective financial statements.
- (v) Adverse key financial ratios.
- (vi) Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- (vii) Arrears or discontinuance of dividends.
- (viii) Inability to pay trade payables on due dates.

- (ix) Inability to comply with terms of loan agreements.
- (x) Change from credit to cash-on-delivery transactions with suppliers.
- (xi) Inability to obtain financing for essential new product development or other essential investments.

Question 11:

M/s S R & Associates are the Statutory Auditors of Vanee Textile and Garments Ltd., a company engaged in the business of manufacturing of various textile products. The auditor has completed the audit and is in the process of forming an opinion on the financial statements for the F.Y. 2023-2024. CA S, the engagement partner, wants to conclude whether the financial statements as a whole are free from material misstatements, whether due to fraud or error. Guide him about the factors he should consider to reach that conclusion. (MTP MAY 24)

ANSWER:

Factors to be considered to form an opinion:

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

- (1) whether sufficient appropriate audit evidence has been obtained
- (2) whether uncorrected misstatements are material, individually or in aggregate.
- (3) The evaluations required

- (i) 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

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? (MTP MAY'22)

ANSWER

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.

1. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:
2. 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
3. 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. (MTP NOV'23)

ANSWER

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:

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.

(PYP MAY '23)

ANSWER

Circumstances When a Modification to the Auditor's Opinion Is Required

The auditor shall modify the opinion in the auditor's report in the following circumstances:

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.

Question 4:

Discuss the objective of the auditor as per Standard on Auditing (SA) 705 "Modifications to The Opinion in The Independent Auditor's Report".

^(MTP MAY 24)

ANSWER:

As per Standard on Auditing (SA) 705 "Modifications to the Opinion In The Independent Auditor's Report", the objective of the auditor is **to express clearly an appropriately modified opinion** on the financial statements that is necessary when:

- (a)** The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or

The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Question 5:

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

- (i) He has not been provided with necessary support for attending inventory count process of entity as at year end.**
- (ii) Accounts Manager is not providing him present addresses of customers as well as suppliers for sending external confirmations. Even mail ids have not been provided on the pretext of business confidentiality.**
- (iii) He was not able to verify revenues of entity due to lack of complete details.**
- (iv) He has been asking for bills on a sample basis for the purpose of verifying expenses, but staff has been making lame excuses.**

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

case, a qualification of the opinion would be inadequate to communicate the gravity of the situation.

How should the auditor proceed in such a situation?

(MTP MAY 24)

Answer:

In the given case, auditor has not been able to obtain sufficient appropriate audit evidence relating to inventories, debtors, creditors, revenues and expenses. The matter was brought to the knowledge of management but no result has been achieved. In such circumstances, auditor should proceed as given here under: -

If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:

- (i)** Withdraw from the audit, where practicable and possible under applicable law or regulation; or
- (ii)** If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

If auditor withdraws from such an engagement, before withdrawing, auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.



SA 706- EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

Question 1:

The inclusion of an Emphasis of Matter paragraph in the Auditor's Report affects the auditor's opinion. (RTP Nov '23)

ANSWER

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.

Accordance with SA 705.

Question 2:

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 (MTP NOV'22)

ANSWER

If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

1. That the financial statements of the prior period were audited by a predecessor auditor;
2. The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and
3. The date of that report, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.

Question 3:

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.

(MTP NOV'22, MTP NOV'23, RTP NOV'22)

ANSWER

Examples of circumstances to include Emphasis of Matter Paragraph: As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In the Independent Auditor's Report", the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are;

- a. An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- b. A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.

- c. Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- d. A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Question 4:

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. (PYP MAY'22)

ANSWER

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

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



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

The draft of the same is as under:

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

Alternative Solution:

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

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

- (i) (c) whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed

in the financial statements are held in the name of the company,
if not, provide the details thereof in the format below:

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

The auditor should state in the Reason (column 6) for not being held in name of company as follows
“Properties obtained during the year through barter deals and included in the PPE in the books of accounts on the basis of possession letter only”

Question 5:

Mention some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph. (RTP MAY 24)

ANSWER:

Examples of circumstances to include Emphasis of Matter Paragraph:

As per SA 706 (Revised) on “Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor’s Report”, the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are: -

- (a) An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- (b) A significant subsequent event that occurs between the date of the financial statements and the date of the auditor’s report.
- (c) Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- (d) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

SA 701- COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT

Question 1:

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? (RTP NOV '23)

ANSWER

As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:

- i. A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;
- ii. A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report";
- iii. A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
- iv. A separate opinion on individual matters.
- v.

Question 2:

Communicating key audit matters in the auditor's report is a separate opinion on individual matters. (PYP MAY '23)

ANSWER

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:

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?

(PYP MAY'22 MTP NOV 22)

ANSWER

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?

(PYP NOV 22)

ANSWER

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:

That the financial statements of the prior period were audited by a predecessor auditor;

The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and

The date of that report, unless the predecessor auditor's report on the prior period's financial statements is revised with the financial statements.



SA 299. 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.

(MTP MAY'23)

ANSWER

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:

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?

(PYP Nov'22)

ANSWER

Joint Audit of Financial Statements:

As per SA 299, "Joint Audit of Financial Statements", all the joint auditors shall be jointly and severally responsible for:

- 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.

Question 1:

PQR & Associates and MNO & Co., both firms of Chartered Accountants, have been appointed as joint auditors of Gama and Beta Limited. Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard with reference to the Standards on Auditing.

(MTP SEP 24)

ANSWER:

In accordance with SA 299, "Joint Audit of financial statements", before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, PQR & Associates and MNO & Co., the joint auditors should:

- (a)** identify division of audit areas and common audit areas;
- (b)** ascertain the reporting objectives of the engagement;
- (c)** consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;
- (d)** consider the results of preliminary engagement activities, or similar engagements performed earlier

ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

REPORTING REQUIREMENTS UNDER COMPANIES ACT

Question 1:

The auditor's reporting on internal financial control will be applicable with respect to interim financial statements. Discuss (MTP MAY '23)

ANSWER

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 2:

Examine with reasons (in short) whether the following statements are correct or Incorrect: An auditor has to report on the matters specified in section 143(1) of the Companies Act, 2013.

(MTP MAY'22, RTP Nov '22)

ANSWER



Incorrect: The auditor is not required to report on the matters specified in section 143(1) of the Companies Act, 2013 unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. However, the auditor should make a report to the members in case he finds ANSWER to any of these matters in adverse.

Question 3:

Under provisions of Section 143(2), the auditor shall make a report to the members of the company on the accounts examined by him. Explain along with relevant rule of The Companies (Audit and Auditors) Rules, 2014 (MTP MAY'22)

ANSWER

Under provisions of Section 143(2), 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 thereunder or under any order made under sub-section (11).

Further, auditor has to report whether to 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 following matters as prescribed under relevant rules (Rule 11):-

- i. whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
- ii. whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;
- iii. whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.
- iv.
 - (1) Whether the management has represented that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;
 - (2) Whether the management has represented, that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and
 - (3) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material mis-statement.
- v. Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013
- vi. Whether the company has used any accounting software for maintaining books of accounts 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 features have not been tampered with and the audit trail has been preserved by the company as per statutory requirements for record retention. (As per amendment Nov23)

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.

(MTP MAY'23)

ANSWER

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.

(MTP NOV'23)

ANSWER

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:

As per Sec 143(3)(j) of the Companies Act, 2013, the auditor's report shall also include such other matters as may be prescribed by Rule 11 of the Companies (Audit and Auditors) Rule, 2014. Discuss those matters on which views and comments of the auditor are required.

ANSWER

Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report. The auditor's report shall also include their views and comments on the following matters, namely:

- i. whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
- ii. whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;
- iii. whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.
- iv.
 - (1) Whether the management has represented that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities ("Intermediaries"), with the understanding, whether recorded in writing or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;
 - (2) Whether the management has represented, that, to the best of its knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities ("Funding Parties"), with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party ("Ultimate Beneficiaries") or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and
 - (3) Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (1) and (2) contain any material misstatement.
- v. Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.
- vi. 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 7:

During the course of audit of PQR Ltd, the statutory auditor CA G came across payments made to various creditors aggregating to Rs.75 lakhs. On verifying the same it is found that the accounts manager had accounted for fake invoices of credit purchases for Rs.25 lakhs in the books of account in the name of one bogus creditor Mr. X.

Discuss the duties of auditor with reference to the provisions of Companies Act, 2013 and also the disclosure requirements in the Board's Report. (PYP May'23)

ANSWER

The auditor shall report under clause (xi) of the CARO, 2020 that:

Whether any fraud by the company or any fraud on the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated;

Reporting to the Audit Committee or Board: Sub-section (12) of section 143 of the Companies Act, 2013 further prescribes that in case of a fraud involving lesser than the specified amount [i.e. less than Rs.1 crore], the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed.

In this regard, sub-rule (3) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in case of a fraud involving lesser than the amount specified in sub- rule (1) [i.e. less than Rs.1 crore], the auditor shall report the matter to Audit Committee constituted under section 177 or to the Board immediately but not later than 2 days of his knowledge of the fraud and he shall report the matter specifying the following:



- i. Nature of Fraud with description;
- ii. Approximate amount involved; and
- iii. Parties involved.

Disclosure in the Board's Report: Sub-section (12) of section 143 of the Companies Act, 2013 furthermore prescribes that the companies, whose auditors have reported frauds under this sub-section (12) to the audit committee or the Board, but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.

In this regard, sub-rule (4) of Rule 13 of the Companies (Audit and Auditors) Rules, 2014 states that in the Board's Report the following details of each of the fraud reported to the Audit Committee or the Board under sub- rule (3) during the year:

- i. Nature of Fraud with description;
- ii. Approximate Amount involved;
- iii. Parties involved, if remedial action not taken; and
- iv. Remedial actions taken.

CARO

Question 1:

ABC Ltd. is a public company, which has availed various loans and cash credit facilities from Banks and other financial institutions. The company has defaulted in repayments of such borrowings during the year under audit. What are the reporting requirements in this regard under the Companies (Auditor's Report) Order, 2020? (PYP MAY '23, MTP MAY'22)

ANSWER

The auditor is required to report as per clause (ix) of paragraph 3 of CARO 2020 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.				

- whether the company is a declared wilful defaulter by any bank or financial institution or other lender;
- 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;
- whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated;
- 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;
- 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 2:

State the matters to be included in auditor's report as per CARO, 2020 regarding - Verification of inventory and working capital limits. (MTP MAY'22)

ANSWER

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 3:

Discuss the reporting requirements as per CARO, 2020, regarding:

Inventory and Deposits accepted by company or amounts which are deemed to be deposits.

(MTP NOV'22)

ANSWER

Matters to be included as per CARO, 2020:

Inventory Clause (ii)

- 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;

Deposits accepted by company or amounts which are deemed to be deposits

Clause (v)

In respect of deposits accepted by the company or amounts which are deemed to be deposits, 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 and the rules made thereunder, where applicable, have been complied with, if not, the nature of such contraventions be stated; 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;

Question 4:

Discuss the reporting requirements as per CARO, 2020, regarding:

Disputed and Undisputed statutory dues (MTP MAY'23, MTP NOV'22 and internal audit system of the company (MTP MAY'23, MTP 2 NOV'22)

ANSWER

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)

- i. whether the company has an internal audit system commensurate with the size and nature of its business;
- ii. whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor.



Question 5:

Explain the Reporting requirements the auditor should ensure under CARO 2020 related to PPE and Intangible assets. (RTP MAY '22)

ANSWER

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 6:

State the matters to be included in the auditor's report as per CARO, 2020 regarding:

- i. Nidhi Company.
- ii. Transactions with related parties.

(RTP NOV '23)

ANSWER



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 7:

State with reasons whether the following statements are correct or incorrect

According to CARO 2020, the company auditor is required to state that whether the title deeds of

all immovable properties held in the name of the company are disclosed in its financial statements.

(PYP MAY'22)

ANSWER

Incorrect: According to CARO, 2020, the company auditor is required to state whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) disclosed in the financial statements are held in the name of the company.


Question 8:

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

(PYP MAY'22)

ANSWER

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

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

Applying the above to the given case, G Pvt. Ltd., its paid-up capital and reserves are ₹ 95 Lakh (₹ 120 Lakh - ₹ 25 Lakh), borrowings from a Bank and financial institution are (₹ 55 Lakh + ₹ 55 Lakh) i.e., ₹ 1.10 Crore, turnover {including discontinuing operations (₹ 850 lakh + ₹ 250 Lakh)} ₹ 1100 Lakh i.e., ₹ 11 Crore.

Since its borrowings and turnover are exceeding the specified limit and therefore it is not exempt from the applicability of CARO, 2020.

Question 9:

State with reasons whether the following statements are correct or Incorrect:

Mr. T, the director of A Ltd., has purchased an old car belonging to the company against the cooling equipment belonging to the director, which is given to the company as consideration for the car.

The auditor is not required to include this in his CARO report.

(PYP NOV 22)

ANSWER

Incorrect: The auditor is required to report the same as per clause (xv) of Paragraph 3 of CARO, 2020, “whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with”.

Question 10:

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? (PYP NOV 22)

ANSWER

Reporting Requirements under CARO 2020 for raising funds: As per clause (x)(b) of Para 3 of CARO, 2020, the auditor of a company has to report whether the company has made any preferential allotment or private placement of shares or convertible debentures (fully, partially or optionally convertible) during the year and if so, whether the requirements of section 42 and section 62 of the Companies Act, 2013 have been complied with and the funds raised have been used for the purposes for which the funds were raised, if not, provide details in respect of amount involved and nature of non-compliance.

In the present case, TS Ltd. has raised funds by issuing fully convertible debentures for expansion and diversification of the business. However, the company used the funds for repayment of long-term loans and advances instead of utilization of the same for the purpose for which the funds were raised i.e. expansion and diversification of business.

Here, the auditor should report the fact in his report that the funds were used for the purpose other than the purpose for which the funds were raised, as per clause (x)(b) of Para 3 of CARO, 2020.

Question 11:

DOX Limited, a service provider company engaged in providing courier services pan-India as well as internationally, has appointed an internal auditor, Mr. G, in accordance with requirements of the Companies Act, 2013 during financial year 2023-24. The company's annual turnover during year 2022-23 and 2023-24 has been about Rs. 300 crores during each of above years. Business of the company has been profitable. Mr. G heads internal audit department of the company assessing governance activities, assisting in improving risk management activities and reviewing controls. Discuss reporting responsibility of statutory auditor of the company under the Companies Act, 2013 specifically in relation to internal audit and related matters for the year 2023-24. (MTP MAY 24)

Answer:

DOX Limited is in business of providing courier services. As name of the company and given facts suggest: -

➤ It is not a small company under section 2(85) of Companies Act, 2013.

- It is not a private company.
- It is not a one person company.
- It is not a banking or insurance company.
- It is not a Section 8 company as it does not has charitable objects etc.

Therefore, it does not qualify for any exemption from applicability of CARO, 2020. Hence, reporting requirements under CARO, 2020 are applicable. While reporting under CARO, 2020, statutory auditor is required to report under clause (xiv) of paragraph 3 as under:

- (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 auditor

Question 12:

CA. Ravi Patnaik is conducting audit of a company for which reporting requirements under CARO, 2020 are applicable. He finds that cash credit facilities amounting to Rs. 4 crores were released to the company by branch of a bank for meeting its working capital requirements. He finds that out of above funds, Rs. 1 crore have been used by company for installing effluent treatment plant to meet State pollution control Board requirements.

Is there any reporting obligation upon him under CARO, 2020?

(MTP MAY 24)

ANSWER:

Clause (ix) (d) of CARO, 2020 whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated.

In the given situation, funds have been raised for meeting working capital requirements for Rs. 4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings. Out of above, Rs. 1 crore have been used by the company for investment in effluent treatment plant which is ostensibly for a long-term purpose.

Hence, the matter needs to be reported in accordance with requirements of Clause (ix) (d) of CARO, 2020.

Question 13:

Mr. Chetan is appointed as an auditor of Spot Limited, a small company. Mr. Chetan is aware that CARO 2020 is not applicable to small company. List out the classes of companies that are specifically exempt from the applicability of CARO 2020.

(MTP SEP 24)

ANSWER:

CARO 2020 shall apply to every company including a foreign company as defined in clause (42) of section 2 of the Companies Act, 2013, except—

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;
- (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 in clause (62) of section 2 of the Companies Act and a small company as defined in clause (85) of section 2 of the Companies Act; and

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

Question 14:

Discuss the reporting requirements as per CARO, 2020, regarding:

(i) Statutory Dues and

(ii) Transactions with Related Parties

(RTP SEP 24)

ANSWER:

(i) Reporting under CARO,2020 regarding statutory Dues [Para 3(vii)]

- (a) whether the company is regular in depositing undisputed statutory dues including Goods and Services Tax, provident fund, employees' state insurance, income tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;
- (b) where statutory dues referred to in sub-clause (a) have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned (a mere representation to the concerned Department shall not be treated as a dispute);

(ii) Reporting under CARO,2020 regarding transactions with related parties [Para 3(xiii)]

Whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act where applicable and the details have been disclosed in the financial statements, etc., as required by the applicable accounting standards.

4. COMPLETION AND REVIEW

ILLUSTRATIONS

ILLUSTRATION 1.

CA PK Jacob is conducting audit of a company for year 2021-22. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2022. However, it becomes known to the auditor that one of overseas buyers has made a legal claim against the company on 1st June 2022 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August, 2021. The management of company has decided to agree to an out of court settlement of Rs.5 crore to protect its reputation. The financial statements of the company are silent on this issue.

Discuss, how, CA PK Jacob should proceed to deal with above issue.

ANSWER:

In the given case, the auditor has come to know of legal claim against the company before issue of audit report. It has also come to his knowledge that management of company has agreed to an out of court settlement of Rs.5 crore. It is an example of subsequent event between the date of the financial statements and the date of the auditor's report. It provides evidence of conditions that existed at the date of the financial statements and requires adjustment in financial statements.

He should ask company management to make necessary adjustment to the financial statements. If adjustment is not made by management, he should consider impact on auditor's report.

ILLUSTRATION 2.

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

ANSWER:

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

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

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

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

ILLUSTRATION 3.

During course of audit of a company, CA. Varun Aggarwal notices that company is facing significant skilled labour shortages resulting in hampering of operations of company. The company's manufacturing is dependent upon skilled labour coming from villages in certain districts of Eastern UP. However, due to job opportunities available near villages now, many are not interested in going out from their native villages.

Such a situation has led to company not being able to keep its commitments, losing out on orders and fall in its revenues. Fixed costs of the company remain at a high level. As a result, company is facing a liquidity crunch and is not able to pay its creditors on time. The bankers of company are also not willing to help the company to tide over liquidity crisis. The auditor is having doubts over going concern status of the company.

How should management of the company try to address auditor's concerns? What audit procedures may be performed by auditor in such a situation?

ANSWER:

Significant shortage of skilled labour, inability to pay creditors on time and overall liquidity crisis faced by the company are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

In such a situation, management should try to address auditor's concerns by preparing its future plan of action including preparation of cash flow forecast showing inflow and outflow of cash. Such a cash flow forecast should address auditor's concerns regarding liquidity crisis being faced by the company. The auditor should perform audit procedures to evaluate the reliability of the underlying data to prepare the forecast and determining whether there is adequate support for the assumptions underlying the forecast. The auditor should also consider whether any additional facts or information have become available since the date on which management made its assessment.

ILLUSTRATION 4.

You are nearing completion of audit of a company. On going through your working papers, it is noticed that finished goods inventory was overvalued by Rs. 2 crore. It has also been noticed that freight of Rs.10 lacs paid on import of machinery was charged to statement of profit and loss.

Discuss, how you should, proceed and communicate in above situation before signing audit report.

ANSWER:

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

The auditor should communicate above identified misstatements to those charged with governance and request for correction of these misstatements. In case, these are not corrected, understand the reasons for not making the corrections and reassess materiality. It should also be considered whether uncorrected statements are material individually or in aggregate. Effect of uncorrected misstatements on the opinion in auditor's report should be communicated to those charged with governance.

ILLUSTRATION 5.

CA R Gurumurthy is about to complete audit of a company. Before completion, he asks management to provide him a written representation confirming that management has fulfilled its responsibilities regarding preparation of financial statements. He also wants management to confirm in writing about providing of all the necessary information and completeness of transactions to him. The management feels that auditor is seeking irrelevant documents near the completion of audit. Why view of management is not proper? What possible implications it may lead to?

ANSWER:

The view of management is not proper. Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities.

In case of refusal of management to provide such a confirmation, it may lead to disclaimer of opinion by the auditor.

ILLUSTRATION 6.

On reviewing internal control over inventories as part of statutory audit of a company, auditor finds that physical verification is not being conducted at regular intervals as stipulated by the management. The auditor finds it to be significant deficiency in internal control over inventories.

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

“Physical verification of inventories is not being conducted at regular intervals as stipulated by management.” Is above communication by auditor proper? Ignore statutory reporting requirements, if any in this regard.

ANSWER:

While pointing out significant deficiencies in internal control, auditor has not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information to those charged with governance and management to understand context of communication.

Therefore, the above communication is not proper. Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of not carrying out physical verification of inventories at regular intervals as stipulated by management. It should explain that such a significant deficiency can lead to misstatement of inventories impacting profits of the company. Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.



TEST YOUR KNOWLEDGE

Q.NO.1. List out some matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a “significant deficiency”.

ANSWER:

Q.NO.2. In what ways an effective two-way communication between auditor and those charged with governance is important?

ANSWER:

Q.NO.3. The auditor of a company is having concerns about following of going concern basis of accounting followed by management for preparation of financial statements. It asks the management to justify preparation of financial statements. However, management is not willing to make its assessment and share with auditor. What are implications for auditor's report in such a scenario?

ANSWER:



Q.NO.4. Discuss documentation requirements for an auditor regarding misstatements identified during audit under SA 450.

ANSWER:

Q.NO.5. Discuss meaning of “Date the financial statements are issued” under SA 560.

ANSWER:

QUESTIONS FROM RTP'S, MTP'S, QP'S

SA 450- EVALUATION OF MISSTATEMENT IDENTIFIED DURING THE AUDIT

Question 1:

Up and High Private Limited has started its export business during the year 2023-24. The company was catering to domestic market only in past years. CA H, statutory auditor of the company, is of the view that the company has understated its revenue by Rs. 50.00 lacs in the year 2023-24 by not complying with requirements of AS 9 relating to revenue recognition.

- (i) Discuss responsibilities of statutory auditor to communicate with management in the above situation in accordance with SA 450. Also explain the usefulness of such communication.**
- (ii) If management refuses to correct misstatement as communicated by the statutory auditor, how should he proceed?**

ANSWER:

The above situation is an example of misstatement relating to non-compliance with requirements of AS 9 identified during audit. In accordance with requirements of SA 450, the auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements.

Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees and take action as necessary. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

-

SA 560- SUBSEQUENT EVENTS

Question 1: 1

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.

(MTP NOV’23)

ANSWER

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 2:

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

(RTP MAY 24)

Answer:

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

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

in financial statements: -

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

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



SA 570- GOING CONCERN

Question 1:

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

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

How will you deal in your audit report?

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

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

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

(PYP MAY '23)

ANSWER

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

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

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

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

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

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

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

Question 2:

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

Communicating key audit matters in the auditor's report is 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. (RTP MAY '22)

ANSWER

Incorrect: Communicating key audit matters in the auditor's report is not a substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may

cast significant doubt on an entity's ability to continue as a going concern

Question 3:

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

ANSWER:

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

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

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

Question 4:

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

(MTP SEP 24)

ANSWER:

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

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

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

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



SA 580- WRITTEN REPRESENTATIONS

Question 1:

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

(MTP NOV'22)

ANSWER

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 2:

Akash & Associates are the statutory auditors of Deluxe Ltd. for the FY 2020 -21. During the course of audit, CA Akash, the engagement partner requested the management of the company to provide written representation with respect to valuation of a transaction. The management, however does not provide the same to CA Akash. What course of action should CA Akash follow in such situation?

(MTP MAY'23, RTP MAY'23)

ANSWER



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 3:

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 MAY'23)

ANSWER

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

- 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 4:

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

One of the objectives of the written representation is to support other audit evidence relevant to the financial statements. (RTP MAY '22)

ANSWER

Correct: One of the objectives of the written representation is to support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representation. Written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available.

Question 5:

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

Explain (RTP Nov '23)

ANSWER

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

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

- 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 6:

Written representation about management's responsibilities involves confirmation of fulfilment of management's responsibilities in the preparation of the financial statements providing the

relevant information and also informing about completeness of transactions. Explain.

(MTP MAY 24)

ANSWER:

Written representation about management's responsibilities involves confirmation of fulfilment of management's responsibilities in following areas: -

(I) Preparation of the financial statements

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as set out in the terms of the audit engagement.

Due to its responsibility for the preparation and presentation of the financial statements and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.

(II) Information provided and completeness of transactions

The auditor shall request management to provide a written representation that: -

- (i)** It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement and

All transactions have been recorded and are reflected in the financial statements.



Question 7:

CA Manoj is the statutory auditor of a company. He has completed the audit and issued the audit report dated June 30, 2024. Before signing the audit report, written representations dated June 29, 2024, were obtained from the management of the company. Discuss the significance of the date of written representations. Also state whether the written representations obtained on June 29, 2024 is appropriate or not. (RTP SEP 24)

ANSWER:

As per SA 580, "Written Representations" the date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. Since written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated before the date of the written representations. Furthermore, because the auditor must consider events occurring up to the date of the auditor's report that might require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

In the given situation, CA Manoj obtained written representations dated June 29, 2024, from the management of the company before signing the audit report on June 30, 2024.

From the above it can be concluded that written representations have been obtained

appropriately.

Question 8:

While conducting audit of BYN Limited, CA Y notices that company has lost one of its key markets along with important customers. Additionally, several highly successful competitors have emerged, impacting business of the company. Despite the existence of material uncertainty, CA Y finds the use of going concern basis of accounting appropriate for preparation of financial statements. The company has also disclosed material uncertainty in notes to accounts adequately. How should he deal with the matter in auditor's report? (RTP SEP 24)

ANSWER:

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

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



5. AUDIT DOCUMENTATION

ILLUSTRATIONS

ILLUSTRATION 1.

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

ANSWER:

The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

In the instant case, an important matter regarding treatment of interest costs of company on its restructured loans taken from a bank directly impacting profits of the company was discussed. Although issue was resolved, it is necessary to document the same by including detail of the person with whom discussions took place along with date.

ILLUSTRATION 2.

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

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

ANSWER:

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

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

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

ADDITIONAL ILLUSTRATIONS

ILLUSTRATION 1.

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

ANSWER:

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

ILLUSTRATION 3.

While auditing the books of accounts of Very Careful Limited for the financial year 2020-21, a team member of the auditors of Very Careful Limited was of the view that with regard to audit of the company, no relation exists between Audit File and Audit Documentation. Explain the relationship between Audit File and Audit Documentation.

ANSWER:

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

ILLUSTRATION 4.

A director of Very Different Limited was of the view that Audit Documentation of a company is the property of that company. Comment on the contention of the director regarding the audit documentation of the company.

ANSWER:

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

TEST YOUR KNOWLEDGE

Q.NO.1. The form, content and extent of audit documentation depends upon number of factors.
List out any four such factors.

ANSWER:

Q.NO.2. Discuss any two purposes of audit documentation.

ANSWER:

Q.NO.3. Define audit documentation. Also give some examples.

ANSWER:

Q.NO.4. “Audit documentation summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits”. Explain.

ANSWER:



QUESTIONS FROM RTP'S, MTP'S, QP'S

Question 1:

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. (PYP NOV 22, RTP MAY '23)

ANSWER

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:

Electronic payment of Income Tax cannot be made by an assessee from the account of any other person. (MTP MAY'22)

ANSWER

Incorrect: Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards. The assessee can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account Number (PAN) of the assessee on whose behalf the payment is made. It is not necessary for CA Inter (New) | P5 Auditing and Ethics | Comprehensive Question Bank | CA Ram Harsha

the assessee to make payment of taxes from his own account in an authorized bank.

Question 3:

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

(MTP NOV'22)

ANSWER

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 4:

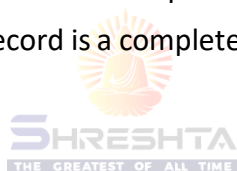
Examine with reasons (in short) whether the following statements are correct or incorrect.

Narrative record is a series of instructions and/or questions which a member of the auditing staff must follow and/or ANSWER.

(MTP MAY'23)

ANSWER

Incorrect: Check list is a series of instructions and/or questions which a member of the auditing staff must follow and/or ANSWER. Narrative record is a complete and exhaustive description of the system as found in operation by the auditor.



Question 5:

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

The internal control questionnaire is a series of instructions. questions which a member of the auditing staff must follow and or ANSWER.

(MTP NOV'22)

ANSWER

Incorrect: Checklist is a series of instructions and or questions which a member of the auditing staff must follow and/or ANSWER. Internal control questionnaire is a comprehensive series of questions concerning internal control. The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees.

Question 6:

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

(RTP NOV'22)

ANSWER

As per SA 230, "Audit Documentation", if, in exceptional circumstances, the auditor performs new or

additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document:

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

Question 7:

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

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 8:

Audit Documentation refers to the record of three items. Explain stating clearly the objective and nature of audit documentation. (RTP NOV '23)

ANSWER

Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

The objective of the auditor 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 9:

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.

(RTP NOV '23, MAY'23)

ANSWER

The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report.

- ⬆ 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 10:

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.

(PYP NOV '22)

ANSWER

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

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

Question 11:

What is meant by audit documentation? What are objectives of an independent auditor in accordance with SA 230? (MTP MAY 24)

ANSWER:

Audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. The objective of the auditor in accordance with SA 230 is to prepare documentation that provides: -

- (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.

Question 12:

One of the factors affecting the form, content and extent of audit documentation relates to size and complexity of the entity. State six other factors in this respect. (MTP MAY 24)

ANSWER:

One of the factors affecting the form, content and extent of audit documentation relates to size and complexity of audit. Other factors are:

1. The nature of the audit procedures to be performed.
2. The identified risks of material misstatement.
3. The significance of the audit evidence obtained.
4. The nature and extent of exceptions identified.
5. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
6. The audit methodology and tools used.

Question 13:

Rajni, a CA student, has understood that SA 230 requires auditor to prepare audit documentation on a timely basis. While reading about SQC 1, she notices that time limit for completion of final audit file is ordinarily not more than 60 days after the date of auditor's report. She finds it to be puzzling. Unable to comprehend, she seeks your guidance. Guide her. (RTP MAY 24)

ANSWER:

SA 230 requires that the auditor shall prepare audit documentation on a timely basis. Preparing

sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized.

SQC 1, however, requires auditor to complete assembly of final audit file in ordinarily not more than 60 days after the date of the auditor's report. The completion of the assembly of the final audit file after the date of the auditor's report is only an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.

Therefore, auditor shall prepare documentation on a timely basis. However, for completion of assembly of final audit file which is an administrative process, time period of 60 days after the date of auditor's report has been required in SQC 1.

Question 14:

Discussing meaning of completion memorandum, elaborate upon its importance.

(RTP MAY 24)

ANSWER:

Completion memorandum is a summary that describes the significant matters identified during the audit and 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 15: 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 SEP 24)

ANSWER:

As per SA 230, "Audit documentation" judging the significance of a matter requires an objective analysis of the facts and circumstances.

Examples of significant matters include:

- 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 judgement exercised in performing the work and evaluating the results.

Documentation of the professional judgements made, where significant, explains the auditor's conclusions and reinforces the quality of the judgement.

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).



6. AUDIT EVIDENCE

ILLUSTRATIONS

ILLUSTRATION 1.

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

ANSWER:

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

ILLUSTRATION 2.

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

ANSWER:

Inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. Mere inquiry does not lead to obtaining of sufficient appropriate audit evidence. In the instant case, CA Sooryagaythri should verify whether proper bank reconciliations have been carried out monthly as stipulated by management. Only then, she can be satisfied about operating effectiveness of controls in this regard.

ILLUSTRATION 3.

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

ANSWER:

The management is carrying out reconciliations of items contained in Property, Plant and Equipment records with physical verification of such items at regular intervals. It means that controls in this regard have operated effectively. The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

ILLUSTRATION 4.

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

ANSWER:

One of the functions of internal auditor includes responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In the given case, internal auditor has found that controls relating to levying of interest have not operated. The system has not levied stipulated interest in respect of a certain period. It can result in loss of income for the company and improper financial reporting. Such a matter, definitely, falls in the domain of reporting by internal auditor.

ILLUSTRATION 5.

CA Suresh is external auditor of an entity. He comes to know that there is also an internal auditor in the entity. However, he finds that internal auditor is not reporting directly to higher echelons of the management. CA Suresh has also assessed risk of material misstatement to be high. Discuss, whether it would be proper for CA Suresh to rely upon work of internal auditor extensively in above situation.

ANSWER:



In the given case, the organizational status of internal audit function is not commensurate with his duties. He is not reporting directly to higher echelons of management. It shows that such a function is not given its due importance in entity. Since risk of material misstatements has also been assessed as high by CA Suresh, both the above factors suggest that he should not rely upon work of internal auditor extensively.

ILLUSTRATION 6.

An auditor, while conducting audit of an entity, has selected samples based upon his personal experience and knowledge. Later on, it turns out that selected samples were not representative and it has led to faulty selection of samples. The auditor contends that samples were selected based upon his personal experience and knowledge. Can auditor escape from his responsibility in this regard?

ANSWER:

In the provided situation, the auditor has selected samples based upon his personal experience and knowledge. It is a case of non-statistical sampling approach adopted by the auditor. Whatever may be the approach nonstatistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The auditor cannot escape his responsibility in this regard.

ILLUSTRATION 7.

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

ANSWER:

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

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

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

ILLUSTRATION 8.

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

ANSWER:

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

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

ADDITIONAL ILLUSTRATIONS

ILLUSTRATION 1.

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

ANSWER:

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

ILLUSTRATION 2.

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

Give your views as auditor of Genuine Limited.

ANSWER:

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

ILLUSTRATION 3.

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

ANSWER:

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

ILLUSTRATION 4.

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

procedure used by the auditor of Extremely Distinct Limited.

ANSWER:

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

ILLUSTRATION 5.

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

ANSWER:

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

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

ILLUSTRATION 6.

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

ANSWER:

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.

ILLUSTRATION 7.

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

ANSWER:

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

ILLUSTRATION 8.

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

ANSWER:

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

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

ILLUSTRATION 9.

CA Aarav wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2022-23. The rent amounts to Rs.50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of Rs.10,000/- per month for a similar location. How will applying the analytical

procedures impact the verification process of such rental payments by XYZ Ltd.?

ANSWER:

If CA Aarav checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e., XYZ Ltd. paid Rs.50,000/- per month as rent and the same is getting reflected in the rent agreement. Here, CA Aarav may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location.

If CA Aarav applies analytical procedure i.e., compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.

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

ILLUSTRATION 10.

Analytical procedure involves analysis of relationship among financial and non- financial data.

Explain with the help of an example as to how, the statutory auditor of ABC Ltd. will analyse such relationship with respect to the total wages paid by ABC Ltd. during the FY 2022-23.

ANSWER:

As per SA 520, Analytical Procedures means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. The following example explains the analysis of relationship between financial and non-financial data while applying analytical procedures.

The statutory auditor of ABC Ltd. has to verify the total wages paid by the company having factories in various states. He can verify the same by analyzing the relationship between wages per worker and total number of workers across all the factories.

i.e.. $\text{Total wages} = \text{Wages per worker} \times \text{Total number of workers}$.

Here wages per worker is financial data i.e. in Rs. and total number of workers is a number which is a non financial data. Thus, the statutory auditor of ABC Ltd. is evaluating financial information i.e. total wages paid (in Rs.) by analyzing the relationship between wages per worker (in Rs.) which is financial data and number of workers which is a non financial data.

Analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.

TEST YOUR KNOWLEDGE

Q.NO.1. Many related party transactions are in the normal course of business. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Give few examples of such areas.

ANSWER:

Q.NO.2. An auditor is appointed for the first time for audit of accounts of an entity. The accounts of previous year were unaudited. He is unable to obtain sufficient appropriate audit evidence regarding the opening balances. What is his responsibility in this regard?

ANSWER:

Q.NO.3. Discuss some of circumstances when work of the internal auditor cannot be used by external auditor.

ANSWER:



Q.NO.4. Discuss what is understood by “appropriateness” of audit evidence.

ANSWER:

Q.NO.5. Maintaining accounts using accounting software having a feature of recording audit trail can be useful for an auditor. Discuss some of the advantages for such a feature in accounting software for auditors.

ANSWER:

Q.NO.6. Explain how a statutory auditor of a company can apply analytical procedures at the planning phase of audit.

ANSWER:

Q.NO.7. Discuss the objective of Auditor with respect to Opening balances in conducting an initial audit engagement.

ANSWER:

Q.NO.8. M/s Pankaj & Associates, Chartered Accountants, have been appointed as an auditor of ABC Limited. CA Pankaj did not apply any audit procedures regarding opening balances. He argued that since financial statements were audited by the predecessor auditor therefore, he is not required to verify them. Is CA Pankaj correct in his approach?

ANSWER:

Q.NO.9. While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence?

ANSWER:



Q.NO.10. The nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Explain with the help of at least three examples.

ANSWER:

Q.NO.11. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests.

ANSWER:

Q.NO.12. Explain clearly the examples of matters relevant in planning attendance at physical inventory counting.

ANSWER:

Q.NO.13. The statutory auditor of MNO Ltd., CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non financial data of MNO Ltd. What should CA Kishore do in this case with reference to SA 520 on “Analytical Procedures”?

ANSWER:

As per SA 520- “Analytical Procedures” If while applying analytical procedures in accordance with SA 520, the statutory auditor identifies fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

- 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 in to account the auditor’s understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.
- ii. Performing other audit procedures as necessary in the circumstances:** The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management’s response, is not considered adequate.

In the present case, CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non financial data of MNO Ltd. CA Kishore should inquire the management of MNO Ltd. And obtain sufficient and appropriate audit evidence relevant to management response. Further, CA Kishore should also perform other audit procedures if required in the circumstances of the case to obtain further sufficient and appropriate audit evidence.

Q.NO.14. Most of the auditor’s work in forming the auditor’s opinion consists of obtaining and evaluating audit evidence. Explain

ANSWER:

Audit evidence is necessary to support the auditor’s opinion and report.

It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

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

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

Q.NO.15. 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:

Q.NO.16. Define Analytical Procedures.

ANSWER:

Q.NO.17. M/s PQR and associates are the statutory auditors of TUV Ltd. for the FY 2022-23-. They have been appointed as statutory auditors of TUV Ltd. for the first time. What is the objective of the engagement partner in terms of SA 510?

ANSWER:

Q.NO.18. What is meant by sufficiency of Audit Evidence? Explain the factors affecting the auditor's judgement as to the sufficiency of audit evidence.

ANSWER:

Q.NO.19. What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 "Audit Sampling".

ANSWER:

Q.NO.20. With reference to Standard on Auditing 530, state the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

ANSWER:



Q.NO.21. While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

ANSWER:

Q.NO.22. What precautions should be taken by the auditor while applying test check techniques?

ANSWER:

Precautions to be taken while applying test check techniques are

- Thorough study of accounting system should be done before adopting sampling.
- Proper study of internal control systems.
- Areas which are not suitable for sampling should be carefully considered.
E.g.,: compliance with statutory provisions, transactions of unusual nature etc.
- Proper planning for Sampling methods to be used and explaining the staff,
- Transactions and balances have to be properly classified (stratified)
- Sample size should be appropriately determined.

- Sample should be chosen in unbiased way,
- Errors located in the sample should be analysed properly.

Q.NO.23. Explain the factors to be considered while determining the extent of checking on a sampling plan.

ANSWER:



QUESTIONS FROM RTP'S, MTP'S, QP'S

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. (MTP 2 MARKS NOV '21 & MARCH 22)

ANSWER

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:

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

(MTP 3 MARKS MARCH 22, RTP MAY 18)

ANSWER

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:

The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

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.

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).

Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

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 3:

Examine with reasons (in short) whether the following statements are correct or incorrect Audit evidence obtained through observation of the application of a control is less reliable than audit evidence obtained by inquiry about the application of a control. (MTP OCT'22)

ANSWER

Incorrect: Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

Question 4:

CA Amar is the statutory auditor of XYZ Ltd. for the FY 2021-22. During the course of audit, CA Amar found that a litigation is going against the company for which the company has hired an external legal team (management expert). CA Amar wanted to use the information as audit evidence which is prepared using the work of the management expert. What should CA Amar consider before using the work of such management expert? (MTP OCT'22)

ANSWER

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

Evaluate the competence, capabilities and objectivity of that expert;

Obtain an understanding of the work of that expert; and

Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

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

Question 5:

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. (RTP MAY '18 , MAY '19 , MTP APRIL '23, RTP NOV 20 & MAY 23,)

ANSWER

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:

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.

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

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".

(MTP 2 MARKS SEP '23 & OCT '23)

ANSWER

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:

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

Negative assertions, encountered in the financial statements, may be expressed or implied.

(MTP 2 MARKS OCT '23, RTP NOV '22)

ANSWER

Correct: Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is no contingent liability, it would be an

expressed negative assertion. On the other hand, if in the balance sheet there is no item as “building”, it would be an implied negative assertion that the entity did not own any building on the balance sheet date.

Question 8:

Discuss the following:

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

(MTP 3 Marks Oct’23, MTP 3 Marks Oct 20)

ANSWER

The Nature of Audit Procedures: The auditor carries out his work by obtaining audit evidence through performance of audit procedures. There are practical and legal limitations on the auditor’s ability to obtain audit evidence. For example:

There is 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.

Fraud may involve sophisticated and carefully organised 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.

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 9:

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

(MTP OCT’23)

ANSWER

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:-

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.

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 10:

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)

ANSWER

Inquiry: As per SA 500 Audit Evidence: -

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.

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.

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.

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 11:

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

ANSWER

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

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

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

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

Question 12:

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

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

Question 13:

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”. (RTP MAY '23)

ANSWER

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 14:

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 Rs.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

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 15:

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)

ANSWER

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

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:

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.

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 16:

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?

(PYP MAY'22, RTP MAY 24)

ANSWER

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:

The auditor determines that the matter is a significant risk.

The matter is complex.

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 17:

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?

(PYP NOV 22)

ANSWER

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

Risk assessment procedures; and

Further audit procedures, which comprise:

Test of controls, when required by the SAs or when the auditor has chosen to do so; and

Substantive procedures, including tests of details and substantive analytical procedures.

Audit procedures to obtain audit evidence can include

- Inspection
- Observation
- External Confirmation
- Recalculation
- Reperformance
- Analytical Procedures
- Inquiry

Question 18:

Appropriateness is the measure of the quantity of audit evidence.

(PYP MAY '23)

ANSWER

Incorrect: Appropriateness is the measure of the quality of audit evidence, that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Question 19:

Management is often in the best position to perpetrate fraud. As an auditor you are suspecting existence or suspicion of fraud from management. Give any three examples of "others within the entity" to whom direct inquiries can be made.

(PYP MAY '23)

ANSWER

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

Operating personnel not directly involved in the financial reporting process.

Employees with different levels of authority.

Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.

In-house legal counsel.

Chief ethics officer or equivalent person.

The person or persons charged with dealing with allegations of fraud.

Question 20:

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

- (i) One purchase bill amounting to Rs. 5.00 lacs pertaining to TIM Industries has been entered in books of TIM Private Limited.
- (ii) The management has refused to provide a written representation relating to physical verification of inventories during the year. She has brought it to knowledge of engagement partner who has decided to use lack of such a representation as audit evidence.

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

ANSWER:

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

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

Question 21:

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

(MTP MAY 24)

ANSWER:

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

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

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

Question 22:

CA Kanika audited books of accounts of Engineering Ltd. for the financial year 2022-2023. The auditor used an audit procedure according to which all the documents and records maintained by the company were checked in detail to obtain audit evidence. Explain the audit procedure used by the auditor. Comment on reliability of audit evidence obtained by performing such an audit procedure in some situations. (RTP MAY 24)

ANSWER:

Audit Procedure:

Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. In view of above, it can be concluded that CA Kanika used Inspection as an audit procedure.

Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production.

Example of inspection used as a test of controls is inspection of records for evidence of authorisation. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a inventory or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

AUDIT SAMPLING

Question 1:

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.

(PYP MAY '23, RTP May '22, MAY'23)

ANSWER

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 Mistakes
- 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 2:

What are the advantages of statistical sampling techniques in Auditing?

(RTP MAY'22)

ANSWER

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 3:

State the requirements relating to audit sampling, sample design, sample size and selection of items for testing. (MTP RTP NOV 22)

ANSWER

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 4:

ABC Ltd is a Large Company with huge purchase and sales transactions. Which sampling approach is recommended in such a company? Explain giving features of such sampling approach along with example (MTP MAY22)

ANSWER

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

Features/Characteristics of Statistical Sampling:

- i. Audit testing done through this approach is more scientific than testing based entirely on the auditor’s own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances.
- ii. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance

testing, trade receivables' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

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

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

Question 5:

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

(MTP MAY'22, RTP NOV '22)

ANSWER

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 6:

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



(MTP NOV'22)

ANSWER

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

Question 7:

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.

(MTP NOV'22)

ANSWER

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 8:

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.

(MTP MAY 22)

ANSWER

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 9:

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

The higher the auditor's assessment of the risk of material misstatement, the smaller the sample size needs to be.



(MTP NOV'22)

ANSWER

Incorrect: The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.

Question 10:

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

Low acceptable sampling risk requires larger sample size.

(MTP MAY'23)

ANSWER

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

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.

(MTP MAY'23)

ANSWER

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

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

Question 12:

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

(MTP NOV'23, RTP NOV 23)

ANSWER

- i. 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
- iii. misstatements to the population. However, the effect of any such misstatement, if uncorrected, still
- iv. needs to be considered in addition to the projection of the non-anomalous misstatements.
- v. 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

Question 13:

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

(RTP NOV'22)

ANSWER

Simple Random Sampling: Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection. Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum). Today random numbers are also generated using various applications on the cell phones like the random number generator.

This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e. it is suitable for a homogeneous population having a similar range.

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

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:

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

(PYP MAY'22)

ANSWER

Sampling: An Audit Procedure: No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all the efforts are directed to check all transactions without any exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished i.e., the internal controls as designed by the management are for the very purpose of Prevention, Detection and Correction of Frauds and Errors. Thus, the auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals

anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of principles and controls with a curtailment of non-consequential routine checking. By routine checking, we traditionally think of extensive checking and vouching of all the entries, disregarding the concept of materiality.

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor. There is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent it has to be done. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do as an auditor is to express his opinion on the financial statements and become bound by that. To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking (i.e., sampling), he should adopt standards and techniques which are widely followed and which have a recognised basis.

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

Question 16:

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



(PYP NOV 22)

ANSWER

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.

Question 17:

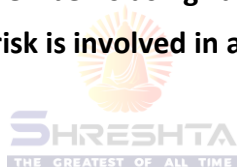
Sanjeev, an articled clerk in an audit firm, is part of an engagement team conducting audit of a company for year 2023-24. It is a small company having a turnover of about Rs.25 crores. During the course of audit, he notices that senior team member has taken following approach for selecting items for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

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

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

(MTP MAY 24)

ANSWER:



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

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

Specific items selected may include: -

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

Therefore, Sanjeev’s understanding is not proper.

The above approach for selecting items for testing is subject to non- sampling risk. Non-sampling risk is the risk that auditor may reach an erroneous conclusion for any reason not related to sampling risk. Like,

erroneous conclusion may be reached due to some inappropriate audit procedure.

SA 501- AUDIT EVIDENCE-SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS

Question 1:

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.

(MTP NOV'23, RTP MAY '23)

ANSWER

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 2:

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

(RTP MAY '22)

ANSWER

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 3:

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

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:

- i. 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
- ii. 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.

Question 4:

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

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

- **Nature of inventories i.e. LED light components, parts, circuits, panels, body, WIP and**

finished packed LED lights

- **Materiality of inventories at different locations A, B and C**
- **Stage of completion of work-in-progress**
- **Maintenance of perpetual inventory system by company**
- **Materiality of inventories lying with service providers**
- **Timing of physical inventory counting i.e. year end**

There are two important matters which do not find place in above list. Without considering these crucial matters, it would be difficult for the auditor to properly plan his attendance at inventory count process in accordance with relevant SA. Discuss such matters. (MTP MAY 24)

ANSWER:

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

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

Question 5:

In an initial audit engagement, in the case of inventories, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, in such a case, additional audit procedures become necessary so that auditor may obtain sufficient appropriate audit evidence. Discuss those additional audit procedures. (MAY MTP 24)

ANSWER:

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

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

Performing audit procedures on gross profit and cut-off.

Question 6:

Zed Limited is engaged in the manufacturing and export of shoes. The statutory auditor of the company wants to reasonably ensure that only the inventories recorded in the financial statements are exclusively owned by the company and do not include any inventories that belong to third

parties but includes inventories owned by the company but lying with third party. Advise the auditor on the audit procedures to be performed to achieve this assurance. (MTP SEP 24)

ANSWER:

Audit procedures to be followed by the statutory auditor of Zed Limited to ensure that only the inventories held by entity have been recorded in the financial statements and do not include any inventories that belong to third parties but does include inventories owned by the entity and lying with a third party are as under: -

- Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).
 - Compute inventory turnover ratio (COGS/ average inventory)
 - Perform vertical analysis (inventory/ total assets)
 - Compare budgetary expectations vis-à-vis actuals
- Examine non-financial information related to inventory, such as weights and other measurements.
- Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end.
- With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions.
- Verify the clerical and arithmetical accuracy of inventory listings.
- Reconcile physical inventory amounts with perpetual records.
- Reconcile physical counts with ledger control totals.
- Reconcile inventories which belong to client but are held with third parties like transporters, warehouses, port authorities etc.
- Goods received on a consignment basis have been properly segregated from other items of inventory.

Question 7:

CA X is contemplating the use of negative confirmation requests as the sole substantive audit procedure to verify certain accounts payable balances reflected in financial statements of a company. Which conditions need to be met to use negative confirmation requests as stated above? Additionally, CA X is of the view that negative confirmations provide same level of persuasive audit evidence as in case of positive confirmations. Do you agree with his viewpoint? Provide reasons for your answer. (MTP SEP 24)

ANSWER:

In accordance with SA 505, “External Confirmations”, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

- (i) 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.
- (ii) The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions.
- (iii) A very low exception rate is expected and
- (iv) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request.

Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Therefore, view of CA X is not correct.

Question 8:

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

ANSWER:

In accordance with requirements of SA 501, "Audit Evidence- Specific Considerations for Selected Items", when inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

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

Other audit procedure may include –

- ✦ Inspecting documentation regarding inventory held by third parties
- ✦ Requesting confirmation from other parties when inventory has been pledged as collateral.
- ✦ Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.

Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.

SA 505- EXTERNAL CONFIRMATIONS

Question 1:

R Ltd. has asked for email responses for the purpose of external confirmation. The auditor, however, feels that external confirmation received electronically involves the risk of its reliability.
(MTP MAY'22)

ANSWER

Correct: SA 505, "External Confirmations", responses received electronically, for example by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect. Hence R Ltd. Should avoid using email responses as evidence for external confirmation.

Question 2:

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?
(MTP MAY'22, RTP NOV'22)

ANSWER

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

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

Question 3:

CA J is conducting statutory audit of Gemini Ltd engaged in manufacturing of pharma products. The company is fairly large one and has a well-functioning internal audit department. While considering sending out external confirmation requests to trade receivables outstanding as on date of financial statements, CA J has delegated the process of choosing trade receivables, designing requests and receiving responses from customers to internal audit department. The responses are also received on the mail id of internal audit department. Is the approach of CA J proper?
(RTP MAY 24)

ANSWER:

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

- (a) Determining the information to be confirmed or requested;

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

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

SA 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? (RTP MAY '23)

ANSWER

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

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

Question 2:

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?

(PYP MAY'22, MTP MAY'23, RTP MAY 24)

ANSWER

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.

(MTP NOV'23)

ANSWER

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

Entity income tax returns.

Information supplied by the entity to regulatory authorities.

Shareholder registers to identify the entity's principal shareholders.

Statements of conflicts of interest from management and those charged with governance.

Records of the entity's investments and those of its pension plans.

Contracts and agreements with key management or those charged with governance.

Significant contracts and agreements not in the entity's ordinary course of business.

Specific invoices and correspondence from the entity's professional advisors.

Life insurance policies acquired by the entity.

Significant contracts re-negotiated by the entity during the period.

Internal auditors' reports.

Documents associated with the entity's filings with a securities regulator e.g., prospectuses)

Question 2:

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?

(PYP MAY'22)

ANSWER

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

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

The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;

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

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

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

Question 3:

While performing audit of financial statements of a listed company, statutory auditor needs to maintain an attitude of professional skepticism for related party information. State examples of the records or the documents that may provide information about related party relationships and transactions.

(MTP SEP 24)

ANSWER:

During the audit, the auditor should maintain alertness for related party information while reviewing records and documents. Examples of the records or the documents that may provide information about related party relationships and transactions are:

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

11. Internal auditor's reports.

12. Documents associated with the entity's filings with a securities regulator (e.g. prospectuses).

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.

(MTP MAY 23)

ANSWER

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:

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

(MTP MAY'22)

ANSWER

Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Question 3:

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.?

(MTP APRIL '21)

ANSWER

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 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?

ANSWER

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

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.

(MTP NOV'23, RTP May '23, May'22)

ANSWER

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:

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.

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:

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

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 7:

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

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:

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. 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.

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

Question 8:

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

ANSWER

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 9:

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

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 10:

Flower Limited presented its financial statements for the F.Y. 2022-2023 to its auditor for expressing an opinion thereon. The auditor while carrying out the audit started comparing various items of profit and loss account of the year under audit with previous financial years. What is auditor trying to achieve by carrying out those comparisons?

(RTP NOV '23, PYP MAY '22)

ANSWER

Purpose of Applying Analytical Procedure: Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable.

The auditor of Flower Ltd. would achieve the following by carrying out the comparison stated in the question:

- i) If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years.
- ii) By setting up certain expenses' ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales.
- iii) If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

- iv) It would be possible to identify the existence of unusual transactions, amounts, ratios and trends that might indicate matters that have audit implications.

Question 11:

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

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 12:

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. . (PYP MAY'22)

ANSWER

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 13:

State with reasons whether the following statements are correct or Incorrect:

The term "Analytical Procedures" means evaluation of financial information through analysis of plausible relationships among financial data and non-financial data. (PYP NOV 22)

ANSWER

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

Question 14:

As per the Standard on Auditing (SA) 520 "Analytical Procedures", what are the examples of analytical procedures having consideration of relationships? (PYP NOV 22)

ANSWER

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:

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 15:

Analytical procedures are used in all stages of audit by experienced auditors.

(PYP MAY '23)

ANSWER

Correct: Experienced auditors use analytical procedures in all stages of the audit. 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.

Alternative solution

Incorrect: Every auditor shall use analytical procedures in all stages of the audit. 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.

Question 16:

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

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

(i) List out a few possible reasons which could have led to abnormal jump in gross profit ratio.

(ii) Do you agree with viewpoint of Tisha? Provide reasons for your answer. (MTP SEP 24)

ANSWER:

(i) In the given case, risk of material misstatement has been assessed as high in respect of assertions relating to revenue and various direct expenses due to increase in gross profit ratio of company from 14% in year 2022-23 to 24% in year 2023-24.

Few possible reasons which could have led to abnormal jump in gross profit ratio include: -

- Overvaluation of inventories
- Overstatement of revenues
- Understatement of direct expenses



(ii) SA 200, "Overall Objectives of the Independent auditor and the conduct of an audit in accordance with Standards on Auditing" defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Tisha is of a view that detection risk in this engagement should be kept at high level whereas in the given situation, risk of material misstatement has been assessed as high for assertions relating to revenue and direct expenses. Therefore, detection risk has to be kept at low level so that a material misstatement in these assertions does not remain undetected.

Therefore, view of Ms. Tisha is not proper.

SA 610 USING THE WORK OF INTERNAL AUDITORS

Question 1:

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

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

ANSWER:

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

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

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

Question 2:

CA J is working as internal auditor in JKL Limited, a non-listed company. The responsibilities of internal auditor include reviewing financial information and performing detailed tests on transactions and balances. He is also responsible for compliance with laws, regulations and external requirements.

During the year 2022-23, services of an employee of company were terminated. The said employee had filed a suit against the company in respect of certain compensation dues amounting to Rs. 10 lakhs which were not paid to him. Based upon advice of legal counsel, the company had made a provision of Rs. 10 lacs in financial statements for year 2022- 23. However, somewhere in June 2023, there is an out of court settlement between company and employee for Rs. 6 lakhs. The statutory audit of company is under progress and audit report has not yet been finalized. How internal auditor should have proceeded in situation? (MTP MAY 24)

ANSWER:

Subsequent events are events occurring between the date of financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report.

In the given case, the company had already made provision of Rs. 10 lakhs in financial statements for year 2022-23. However, there is an out of court settlement between the company and employee for Rs. 6 lakhs. It is an example of event which provides evidence of conditions that existed at the date of financial statements i.e. 31st March, 2023. It provides evidence on adjustment in provision amount already made in financial statements. Therefore, internal auditor should ask management to revise provision downwards to Rs. 6 lakhs so that financial statements are in accordance with applicable accounting standards



7. AUDIT OF DIFFERENT TYPES OF ENTITIES

ILLUSTRATIONS

Question 1:

It is the duty of Comptroller and Auditor General of India to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it. Discuss, in above context, what is understood by “Consolidated Fund of India”? What is its importance?

ANSWER:

Consolidated Fund of India consists of all the revenue received from direct and indirect taxes, all the loans taken by the Govt. of India and all the amount of repayment of loans received by the Govt. of India. Its importance lies in the fact that all government expenditure is incurred from this fund. No moneys out of the Consolidated Fund of India shall be appropriated except in accordance with law and for the purposes and in the manner provided in the Constitution.

Question 2:

CA Akash Virmani is auditor of a partnership firm consisting of 4 partners. During the year, one of the partners has retired and another partner has joined the next day. Discuss, any one point, which shall be considered by you to ensure that financial statements of firm are not misstated due to change of constitution of firm.

ANSWER:

The auditor shall consider provisions of retirement deed/partnership deed for date of retiring and joining of partners. It should be ensured that profits are appropriately distributed up to date of retirement. Further, profits after retirement should have been distributed among partners as per terms of new partnership deed.

TEST YOUR KNOWLEDGE

Q.NO.1. Discuss, in what circumstances, Central Registrar can hold an inquiry into working and financial condition of a multi-state cooperative society.

ANSWER:

Q.NO.2. Sporting Club of India is a private club engaged in promotion of sports in the country. As an auditor of this leading club, discuss any two points to ensure that expenditure incurred by club during the year is properly authorised.

ANSWER:

Q.NO.3. Tomo Construction Engineering LLP approached CA K to understand various returns to be filed by them as part of statutory compliance. Discuss, how, CA K should advise them.

ANSWER:



Q.NO.4. CA Irfan Zaidi is auditor of a prestigious five-star hotel in Jaipur. He notices that there is a gift shop doing brisk business inside the hotel premises. On further enquiries, he comes to know that stocks in gift shop belong to gift shop owner and hotel receives rent for letting out this space. Discuss, how, auditor can verify payment of common amenities used by gift shop owner to the hotel.

ANSWER:

Q.NO.5. A multi-speciality hospital has come up in your city. You are appointed as auditor for first year. Discuss, any four, broad areas to be kept in mind while conducting audit of accounts of such a newly opened multi-speciality hospital.

ANSWER:

Q.NO.6. You have been appointed as an auditor of an NGO, briefly state the points on which you would concentrate while planning the audit of such an organisation?

ANSWER:

Q.NO.7. The general transactions of a hospital include patient treatment, collection of receipts, donations, capital expenditures. You are required to mention special points of consideration while auditing such transactions of a hospital?

ANSWER:

Q.NO.8. Mention the special points to be examined by the auditor in the audit of a charitable institution running hostel for students pursuing the Chartered Accountancy Course and which charges only INR 500 per month from a student for their lodging/boarding.

ANSWER:



Q.NO.9. Explain in detail the duties of Comptroller and Auditor General of India

ANSWER:

Q.NO.10. An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations.

ANSWER:

Receipt of Donations:

- 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.

Q.NO.11. As an auditor, what would be your areas of consideration while auditing the element of ROOM SALES during the audit of a 5-Star Hotel.

ANSWER:

Q.NO.12. 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:

Q.NO.13. Define Government Audit & explain its objectives.

ANSWER:

Q.NO.14. CA A is appointed as the auditor of a charitable institutions. Discuss the audit procedure undertaken by him while auditing the Subscription and Donation received by the charitable institution.

ANSWER:

Q.NO.15. In case of Government entities, audit of accounts of stores and inventories has been developed as a part of expenditure audit. Discuss about the duties and responsibilities entrusted to C&AG.

ANSWER:



Q.NO.16. Local Fund Audit Wing of a State of a State Government has appointed you to audit the accounts of one of the Local body governed by it. As an auditor, what will be your reporting areas?

ANSWER:

Q.NO.17. 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:

Q.NO.18. State the points which merit consideration in the audit of a CLUB w.r.t its members.

ANSWER:

QUESTIONS FROM RTP'S, MTP'S, QP'S

Question 1:

You have been appointed auditor of M.s. BLK Hospital. Discuss important points that would attract your attention while audit.

(MTP MARCH'22)

ANSWER

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 2:

The C & AG Act gives powers to the C&AG in connection with the performance of his duties. Explain.
(MTP MAY'23, OCT'23)

ANSWER7

Powers of C&AG: The C & AG Act gives the following powers to the C & AG in connection with the performance of his duties-

- i. To inspect any office of accounts under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.
- ii. To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.
- iii. To put such questions or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which is his duty to prepare.

In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transactions as he may determine.

Question 3:

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?
(PYP, RTP NOV'22)

ANSWER

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 4:

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.

(MTP NOV'22)

ANSWER

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 5:

CA. Z. a Chartered Accountant is the Senior manager of a Multi-State Co-operative Society in Mumbai. He is proposed to be appointed as an auditor of the said Multi-State Cooperative Society. Analyse the provisions of the Multi-State Co-operative Societies Act, 2002 and comment on validity of proposed appointment.

(PYP MAY '23)

ANSWER

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 6:

"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. (RTP NOV '23)

ANSWER

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 7:

Audit of government expenditure is one of the major components of government audit conducted by the office of C & AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Explain those standards.

(MTP MAY'22, RTP MAY '23)

ANSWER

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 8:

The Constitution of India contains no specific provisions regarding the appointment, salary and duties and powers of the C&AG. Moreover, the constitution does not guarantee the independence of the C&AG of India.

(MTP MAY' 22)

ANSWER

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 9:

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

(MTP MAY'22)

ANSWER

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 10:

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

(MTP MAY'22, MTP NOV'22)

ANSWER

Audit against Rules & Orders - Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. 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 of government servants.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that:

- a. they are not inconsistent with any provisions of the Constitution or any laws made thereunder;
- b. they are consistent with the essential requirements of audit and accounts as determined by the C&AG;
- c. they do not come in conflict with the orders of, or rules made by, any higher authority; and
- d. in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C&AG.

Question 11:

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession. Explain stating clearly the definition of Government auditing as discussed in U.N. Handbook on Govt Auditing and Developing Countries and also state Objectives of Govt audit. (MTP MAY'22)

ANSWER

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession.

The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:

Government auditing is

- the objective, systematic, professional and independent examination
- of financial, administrative and other operations
- of a public entity
- made subsequently to their execution
- for the purpose of evaluating and verifying them,
- presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions
- by the responsible officials
- and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

OBJECTIVES: -

- a. Accounting for Public Funds:-Government audit serves as a mechanism or process for public accounting of government funds.
- b. Appraisal of Government policies:-It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.
- c. Base for Corrective actions:-Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.
- d. Administrative Accountability: The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration

Question 12:

What are the special steps involved in conducting the audit of an Educational Institution? (Write any 12 points) (MTP MAY'22)

ANSWER

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 13:

Explain and also state the role of auditor with respect to the following in case of a hotel:

Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined.

(MTP NOV'22, RTP MAY '22)

ANSWER

Internal control: Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will minimise the leakage as far as possible. Evidence of their success is provided by the preparation of regular perhaps weekly, trading accounts for each sales point and a detailed scrutiny of the resulting profit percentages, with any deviation from the anticipated form being investigated. The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.

The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order. The auditor should satisfy himself that all taxes collected from occupants on food and occupation

have been paid over to the proper authorities. If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts. As a result, the scope of his audit tests will necessarily be increased and, in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.

Question 14:

Explain and also state the role of auditor with respect to the following in case of a school: Other Receipts/Grants & Donations (MTP NOV'22)

ANSWER

Other Receipts, Grants & Donations :-

1. Verify rental income from landed property with the rent rolls, etc.
2. Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
3. Verify any Government or local authority grant with the memo of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons thereof.

Question 15:

Explain the meaning of Government Audit and also discuss its objectives. (MTP NOV'22)

ANSWER

The U.N. Handbook on Government Auditing and Developing Countries defines government auditing in a comprehensive manner which is as follows:

Government Audit is the objective, systematic, professional and independent examination of financial, administrative and other operations of a public entity, made subsequently to their execution for the purpose of evaluating and verifying them, presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future action by the responsible officials and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

OBJECTIVES of the Govt Audit are :

1. Accounting for Public Funds: It serves as a mechanism or process for public accounting of government funds.
2. Appraisal of Govt. Policies: It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.
3. Corrective Actions: Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.
4. Administrative Accountability: The main objective of audit is a combination of ensuring

accountability of administration to legislature and functioning as an aid to administration

Question 16:

Explain and also state the role of auditor with respect to the following in case of a hotel:

- i. Inventories (MTP MAY'23 & NOV'22)
- ii. Travel agents & shops (MTP MAY'23)

ANSWER

i. Inventories

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.

Areas where large quantities of inventory are held should be kept locked, the key being retained by the departmental manager. The key should be released only to trusted personnel and unauthorised persons should not be permitted in the stores areas except under constant supervision. In particular, any movement of goods in or out of the stores should be checked. Many hotels use specialised professional valuers to take and value the inventories on a continuous basis throughout the year. Such a valuation is then almost invariably used as the basis of the balance sheet inventory figure at the year end. Although such valuers are independent of the audit client, it is important that the auditor satisfies himself that the amounts included for such inventories are reasonable. In order to satisfy himself of this, the auditor should consider attending the physical inventory taking and carrying out certain pricing and calculation tests. The extent of such tests could well be limited since the figures will have been prepared independently of the hotel.

ii. Travel agents & shops:

For ledgers coming through travel agents or other booking agencies the bills are usually made on the travel agents or booking agencies. The auditor should ensure that money are recovered from the travel agents or booking agencies as per the terms of credit allowed.

Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.

Question 17:

State the points which merit consideration in the audit of a CLUB w.r.t its members.

(MTP MAY'23)

ANSWER

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. (MTP MAY '23)

ANSWER

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 19:

As an Auditor of NGO, how do you check.verify at least four receipts of income during the year?

(MTP MAY'23 & NOV'23)

ANSWER

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.
- iv. Subscriptions: Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine. circulars, periodicals. Check the receipts with subscription rate schedule.
- v. Interest and Dividends: Check the interest and dividends received and receivable with investments held during the year.

Question 20:

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.

(MTP MAY'23)

ANSWER

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 21:

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?

(MTP NOV'23)

ANSWER

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 22:

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?

(MTP NOV'23, RTP NOV '22)

ANSWER

Verification of inventories in the nature of food and beverages:

The inventories in any hotel are both readily portable and saleable particularly the food and beverage

inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores' areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed. Therefore, following 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 23:

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



(RTP MAY '22)

ANSWER

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 24:

Before holding inquiry by the Central Registrar thirty days' notice must be given to the Multi-State co-operative society.

(RTP MAY '22)

ANSWER

Incorrect: Before holding inquiry by the Central Registrar fifteen days' notice must be given to the Multi- State co-operative society.

Question 25:

No inspection under Section 79 of Multi-State Co-operative Societies Act, 2002 shall be made unless a notice has been given to the multi-state co-operative society. Explain 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

- 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. 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 26:

State six important advantages of audit of accounts of a Partnership firm. (RTP NOV '23)

ANSWER

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 27:

The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. Explain stating important objectives of audit of such bodies. (RTP MAY '23)

ANSWER

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 28:

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.

(PYP MAY '23)

ANSWER

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 29:

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?

(PYP MAY'22)

ANSWER

Audit of a Hospital:

A. Receipts from treatment of patients

1. Register of Patients: Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.
2. Collection of Cash from patients: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patient's bills.

B. Donations from donors to treat the patients: Ascertain those legacies and donation received for a specific purpose have been applied in the manner agreed upon.

C. Capital Expenditure Incurred: Verify the Capital Expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee.

D. Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax.

This involves:

- i. vouching the Income-tax refund with the correspondence with the Income-tax Department; and
- ii. checking the calculation of the repayment of claims.refund claim.

Question 30:

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? (PYP NOV'22)

ANSWER

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 31:

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?

(PYP NOV'22)

ANSWER

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 32:

In the case of Co-operative societies, contribution to Education fund is a charge on profits and not an appropriation. (PYP MAY '23)

ANSWER

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 33:

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. (PYP MAY '23)

ANSWER

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.

Question 34:

Goods and Services Tax Network (GSTN) is a not for profit, limited by shares, company. Its 50% shareholding is with Union Government and 50% with different State Governments. The company provides IT infrastructure and services to various stakeholders including governments and tax payers. The company is in operation since past few years and subsequent auditor needs to be appointed during financial year 2023-24. Who appoints statutory auditor of such a company described above in accordance with provisions of Companies Act, 2013? Can any directions be issued to statutory auditors of above company? (MTP MAY 24)

ANSWER:

The above company is a government company. Section 143(5) of the Companies Act, 2013 states that, in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the comptroller and

Auditor-General of India shall appoint the auditor under sub-section (5) of section 139 i.e. appointment of subsequent auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statements of the company.

Question 35:

You have been appointed as an auditor of ABC Hotel, a three star hotel, for Financial Year 2022-23. As an auditor what are the special points that need to be considered in verifying the Inventories in the nature of food and beverages?

ANSWER:

Verification of inventories in the nature of food and beverages: The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores' areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed. Therefore, following may be noted in this regard:

- (a) All movement and transfer of inventories must be properly documented.
- (b) Areas where inventories are kept must be kept locked and the key retained by the departmental manager.
- (c) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.
- (d) Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.

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 36:

The audit of Government expenditure is one of the major components of Government audit. Briefly explain the basic standards set in relation to audit of Government expenditure.

(MTP MAY 24)

ANSWER:

Expenditure Audit: The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorized by competent authority fixing the limits within which expenditure can be incurred. These standards are—

- (i) that the expenditure incurred conforms to the relevant provisions of the statutory enactment

and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the audit against 'rules and orders'.

- (ii) that there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the audit of sanctions.
- (iii) that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as audit against provision of funds.
- (iv) that the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as propriety audit.
- (v) that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the performance audit.

Question 37:

Cinescreen Multiplex Ltd. is operating cinemas in different locations in Mumbai and has appointed you as an internal auditor. What are the areas that need to be verified in relation to receipts from sale of Tickets? (MTP MAY 24)

Answer:

The special steps involved in the audit of receipts from sale of tickets are stated below-

- (i) Verify that entrance to the cinema-hall during show is only through printed tickets;
- (ii) Verify that they are serially numbered and bound into books. In case bookings are made online, verify the system for online booking;
- (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 Tax collected with the total number of tickets issued for each class. 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 38:

You are auditor of a college running different courses operating in your city. During audit of a year, it is noticed that fees concessions to students have been provided in substantial number of cases. Discuss, how, you as an auditor, would proceed to verify the same and also explain two other points

to verify fees from students.

(MTP MAY 24)

ANSWER:

Fee from Students:

The fees concessions have to be under proper authority of college management. The auditor would verify internal controls in this regard. Besides, detailed checking of few cases needs to be undertaken to ensure genuineness of fees concessions and proper management approvals.

Other points to verify fee from students are :

1. Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal control which ensures that demands against the students are properly raised.
2. Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
3. Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
4. Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.
5. Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
6. Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.

Question 39:

Audit against propriety seeks to ensure that expenditure conforms to certain principles which have for long been recognised as standards of financial propriety. Explain those principles.

(MTP MAY 24)

ANSWER:

Some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

- (a) The expenditure should not be prima facie more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.
- (b) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

- (c) 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 40:

Section 72(1) of the Multi-State Co-operative Societies Act, 2002 states that only a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can be appointed as an auditor of a multi-state co-operative society. Who, according to Section 72(2), is disqualified from being appointed as auditors of a multi-state co-operative society?

(MTP SEP 24)

ANSWER:

As per section 72 of the Multi-State Co-operative Society Act, 2002 following persons are not qualified for appointment as auditors of a multi- state co-operative society: -

- (a) A body corporate
- (b) An officer or employee of the multi-state co-operative society
- (c) A person who is a member or who is in employment, of an officer or employee of the multi-state co-operative society.
- (d) A person who is indebted to the multi-state co-operative society or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the multi-state co-operative society for an amount exceeding one thousand rupees.

Question 41:

Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. Explain.

(RTP MAY 24)

ANSWER:

Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will minimize the leakage as far as possible. Evidence of their success is provided by the preparation of regular perhaps weekly, trading accounts for each sales point and a detailed scrutiny of the resulting profit percentages, with any deviation from the anticipated form being investigated. The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.

The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order.

The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities. If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts. As a result, the scope of his audit tests will necessarily be increased and, in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.

Question 42:

From a lessee's perspective, highlight main differences between an operating lease and finance lease only in relation to accounting treatment and tax benefits. (RTP SEP 24)

ANSWER:

Accounting treatment

Operating lease is generally treated like a renting arrangement. Lease payments are treated as operating expenses and asset does not appear as asset in lessee's balance sheet. Finance lease is treated like a loan arrangement. Hence, asset ownership is considered of that of lessee and thus appears on the balance sheet of the lessee.

Tax benefits

Operating lease payment is considered like an expense just as in case of renting. However, no depreciation can be claimed by lessee. In case of finance lease, lessee can claim both interest and depreciation as it is treated like a loan.



Question 43:

Section 77 of Multi-State Cooperative Societies Act, 2002 states that the Central Government may at any time by order direct that a special audit of the Multi-State Co-Operative Society's accounts for such period or periods as may be specified in the order, shall be conducted. Further, it may by the same or a different order appoint either a Chartered Accountant or the Multi-State Co-Operative Society's auditor himself to conduct special audit. Under which circumstances such power can be exercised by the Central Government? (RTP SEP 24)

ANSWER:

The Central government has power to order special audit of Multi-State Cooperative Society's Accounts where it is of the opinion: -

- (a)** that the affairs of any multi-state co-operative society are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles or
- (b)** that any multi-state co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains or
- (c)** that the financial position of any multi-state co-operative society is such as to endanger its solvency.

8. AUDIT STRATEGY, AUDIT PLANNING AND

AUDIT PROGRAMME

ILLUSTRATIONS

ILLUSTRATION 1.

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

ANSWER:

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

ILLUSTRATION 2.

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

ANSWER:

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

ILLUSTRATION 3.

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

ANSWER:

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Development of Overall Audit strategy and Audit plan are the responsibilities of the auditor.

Write ANSWER related to involvement of management and engagement team.

Conclusion: In the above case the finance head of the company prepared overall audit strategy on the request of the auditor W. Hence Mr W, the auditor of the company violated SA 300 and is wrong in insisting finance head regarding the same.

ILLUSTRATION 4.

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

ANSWER:

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

ILLUSTRATION 5.

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

ANSWER:

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

ILLUSTRATION 6.

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

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

ANSWER:

Attitude of Rohit is not proper. The assistants should observe matters objectively and bring

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

TEST YOUR KNOWLEDGE

Q.NO.1. Discuss how performing preliminary engagement activities as part of planning an audit assists auditor.

ANSWER:

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

Q.NO.2. Discuss how an engagement partner ensures that firm complies with relevant ethical requirements including independence in relation to client.

ANSWER:

Refer to point on evaluating compliance with ethical requirements including independence.

Q.NO.3. "Purported disadvantages of an audit programme can be overcome". Do you agree?

ANSWER:

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

Q.NO.4. An auditor of a company fails to document audit strategy and audit plan. Briefly outline consequences of such failure.

ANSWER:

Refer to point on documentation

Q.NO.5. SA 300 states that auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. Discuss few factors affecting such supervision and review of work of engagement team members.

ANSWER:

Refer to point on Planning supervision and review of work of engagement team members

QUESTIONS FROM RTP'S, MTP'S, QP'S

Question 1:

“The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client’s business” Discuss stating clearly the broad points you would be covering in framing plan to conduct audit in an efficient and effective manner (RTP MAY’23)

ANSWER

“The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client’s business”.

Plans should be made to cover, among other things:

- a. acquiring knowledge of the client’s accounting systems, policies and internal control procedures;
- b. establishing the expected degree of reliance to be placed on internal control;
- c. determining and programming the nature, timing, and extent of the audit procedures to be performed; and
- d. coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit.

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

Question 2:

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. (MTP MAY’22)

ANSWER

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 3:

Once the audit plan has been drafted and communicated, it is obligatory on the auditor to follow the same. (MTP MAY’23)

ANSWER

Incorrect: The auditor shall update and change the overall audit strategy and the audit plan as CA Inter (New) | P5 Auditing and Ethics | Comprehensive Question Bank | CA Ram Harsha

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.

Question 4:

"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

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 5:

In establishing overall audit strategy, the auditor shall ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required. Elucidate those cases by which auditor can ascertain the reporting objectives of the engagement. (MTP MAY'23, RTP Nov'23,)

ANSWER

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

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

- iv. The discussion with management regarding the expected communications on the status of audit work throughout the engagement.

Question 6:

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 MAY 22)

ANSWER

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 7:

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



(PYP NOV'22)

ANSWER

Correct: 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.

Question 8:

"An adequate planning benefits the audit of financial statements." Discuss.

(MTP NOV'22 & PYP MARCH '23)

ANSWER

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:

Helping the auditor to devote appropriate attention to important areas of the audit.

Helping the auditor identify and resolve potential problems on a timely basis.

Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.

Assisting in the selection of engagement team members with appropriate levels of capabilities and

competence to respond to anticipated risks, and the proper assignment of work to them.
Facilitating the direction and supervision of engagement team members and the review of their work.
Assisting, where applicable, in coordination of work done by auditors of components and experts.

Question 9:

Arpan Hospitals Ltd having Gross Professional Charges of Rs.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 programmer. Explain. (MTP NOV'22, RTP NOV '22)

ANSWER

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 10:

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

Understanding the Internal Control of a company will not help the auditor in developing an Audit Programme. (MTP MAY'23)

ANSWER

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

Question 11:

Examine with reasons (in short) whether the following statements are correct or incorrect. Planning is a discrete phase of an audit. (MTP MAY'23)

ANSWER

Incorrect: Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begin shortly after (or in connection with) the completion of the previous audit and

continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures.

Question 12:

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 (PYP May 22)

ANSWER

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 13:

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

The overall audit strategy is more detailed than the audit plan. (MTP NOV'23)

ANSWER

Incorrect: 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. Once the overall audit strategy has been established, an audit plan can be developed to achieve the audit objectives through the efficient use of the auditor's resources.

Question 14:

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

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 15:

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

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 16:

The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors. Discuss those factors. (RTP Nov'22)

ANSWER

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

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

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

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

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

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

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:

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, NOV'23)

ANSWER

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:

The "documentation of the overall audit strategy" is a record of the audit evidence considered necessary to properly plan the audit and to assign various audit functions to the engagement team.

(PYP MAY '23)

ANSWER

Incorrect: 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.

Question 22:

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

(MTP MAY 24)

ANSWER:

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

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

work.

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

Question 23:

Auditor shall develop an audit plan that includes description of audit procedures. Specify requirements in this regard. (MTP MAY 24)

ANSWER:

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

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

Question 24:

Planning includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, certain matters. Discuss those matters. (MTP MAY 24)

ANSWER:

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



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

The performance of other risk assessment procedures

Question 25:

The ascertaining of reporting objectives of engagement helps the auditor to plan timing of different audit procedures and also nature of communications. Give three instances to explain. (MTP MAY 24)

ANSWER:

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

- The entity's timetable for reporting
- Organization of meetings to discuss of nature, timing and extent of audit work with management
- Discussion with management regarding the expected type and timing of reports to be issued

including the auditor's report

- Discussion with management regarding the expected communications on the status of audit work throughout the engagement.

Expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

Question 26:

The auditor needs to direct efforts of engagement team towards matters that in his professional judgment are significant. Preliminary identification of material classes of transactions, account balances and disclosures help auditor in establishing overall audit strategy. More energies need to be devoted to significant matters to obtain desired outcomes. Give three examples to explain the above situation. (MTP MAY 24)

ANSWER:

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

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

Question 27:

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

Timing of Audit Activities

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

Review by Partners – internally post response on audit memo	August 29, 2023
Review by EQCR	August 30, 2023
Finalization of Audit Report and Financial Statements	September 01, 2023 – September 02, 2023
Issuance of Audit Report and Financial Statements	September 03, 2023

The above working paper lists certain factors which are considered by the auditor while establishing audit strategy. Explain how these considerations highlighted in above working paper could have helped the auditor? **(MTP SEP 24)**

ANSWER:

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

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

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

Question 28:

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

Comment.

(MTP SEP 24)

ANSWER:

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

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

Question 29:

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

ANSWER:

Preliminary engagement activities

Preliminary engagement activities include following activities: -

- (a) Performing procedures regarding the continuance of the client relationship
- (b) Evaluating compliance with ethical requirements, including independence
- (c) Establishing an understanding of terms of engagement

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

Question 30:

The assistant of CA K is assigned responsibility of drafting "audit programme" relating to purchases appearing in financial statements of "Broad Industries", a partnership firm. The said firm is a GST registered tax payer and is engaged in manufacturing of packing boxes from a special type of paper taxable under GST. Help him by drafting a sample audit programme for purchases. (RTP SEP 24)

ANSWER:

Sample audit programme pertaining to purchases

Name of Concern : Broad Industries

Financial Year : 20XX-XX

Prepared by : Name of person with date

Reviewed by : Name of person with date

Approved by : Name of person with date

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

Question 31:

CA N, engagement partner of LPS & Associates, is planning for audit of a large company. As part of preliminary engagement activities being performed in this regard, he wants to ensure that compliance with independence requirements is adhered. How shall he form a conclusion that audit firm complies with independence requirements? (RTP SEP 24)

ANSWER:

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

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

9. RISK ASSESSMENT AND INTERNAL CONTROL

SA 315, 330 AND 320

ILLUSTRATIONS

ILLUSTRATION 1.

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

ANSWER:

It has been stated that many companies engaged in providing holistic solutions to problem of stubble burning have not been successful. It shows that line of activity is inherently risky. Therefore, there is a greater possibility of misstatements. The component of risks of material misstatement involved is “inherent risk.”

ILLUSTRATION 2.

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

ANSWER:

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

ILLUSTRATION 3.

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

ANSWER:

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

ILLUSTRATION 4.

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

ANSWER:

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

ILLUSTRATION 5.

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

ANSWER:

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

ILLUSTRATION 6.

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

ANSWER:

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

ILLUSTRATION 7.

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

ANSWER:

The study of company policies and practices regarding employee recruitment, training, orientation and related matters including hiring of best candidates is part of understanding HR function of the

company. It, in turn, helps in understanding control environment of the company. By gaining such a knowledge, she can better understand internal control of the company.

ILLUSTRATION 8.

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

ANSWER:

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

ILLUSTRATION 9.

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

ANSWER:

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

ILLUSTRATION 10.

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

ANSWER:

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

ADDITIONAL ILLUSTRATIONS

ILLUSTRATION 11.

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

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

ANSWER:

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

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

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

ILLUSTRATION 12.

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

ANSWER:

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

ILLUSTRATION 13.

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

ANSWER:

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

ILLUSTRATION 14.

The auditor of ABC Textiles Ltd chalks out an audit plan without understanding the entity's business. Since he has carried out many audits of textile companies, there is no need to

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understand the nature of business of ABC Ltd. Advise the auditor how he should proceed.

ANSWER:

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

ILLUSTRATION 15.

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

ANSWER:

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

ILLUSTRATION 16.

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

ANSWER:

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

ILLUSTRATION 17.

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

ANSWER:

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.

ILLUSTRATION 18.

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

procedures to be applied while conducting the audit.

ANSWER:

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

ILLUSTRATION 19.

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

Advise Mr. Y.

ANSWER:

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

ILLUSTRATION 20.

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

ANSWER:

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

ILLUSTRATION 21.



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

ANSWER:

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

ILLUSTRATION 22.

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

evaluation of internal control as mentioned above.

ANSWER:

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

TEST YOUR KNOWLEDGE

Q.NO.1. Discuss how “analytical procedures” performed as “risk assessment procedures” can be useful to an auditor.

ANSWER:

Q.NO.2. Is materiality required to be documented by the auditor? What factors have to be considered this regard?

ANSWER:



Q.NO.3. Discuss relationship between “General IT controls” and “application controls” in an automated environment.

ANSWER:

Q.NO.4. A company functions in an automated environment. Discuss in what areas data analytics can be useful for auditor of the company.

ANSWER:

Q.NO.5. What is understood by “non-routine” transactions? Briefly outline why risks of material misstatement is greater for such transactions.

ANSWER:

Q.NO.6. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting” Explain.

ANSWER:

Q.NO.7. “Risk of material misstatement consists of two components” Explain clearly defining risk of material misstatement.

ANSWER:

Q.NO.8. “The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the “risks of material misstatement”” Explain

ANSWER:

Q.NO.9. “The auditor shall obtain an understanding of the control environment” Explain stating what is included in control environment.



ANSWER:

Q.NO.10. Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control.

ANSWER:

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 unauthorised access, use or disposition; and
- iv. the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.



QUESTIONS FROM RTP'S, MTP'S, QP'S

Question 1:

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. (MTP NOV'22)

ANSWER

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 2:

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. (MTP MAY'23)

ANSWER

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 3:

The division of internal control into five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. Mention those components of internal control. (MTP MAY'23, RTP May 23)

ANSWER

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 4:

Control environment can prevent, detect and correct a material misstatement.

(MTP MAY'22, RTP NOV '23 & MAY '23)

ANSWER

Incorrect: 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.

Question 5:

There is an inverse relationship between detection risks and the combined level of inherent and control risks.

(MTP MAY'22, RTP Nov '22 & Nov '23)

ANSWER

Correct: There is an inverse relationship between detection risks and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable detection risks need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risks and still reduce audit risks to an acceptably low level.

Question 6:

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the classes of transactions in the entity's operations that are significant to the financial statements, controls surrounding journal entries etc.

Explain the other considerations in this regard.

(MTP MAY'22 & NOV'23)

ANSWER

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

- a. The classes of transactions in the entity's operations that are significant to the financial statements;

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

Question 7:

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

(MTP NOV'22)

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 frame work. Hence misstatement can arise from error or fraud.

Question 8:

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).

(MTP NOV'22)

ANSWER

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

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

Identifying business risks relevant to financial reporting objectives;

Estimating the significance of the risks;

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 9:

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

(MTP NOV'23)

ANSWER

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

Example

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

Question 10:

What is tolerable misstatement and total rate of deviation?

(MTP NOV'23)

ANSWER

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 11:

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. Analyse and Explain.

(RTP NOV'23)

ANSWER

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 12:



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

ANSWER

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 13:

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

(MTP NOV'22)

ANSWER

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

Question 14:

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

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

(MTP NOV'22)

ANSWER

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

Question 15:

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

Materiality is not a matter of size.

(MTP MAY '23, PYP MAY '22)

ANSWER

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 16:

Briefly discuss the limitations of Internal Control.

(RTP May '23)

ANSWER

Limitations of Internal Control:

- i. Internal control can provide only reasonable assurance: Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control.
- ii. Human judgment in decision-making: Realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.
- iii. Lack of understanding the purpose: Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.
- iv. Collusion among People: Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.
- 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 17:

Examine with reasons (in short) whether the following statement is correct or Incorrect: The SAs do not ordinarily refer to inherent risk and control risk separately. (MTP MAY'22)

ANSWER

Correct: The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important

than the different approaches by which they may be made.

Question 18:

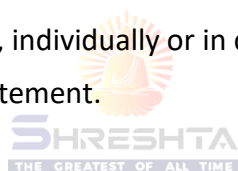
Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as materiality, size of the entity etc. Explain the other relevant considerations in the above context. (MTP MAY'22, RTP Nov'22)

ANSWER

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 19:



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

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

(MTP NOV'22, MTP NOV'23, PYP MAY '23)

ANSWER

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,
- f. especially those measurements involving a wide range of measurement uncertainty; and
- g. 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 20:

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.

(MTP MAY'23)

ANSWER

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

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

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

Question 21:

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.

(MTP NOV'23)

ANSWER

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 22:

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. (MTP NOV'23, MAY'22)

ANSWER

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 23:

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

- i. CAATs
- ii. Data Analytics
- iii. Database
- iv. Information Systems
- v. Privileged access (RTP May'23)

ANSWER

- i. CAATs: Short form for Computer Assisted Audit Techniques, are a collection of computer based tools and techniques that are used in an audit for analysing data in electronic form to obtain audit evidence.
- ii. Data Analytics: A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information

- iii. Database: A logical subsystem within a larger information system where electronic data is stored in a predefined form and retrieved for use.
- iv. Information Systems: Refers to a collection of electronic hardware, software, networks and processes that are used in a business to carry out operations and transactions.
- v. Privileged access: A type of super user access to information systems that enforces less or no limits on using that system.

Question 24:

Examine with reasons (in short) whether the following statement is correct or Incorrect: All automated environments are not complex. (MTP MAY'22)

ANSWER

Correct: The complexity of an automated environment depends on various factors including the nature of business, level of automation, volume of transactions, use of ERP and so on. There could be environment where dependence on IT and automation is relatively less or minimal and hence, considered less complex or even non-complex.

Question 25:

Examine with reasons (in short) whether the following statement is correct or incorrect : A combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is known as meaningful data. (MTP MAY'22)

ANSWER

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

Question 26:

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. (MTP MAY 22, RTP NOV '23)

ANSWER

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

- ⬆ Computation and Calculations are automatically carried out (for example, bank interest computation and inventory valuation).
- ⬆ Accounting entries are posted automatically (for example, sub-ledger to GL postings are automatic).
- ⬆ Business policies and procedures, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).
- ⬆ Reports used in business are produced from systems. Management and other stakeholders rely

on these reports and information produced (for example, debtors ageing report).

- ⬆ User access and security are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively).

Question 27:

The auditor should consider relevance of IT in an audit of financial statements. Explain giving reasons. (MTP NOV'22)

ANSWER

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

- 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.
- 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.
- By relying on automated controls and using data analytics in an audit, it is possible to increase the effectiveness and efficiency of the audit process.

Question 28:

Explain the objective and enlist the activities involved in the General IT Controls over “Program Change”. (MTP NOV'22)

ANSWER

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

Program Change

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

Activities:

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

Question 29:

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

- General (IT) Controls**
- Material Weakness**

iii. Data Processing

(MTP MAY'23)

ANSWER

- i. 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.
- ii. Material Weakness: A control deficiency or a combination of deficiencies in internal controls that is important enough to merit the attention of those charged with governance since there is a reasonable possibility that a material misstatement will not be prevented or detected in a timely manner by management.
- iii. Data processing: Refers to the systematic recording, storage, retrieval, modification and transformation of electronic data using information systems.

Question 30:

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

(MTP MAY'23, MTP NOV'22)

ANSWER

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.
- iv.

Question 31:

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

The Complexity of a business environment depends on the level of automation i.e., if a business environment is more automated, it is likely to be less complex.

(MTP MAY'23)

ANSWER

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

Question 32:

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.

(MTP MAY'23) (PYP MAY '22)

ANSWER

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 33:

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

With reference to General IT control, the objective of Data Center and Network Operations is to ensure that systems are developed, configured and implemented to meet financial reporting objectives.

(MTP NOV'23)

ANSWER

Incorrect: Objective of Data Center and Network Operations is to ensure that production systems are processed to meet financial reporting objectives.

Objective of Application system acquisition, development, and maintenance is to ensure that systems are developed, configured and implemented to meet financial reporting objectives.

Question 34:

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

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

(RTP MAY '22, MTP NOV'23)

ANSWER

- 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 35:

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

(MTP MAY'23)

ANSWER

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

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

Question 36:

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.

(MTP NOV'22)

ANSWER

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

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:

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

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 38:

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

Assertions refer to the representations by the auditor to consider the different types of the potential misstatements that may occur. (RTP MAY '23)

ANSWER

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

Question 39:

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)

ANSWER

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 40:

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

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 41:

While conducting the audit of Smart TV Ltd, engagement team of HTR& Co, has considered materiality and audit risk throughout the audit. Discuss explaining the meaning of audit risk.

(RTP MAY '22)

ANSWER

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Materiality and audit risk are considered throughout the audit, in particular, when:

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

Question 42:

An auditor has to exercise professional judgement in determining materiality. Explain the factors that may affect the identification of an appropriate benchmark in determining materiality for the financial statements as whole.

(PYP MAY '23)

ANSWER

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

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

Question 43:

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

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 44:

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. (RTP MAY'23)

ANSWER

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

For example, the procedure for sales requires the following:

1. Before acceptance of any order the position of inventory of the relevant article should be known to ascertain whether the order can be executed in time.
2. An advice under the authorisation of the sales manager should be sent to the party placing the order, internal reference number, and the acceptance of the order. This advice should be prepared on a standardized form and copy thereof should be forwarded to inventory section to enable it to prepare for the execution of the order in time.
3. The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.

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

Question 45:

So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programmer. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. Explain stating clearly the benefits of evaluation of internal control to the auditor. (RTP NOV'22)

ANSWER

So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programmer. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operations of these internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

Benefits of Evaluation of Internal Control to the Auditor

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

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

- ix. what would be appropriate audit technique and the audit procedure in the given circumstances;
- x. what are the areas where control is weak and where it is excessive; and
- xi. whether some worthwhile suggestions can be given to improve the control system.

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

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:

Saburi Textile Ltd is an established player in the textile manufacturing sector. It has developed strong internal controls in almost every area. It has appointed you as an Internal Audit team head. Internal audit has a very strong relation with internal control of the company. Internal Audit analyses the effectiveness with which the internal control of the company is operating and also makes suggestions for improvement in that internal control. Explain stating clearly activities relating to Internal Control. (RTP May '22, PYP MAY'22)

ANSWER

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 such as the activities Relating to Internal Control:

- i. Evaluation of internal control: The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.
- ii. Examination of financial and operating information: The internal audit function may be assigned

to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

- iii. Review of operating activities: The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including nonfinancial activities of an entity.
- iv. Review of compliance with laws and regulations: The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.
- v. Internal audit has a very strong relation with internal control of a company. Internal Audit analyzes the effectiveness with which the internal control of a company is operating and also makes suggestions for improvement in that internal control.

Question 48:

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

ANSWER

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 49:

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

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:

- i. ensuring the orderly and efficient conduct of its business, including adherence to company’s policies,
- ii. the safeguarding of its assets,
- iii. the prevention and detection of frauds and errors,
- iv. the accuracy and completeness of the accounting records, and
- v. 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 Rs.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 Rs.25 crore.



Question 50:

List the points that an auditor should consider to obtain an understanding of the Company's automated environment. (RTP NOV'22, NOV '23)

ANSWER

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 51:

Which are specific risks to the company's internal control having IT environment?

(RTP NOV'22,)

ANSWER

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. Potential loss of data or inability to access data as required.

Question 52:

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)

ANSWER

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

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

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

viii. Increases efficiency and effectiveness of audit.

Question 53:

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. (MTP MAY '23)

ANSWER

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 54:

Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are detected by obtaining sufficient appropriate audit evidence. . (PYP MAY'22)

ANSWER

Incorrect: Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.



Question 55:

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

ANSWER

Control Environment:

The control environment includes:

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

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

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

Question 56:

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

ANSWER

Meaning and benefits of understanding Internal Control:

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

Benefits of Understanding of Internal Control: An understanding of internal control assists the auditor in:

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

Question 57:

You are appointed as an auditor of Gama Ltd. Your audit assistant wants to understand the meaning of Audit Risk. Explain him the meaning of Audit Risk with example. Also guide him as to what is not included in Audit Risk. (PYP MAY '23)

ANSWER

Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. Thus, it is the risk that the auditor may fail to express an appropriate opinion in an audit assignment.

Example

Gama Limited purchased a Plant and Machinery for Rs.2 Crores in the financial year 2021 -2022. The accountant of Gama limited debited Rs.2 crores in the repair and maintenance account in the statement of Profit and loss instead of taking it to the balance sheet as PPE and claim depreciation on it. While auditing the accounts of this company the auditor may not notice this and consequently may not report anything regarding the plant and machinery. Therefore, opinion given by the auditor would be inappropriate resulting in audit risk.

What is not included in Audit Risk?

- i. Audit risk does not include the risk that the auditor might express an opinion that the financial

statements are materially misstated when they are not. This risk is ordinarily insignificant.

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

Question 58:

CA D has been appointed as an auditor of LMP Ltd. Before developing an overall audit plan, CA D wants to get an understanding and knowledge of the Client's business including applicable financial reporting framework. Guide CA D in understanding of the same with reference to the relevant Standard on Auditing. (PYP MAY '23)

ANSWER

Understanding and Knowledge of the Client's Business

It 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 following:

1. Relevant industry, regulatory and other external factors including the applicable financial reporting framework.
2. 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 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.
3. 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.
4. The entity's objectives and strategies and those related business risks that may result in risks of material misstatement.

The measurement and review of the entity's financial performance.

Question 59:

Define Monitoring of Controls and in respect of monitoring of controls, ANSWER the following questions:

How monitoring of controls would be helpful in assessing the effectiveness of controls?

How can management accomplish monitoring of controls?

What is included in the Management's monitoring activities?

(RTP NOV'22)

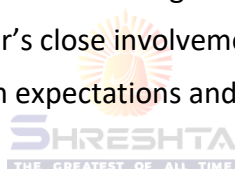
ANSWER

Monitoring of Controls: Component of Internal Control

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

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

- i. Helps in assessing the effectiveness of controls on a timely basis: It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.
- ii. Management accomplishes through ongoing activities, separate evaluations etc.: Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
- iii. Management's monitoring activities include: Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.
- iv. In case of Small Entities: Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.



Question 60:

State with reasons whether the following statements are correct or incorrect Audit findings and control deficiencies can be evaluated or assessed arbitrarily.

(PYP MAY'22)

ANSWER

Incorrect: Evaluation and assessment of audit findings and control deficiencies involves applying professional judgement that include considerations for quantitative and qualitative measures. Each finding should be looked at individually and in the aggregate by combining with other findings. deficiencies.

Question 61:

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

(PYP MAY'22)

ANSWER

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 62:

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? (PYP MAY'22)

ANSWER

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

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

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

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

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

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

Alternative Solution

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

Given below are some of the points that an auditor should consider to obtain an understanding

of the company's automated environment:

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

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

Question 63:

State with reasons whether the following statements are correct or Incorrect:

In an automated environment, the relationship between the application controls and the General IT controls over IT systems are not interrelated. (PYP NOV' 22)

ANSWER

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

Question 64:

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?

(PYP NOV' 22)

ANSWER

Access Security in Automated Environment:

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

Activities:

- i. Security Organization & Management
- ii. Security Policies & Procedures
- iii. Application Security
- iv. Data Security
- v. Operating System Security

- vi. Network Security – internal network, perimeter network
- vii. Physical Security – access controls, environment controls
- viii. System Administration & Privileged Accounts – Sysadmins, DBAs, Super users

Question 65:

If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered less complex and easy to audit compared to using an off the-shelf accounting software. (PYP May '23)

ANSWER

Incorrect: If a company uses an integrated enterprise resource planning system (ERP) viz., SAP, Oracle etc., then it is considered more complex to audit.

On the other hand, if a company is using off-the-shelf accounting software, then it is likely to be less automated, less complex and easy to audit.

Question 66:

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

ANSWER:

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

- (i) 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.
- (ii) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions.
- (iii) 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
- (iv) 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 67:

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

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

Program change controls	?
-------------------------	---

(MTP MAY 24)

ANSWER:

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

Question 68:

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

(MTP MAY 24)

ANSWER:

Internal Control Questionnaire



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

Are pending claims followed-up with insurers?

Question 69:

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

(MTP MAY 24)

Answer:

It is important to carry out Tests of Controls for checking the effectiveness of internal control over

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sales as a part of the debtors' audit procedure. Following points need to be considered in respect of trade receivables:

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

Question 70:

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

(MTP MAY 24)

ANSWER:

Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

1. Assessing risks of material misstatement of the financial statements
2. Determining materiality in accordance with SA 320
3. Considering the appropriateness of the selection and application of accounting policies
4. 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
5. 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 71:

Auditor of Sunshine Ltd. is of the view that due to greater management intervention to specify accounting treatment, the risk of material misstatement is greater for non-routine transactions. Is

view of the auditor correct? Specify the other matters due to which the risk of material misstatement is greater for significant non-routine transactions.

(MTP MAY 24)

ANSWER:

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

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

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

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

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

Question 72:

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

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

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

Is above communication by the auditor proper?

(MTP MAY 24)

ANSWER:

While pointing out significant deficiencies in internal control, auditor has not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information to those charged with governance and management to understand context of communication.

Therefore, the above communication is not proper. Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of not following the standard instructions/procedures specified in relation to various aspects of sales as stipulated by the management. It should explain that such a significant deficiency can lead to misstatement of revenue and trade receivables impacting profits of the company. Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

Question 73:

While conducting the audit of Zeena Limited, CA E is trying to obtain understanding of different components of internal controls of the company. Such an understanding is necessary and is

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required to be documented in accordance with Standards on Auditing. In this context, how he shall obtain understanding of the risk assessment process of the company and how is this understanding important for the auditor? (MTP SEP 24)

ANSWER:

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

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

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

Question 74:

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

ANSWER:

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

SA 200 defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

For example, auditor of a company uses certain audit procedures for the purpose of obtaining audit evidence and reducing audit risk, but still there will remain a risk that audit procedures used by the auditor may not be able to detect a misstatement which by nature is material, then that risk is known as detection Risk.

Detection risk comprises sampling and non-sampling risk.

- (a) **Sampling risk** is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. It simply means that the sample was not representative of the population from which it was chosen.
- (b) **Non-sampling risk** is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Like an auditor may reach an erroneous conclusion due to application to some inappropriate audit procedure.

Question 75:

IT related risks can have an impact on audit. In what different ways, such risks can have an impact on audit of financial statements? (RTP MAY 24)

ANSWER:

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

Impact on substantive checking

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

Impact on controls

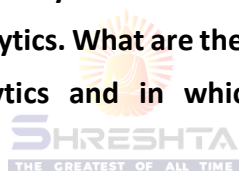
It can lead to non-reliance on automated controls, system calculations and accounting procedures built into applications. It may result in additional audit work.

Impact on reporting

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

Question 76:

Companies are increasingly using data analytics for managing their operations. Auditors can also obtain good results by using data analytics. What are the tools and techniques used by auditors in applying the principles of Data Analytics and in which areas data analytics can be used by auditors? (RTP SEP 24)



ANSWER:

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

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

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

10. AUDIT OF BANKS

ILLUSTRATIONS

ILLUSTRATION 1.

Ranjana Ceramic Private Limited is sanctioned a cash credit facility of Rs.100 lacs from a branch of LMO Bank. Besides, branch has also sanctioned a one-time bankguarantee of Rs. 10 lacs on behalf of the company in favour of a statutory authority. Discuss, what type of credit facilities have been sanctioned by branch of LMO bank to the company along with probable purpose for each of credit facility.

ANSWER:

Cash credit facility sanctioned by bank to company is in nature of funded credit facility. Its purpose is to meet working capital requirements of business.

Bank guarantee sanctioned to the company is in nature of non-funded credit facility. Its probable purpose could be requirement of a guarantee by a statutory authority in exchange of company fulfilling some statutory obligations.

ILLUSTRATION 2.

During course of audit of branch of a nationalized bank, you find that system has generated a report marking ten term loan accounts as SMA. Discuss, meaning of SMA accounts and significance of such a classification.



ANSWER:

Special Mention Account (SMA) is an account which is exhibiting signs of incipient stress resulting in the borrower defaulting in timely servicing of debt obligations, though the account has not yet been classified as NPA as per the RBI guidelines.

In the given case, ten term loan accounts have been classified as SMA. It means that there are overdues in the accounts for a period of 0 to 90 days. Since period of 90 days has not been exceeded as on the date, such accounts have not been classified as NPA as per RBI norms.

Such a classification is significant as early recognition of such accounts enables banks to initiate timely remedial actions to prevent potential slippages of such accounts into NPAs.

ILLUSTRATION 3.

CA P is conducting stock audit of a borrower availing cash credit facility of Rs.100 lacs from branch of a bank. The cash credit facility is against security of paid stocks and debtors up to 90 days. Margin stipulated is 25% for stocks and 40% for debtors. Following further information is available as on 31.12.22:

Value of stocks	Rs. 125 lacs
Value of stocks (fully damaged) included in above	5 lacs
Value of debtors	50 lacs

Value of debtors exceeding 90 days included in above	10 lacs
Value of creditors for goods	50 lacs

Is Drawing Power computed by CA P for Rs. 82.50 lacs proper?

ANSWER:

The computation of Drawing power is as under: -

Value of stocks as on 31.12.22	Rs.125 lacs
Less: value of damaged stocks	<u>Rs.5 lacs</u>
	Rs.120 lacs
Less: creditors for goods as on 31.12.22	<u>Rs.50 lacs</u>
Value of Paid stocks	Rs.70.00 lacs
Less: Margin @ 25%	<u>Rs.17.50 lacs</u>
Drawing power (A)	Rs.52.50 lacs
Value of debtors as on 31.12.22	Rs.50 lacs
Less: debtors exceeding 90 days	<u>Rs.10 lacs</u>
	Rs.40 lacs
Less: Margin @ 40%	<u>Rs.16 lacs</u>
Drawing Power (B)	Rs.24 lacs
Drawing Power (A+B)	Rs.76.50 lacs

The drawing power calculated by CA P is not proper. Drawing Power comes to Rs.76.50 lacs.

ILLUSTRATION 4.

You are verifying interest on deposits paid by branch of a nationalized bank. Discuss, any two “analytical procedures”, to verify interest on deposits paid by branch.

ANSWER:

The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.

The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

TEST YOUR KNOWLEDGE

Q.NO.1. Discuss outline of audit approach including audit procedures while auditing “provisions and contingencies” in financial statements of a bank.

ANSWER:

Q.NO.2. Discuss importance of implementation of KYC norms by a bank from perspective of an auditor of bank.

ANSWER:

Q.NO.3. List out any four points which highlight peculiarities involved in banking operations.

ANSWER:

Q.NO.4. Is statutory auditor of a bank required to report on the requirements relating to Companies (Auditor’s Report) Order, 2020?



ANSWER:

Q.NO.5. Account of a borrower availing cash credit facility from branch of a bank has become “Out of order.” Discuss the term “Out of order”.

ANSWER:

Q.NO.6. The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country. Explain

ANSWER:

Q.NO.7. “The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference”. Explain

ANSWER:

Q.NO.8. Write a short note on reversal of income under bank audit.

ANSWER:



QUESTIONS FROM RTP'S, MTP'S, QP'S

Question 1:

Your firm of Chartered Accountants has been appointed as auditor of a Nationalised bank. Explain how will you proceed to carry out audit of provisions and contingencies. (RTP MAY'22)

ANSWER

For audit of Provisions and contingencies, the auditor should ensure that the compliances for various regulatory requirements for provisioning as contained in the various circulars have been fulfilled. The auditor should obtain an understanding as to how the bank computes provision on standard assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets. The auditor may verify the loan classification on a sample basis. The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger. The auditor should obtain the tax provision computation from the bank's management and verify the nature of items debited and credited to profit and loss account to ascertain that the same are appropriately considered in the tax provision computation. The other provisions for expenses should be examined vis-a-vis the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

Question 2:

"There is no difference in provisioning of NPA as regards to categories of NPA, whether the debt is secured or unsecured." Critically evaluate the statement on the basis of provisioning norms of NPA of nationalised bank stating clearly the provision percent required. (RTP MAY '22)

ANSWER

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
<u>Sub-categories:</u>	

Doubtful up to 1 Year (D1)	25% + 100%
Doubtful 1 to 3 Years (D2)	40% + 100%
Doubtful more than 3 Years (D3)	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 3:

Explain "Advances under Consortium" in the context of Prudential Norms on Income Recognition, Asset Classification and provisioning pertaining to Advances. (MTP NOV'23)

ANSWER

Advances under Consortium: Consortium advances should be based on the record of recovery of the respective individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account should be treated as not serviced in the books of the other member banks and therefore, an NPA.

The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

Question 4:

Explain the audit approach you would follow to check the Operating Expenses of a Bank. (MTP NOV'22 , MAY'23, RTP MAY '23, RTP MAY'22)

ANSWER

Auditing the Operating Expenses of a Bank:

- i. Internal Controls: The auditor should study and evaluate the system of internal control relating to expenses, including authorization procedures in order to determine the nature, timing and extent of his other audit procedures.
- ii. Divergent Trends: The auditor should examine whether there are any divergent trends in respect of major items of expenses.
- iii. Substantive analytical Procedures: The auditor should perform substantive analytical procedures in respect of these expenses. eg. assess the reasonableness of expenses by working out their ratio to total operating expenses and comparing it with the corresponding figures for previous years.
- iv. Vouching & Verification: The auditor should also verify expenses with reference to supporting documents and check the calculations wherever required.

Question 5:

Mr Rishikesh, the Bank Manager develops controls to assist in managing key business and financial risks. Discuss the various requirements for an effective risk management system in a bank.

(RTP MAY '23)

ANSWER

Understanding the Risk Management Process: Management develops controls and uses performance indicators to aid in managing key business and financial risks. An effective risk management system in a bank generally requires the following:

- i. Oversight and involvement in the control process by those charged with governance: Those charged with governance (Board of Directors/Managing Director) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.
- ii. Identification, measurement and monitoring of risks: Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.
- iii. Control activities: A bank should have appropriate controls to mitigate its risks including effective segregation of duties (particularly between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting up limits, reporting and approval of exceptions, physical security and contingency planning.
- iv. Monitoring activities: Risk management models, methodologies and assumptions used to measure and mitigate risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.
- v. Reliable information systems: Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.

Question 6:

When is an agricultural advance considered as non - performing as per the RBI guidelines?

(MTP NOV'22, MTP MAY'22)

ANSWER

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 7:

Explain hypothecation and assignment as the modes of creation of security with respect to advance granted by a bank. (MTP NOV'22)

ANSWER

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 8:

The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. Explain this statement.

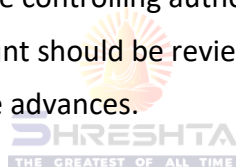
(MTP MAY'22)

ANSWER

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 9:

When are following considered as non performing as per the RBI guidelines?

i. Government guaranteed advances

ii. Advances to staff

(MTP MAY'23)

ANSWER

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 10:

Explain pledge and set off as the modes of creation of security with respect to advance granted by a bank. (MTP MAY'23)

ANSWER

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 11:

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. (MTP MAY'23)

ANSWER

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 12:

In a bank, all accounts should be kept within the drawing power and the sanctioned limit. The accounts which exceed the sanctioned limit or drawing power should be brought to the notice of the management regularly. Analyse the following points to be considered in the computation of drawing power in case of bank audit.

- i. Bank's Duties
- ii. Auditor's concern
- iii. Computation of DP
- iv. Stock audit

(MTP MAY'23)

ANSWER

Computation of Drawing Power:

- i. Bank's Duties: Banks should ensure that drawings in the working capital account are covered by

the adequacy of the current assets. Drawing power is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months is deemed as irregular.

- ii. Auditor's Concern: The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail. The audited Annual Report submitted by the borrower should be scrutinized properly. The monthly stock statement of the month for which the audited accounts are prepared and submitted should be compared and the reasons for deviations, if any, should be ascertained.
- iii. Computation of DP: It needs to be ensured that the drawing power is calculated as per the extant guidelines formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.
- iv. Stock Audit: The stock audit should be carried out by the bank for all accounts having funded exposure of more than 15 crores. Auditors can also advise for stock audit in other cases if the situation warrants the same. Branches should obtain the stock audit reports from lead bank in the cases where the Bank is not leader of the consortium of working capital. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

Question 13:

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

Banks recognize income on Non-Performing Assets on accrual basis.

(MTP NOV'23)

ANSWER

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 14:

While verifying provisions of advances of a branch of MCO Bank as part of statutory branch audit, CA Z notices that credit facilities consisting of term loan to KRT Enterprises have been classified under doubtful asset (D1) category.

The outstanding balance in above term loan account as on 31.3.2023 is ₹ 50 lakhs. Value of security held in account is ₹ 40 lakhs. The branch has made provision of ₹7.50 lakhs. Is provision made by branch proper? Discuss.

(MTP NOV'23)

ANSWER

The provision for advances falling in D1 category is required @ 25% of secured portion and 100% of unsecured portion. Therefore, provision in above case is arrived as under: -

Outstanding balance as on 31.3.23	₹ 50 lakhs
Less: Value of security	₹ 40 lakhs
Unsecured portion	₹ 10 lakhs

Therefore, outstanding balance of ₹50 lakhs is secured to the tune of ₹40 lakhs and balance ₹ 10 lakhs is unsecured. Provision calculation

25% of secured part i.e., 25% of ₹40 lakhs	₹ 10 lakhs
100% of unsecured part i.e., 100% of ₹10 lakhs	₹ 10 lakhs
Required provision	₹ 20 lakhs

Therefore, provision made by branch is not proper. It should have made provision of ₹20 lakhs instead of ₹ 7.50 lakhs.

Question 15:

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

Collateral security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. (MTP NOV'23)

ANSWER

Incorrect: Primary security refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance. Collateral security, on the other hand is an additional security.

Question 16:

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. (MTP NOV'23)

ANSWER

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 17:

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 NOV’23)

ANSWER

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 18:

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. (RTP MAY ’22)

ANSWER

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 19:

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.

(RTP MAY ’22)

ANSWER

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 20:

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

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 21:

While verifying interest income of a mid-corporate branch of an urban centre having advances consisting of only cash credit limits for large borrowers, it was noticed that advances of ₹ 300 crores were outstanding as on balance sheet date carrying average interest rate @8% p.a. One articulated clerk in audit team makes quick back of the envelope calculations of interest income of ₹ 24 crores on advances. However, schedule of profit & loss a/c shows interest income on advances for ₹ 10 crores. Discuss any two probable reasons for such variation. (RTP NOV'22)

ANSWER



The probable reasons for difference in interest calculation could be due to following:

- i. Cash credit accounts, by their very nature, are running accounts and their utilization depends upon needs of business. Further, interest on cash credit account is charged on the extent of funds utilized by the borrower. It could be possible that all cash credit limits were not fully utilized during the year which resulted in lower interest income.
- ii. Some large accounts may have been sanctioned during later part of the year resulting in lower interest income on advances for whole year.

Question 22:

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 ₹ 5 crore (including ₹ 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 ₹ 3 crore (including ₹ 50 lacs outstanding for last 6 months). Trade creditors outstanding as on date are ₹ 2 crore. He calculates DP as on 30.6.23 for ₹ 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

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 ₹ 3.00 crore signifies that company can utilize funds to the tune of ₹3.00 crore only against sanctioned cash credit limit of ₹ 4.00 crore.

Question 23:

Compute the Drawing Power for Cash Credit A.c of S Limited for the month of March 2022 with following information:

(PYP MAY'22)

(Amount in ₹)

Stock	50,000
Debtors (Including Debtor of ₹ 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

Computation of Drawing Power:

Computation of Drawing Power for CC A.c of S Ltd.

Particulars of current assets		Amount (₹)	DP Amt (₹)
(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 ₹ 45000 whereas drawing power as per the above working is ₹ 48000. So, drawing power would be restricted to sanctioned limit i.e., ₹ 45000

Question 24:

After becoming Chartered Accountant, you have got your first assignment as an auditor of a bank branch dealing in various types of advances. What are the areas which you will be looking for obtaining sufficient appropriate evidence (for advances) besides studying and evaluating internal controls? (PYP MAY'22)

ANSWER

Audit Procedure in Audit of Advances in case of Bank Audit: The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

- 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 25:

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? (PYP NOV'22)

ANSWER

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
<u>Sub-categories:</u> 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 ANSWER1:

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: -

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.

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.

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.

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 ANSWER2:

Aspects to be verified by CA R to check correct provisioning of NPAs:

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.

The auditor should obtain an understanding as to how the bank computes provision on standard

assets and non-performing assets. It will primarily include checking the basis of classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets.

The auditor may verify the loan classification on a sample basis.

The auditor should obtain the detailed break up of standard loans, non-performing loans and agree the outstanding balances with the general ledger.

Question 26:

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)? (PYP MAY '23)

ANSWER

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.

Question 27:

Following is the extract from Schedule no. 10 of Advances as appearing in financial statements of branch of a nationalized bank for year ending 31st March, 2024.

Schedule 10 - Advances

S. No.	Particulars	Amount (In Rs. Crores) rounded off
1.	Bills Purchased and Discounted	50.00
2.	Cash credits, overdrafts and loans repayable on demand	150.00
3.	Term Loans	75.00
	Total	275.00

In carrying out audit of above advances as part of statutory audit of branch, a statutory auditor would

obtain evidence about certain matters. State those matters.

(MTP MAY 24)

ANSWER:

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following: -

- (i) Amounts are included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.
- (ii) Advances represent amount due to the bank branch.
- (iii) Amounts due to the bank branch are appropriately supported by loan documents and other documents as applicable to the nature of advances.
- (iv) There are no unrecorded advances.
- (v) The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.
- (vi) The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.

Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

Question 28:

Column A describes description of certain terms used in banking industry. Complete Column B by suggesting term appropriate to description given.

Column A	Column B
Audit of borrower client of bank carried out at bank's request to verify borrower's current assets	?
Limit up to which an entity can withdraw from sanctioned working capital limit	?
Statutory right of a creditor to adjust debit balance in debtor's account against any credit balance lying in another account of debtor	?
Creation of security in a bank branch by mere delivery of title deeds by a prospective borrower of funds	?

(MTP MAY 24)

ANSWER:

Audit of borrower client of bank carried out at bank's request to verify borrower's current assets-

Stock audit

Limit up to which an entity can withdraw from sanctioned working capital limit- **Drawing power**

Statutory right of a creditor to adjust debit balance in debtor's account against any credit balance lying in another account of debtor- **Set-off**

Creation of security in a bank branch by mere delivery of title deeds by a prospective borrower of funds- **Equitable Mortgage**

Question 29:

National Bank has advanced cash credit facility of Rs.25 Lakh to Sun Industries. Following is the extract of account of Sun Industries reflecting in CBS of Bank from December 1, 2023 to March 31, 2024: -

Date	Particulars	Dr.	Cr.	Balance (Dr.)
01/12/2023	To Transfer	45,000		24,75,000
31/12/2023	By Clearing		1,00,000	23,75,000
31/12/2023	To Interest	25,000		24,00,000
31/01/2024	To Interest	24,700		24,24,700
29/02/2024	To Interest	24,800		24,49,500
31/03/2024	To Inspection charges	1,000		24,50,500
31/03/2024	To Interest	24,900		24,75,400

Drawing power during the above period was consistent at Rs.25 Lakh. The account was classified as “Standard asset” as on 31.12.2023 in books of Bank. The security charged with the bank remains intact throughout this period.

Comment on “asset classification” of above account as on 31st March 2024 in books of Bank in accordance with RBI norms. (MTP SEP 24)

ANSWER:

In accordance with RBI norms on asset classification, a non-performing asset is a loan or advance where the account remains “out of order” in respect of an Overdraft/Cash Credit.

An account should be treated as ‘out of order’ if:

- the outstanding balance remains continuously in excess of the sanctioned limit/drawing power or
- In cases where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for 90 days as on the date of Balance Sheet; or
- credits are there but are not enough to cover the interest debited during the same period.

In the given case, although outstanding balance in account is less than sanctioned limit/drawing power of Rs.25 lacs, there are no credits continuously for 90 days as on the date of Balance sheet. Therefore, it has become out of order and is required to be classified as NPA.

Under non-performing assets, it would be classified as “Sub-Standard Asset” as it has remained NPA for a period of less than or equal to 12 months.

Question 30:

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.

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What are CA Z's responsibilities regarding verification of compliance with income recognition norms by branch in respect of above credit facilities? (RTP MAY 24)

ANSWER:

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 31:

While verifying provisions of advances of a branch of MCO Bank as part of statutory branch audit, CA Z notices that credit facilities consisting of term loan to KRT Enterprises have been classified under doubtful asset (D1) category. The outstanding balance in above term loan account as on 31.3.2023 is Rs. 50 lakhs. Value of security held in account is Rs. 40 lakhs. The branch has made provision of Rs. 7.50 lakhs. Is provision made by branch proper? Discuss (RTP MAY 24)

ANSWER:

The provision for advances falling in D1 category is required @ 25% of secured portion and 100% of unsecured portion. Therefore, provision in above case is arrived as under: -

Outstanding balance as on 31.3.23	50 lakhs
Less: Value of security	40 lakhs
Unsecured portion	10 lakhs

Therefore, outstanding balance of Rs. 50 lakhs is secured to the tune of Rs.40 lakhs and balance Rs. 10 lakhs is unsecured.

Provision calculation

25% of secured part i.e., 25% of Rs. 40 lakhs	Rs. 10 lakhs
100% of unsecured part i.e., 100% of Rs. 10 lakhs	Rs. 10 lakhs
Required provision	Rs. 20 lakhs

Therefore, provision made by branch is not proper. It should have made provision of Rs.20 lakhs instead of Rs. 7.50 lakhs.

Question 32:

Compute the Drawing Power for Cash Credit A/c of Kirpa Limited for the month of March 2024 with following information:

	(Amount in Rs.)
Stock	60,000
Debtors	55,000

(Including Debtor of Rs.15,000 for an invoice dated 20.10.2023) Sundry creditors 10,000

Sanctioned Limit 48,000

Margin on stock is 30% and on debtors is 40%.

Note: Debtors older than 3 months are ineligible for calculation of DP. (RTP SEP 24)

ANSWER:

Computation of Drawing Power (DP) for CC A/c of Kirpa Ltd.

Particulars of current assets		Amount (Rs.)	DP Amt (Rs.)
(A) Stocks:			
Stocks at realizable value		60,000	
Less: Unpaid stocks:			
- Sundry creditors	10,000	<u>10,000</u>	
Paid for stocks		50,000	35,000
Margin @ 30%		<u>15,000</u>	
(B) Debtors:			
Total Debtors		55,000	
Less: Ineligible debtors		<u>15,000</u>	
Eligible debtors		40,000	
Margin @ 40%		<u>16,000</u>	<u>16,000</u>
Total Drawing Power			51,000

The sanctioned limit given in the question is Rs.48,000 whereas drawing power as per the above working is Rs.51,000. So, drawing power would be restricted to sanctioned limit i.e., Rs.48,000/-.

11. AUDIT OF ITEMS OF FINANCIAL STATEMENTS

ILLUSTRATIONS

ILLUSTRATION 1.

A company is engaged in manufacturing of fabrics from yarn purchased from different suppliers. Occasionally, it also manufactures fabrics tailor made in accordance with requirements of certain mills from yarn received from these mills. The company raises bill of its labour charges only on mills for converting yarn into fabrics. The auditor of company tries to ensure that stocks of the company as at year end do not include stocks pertaining to these mills. Which assertion auditor tries to verify in above situation? How he can ensure that?

ANSWER:

The auditor is trying to verify assertion relating to “Rights and Obligations”. He is verifying that the company owns or controls the inventory recorded in the financial statements. Any inventory held by the company on behalf of another entity has not been recognized as part of inventory of the company. This can be achieved by verifying stock records pertaining to goods received from mills and sent back to mills after carrying out necessary operations.

Besides, agreements with such mills may also be verified.

ILLUSTRATION 2.

A company has availed cash credit facility of Rs. 2 crore (O/s balance Rs. 2 crore as at year end) from a bank for meeting its working capital requirements against security of stocks and debtors and guaranteed by directors of the company. Discuss, how the above cash credit facility, would be classified and disclosed in financial statements of company.

ANSWER:

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

ILLUSTRATION 3.

Various ratios of current year and preceding year are disclosed in financial statements of a company in accordance with requirements of Schedule III of Companies Act, 2013. Discuss requirements of law in this regard (Do not list out names of ratios)

ANSWER:

A company has to disclose various ratios in its financial statements in accordance with requirements of Schedule III of Companies Act, 2013. The company shall also explain the terms included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

ILLUSTRATION 4.

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

ANSWER:

Substantive analytical procedures in respect of sales will consist of sales trend analysis, comparison with previous accounting period, category-wise sales analysis, any analysis the auditor may find relevant and most important of all, building a sales expectation and comparing that with the client's sales records. The auditor will need to know the sales prices of the products or services over the year, monthly average sales price per product or service, discount policy.

ILLUSTRATION 5.

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

ANSWER:

Depreciation of an asset begins when it is available for use i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management. Depreciation on asset is charged on asset from the date when it is ready for use and not from date of actual usage. Hence, recording of depreciation by company w.e.f. 1st October is not proper.

TEST YOUR KNOWLEDGE

Q.NO.1. How will you vouch and/or verify the following:

- a. Goods sent out on Sale or Return Basis.**
- b. Borrowing from Banks.**

ANSWER:

a. Goods Sent Out on Sale or Return Basis:

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

b. Borrowing from Banks: Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows-

- a.** Reconcile the balances in the overdrafts or loan accounts with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
- b.** Obtain independent balance confirmation from the bank showing balances, particulars of securities deposited with the bank as security for the loans or of the charge created on an asset and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
- c.** Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.
- d.** Confirm, in the case of a company, that the restraint contained in Section 180 of the Companies Act, 2013 as regards the maximum amount of loan that the company can raise has not been contravened.

Q.NO.2. How will you vouch/verify the following:

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

ANSWER:

a. Goods Sent on Consignment:

- i. Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.
- ii. Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.
- iii. Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.
- iv. Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.
- v. See that goods in hand with the consignee have been shown separately under the head inventories.

b. Foreign Travel Expenses:

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

c. Receipt of Capital Subsidy:

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

- iii. Ensure that the conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.
- iv. Check relevant entries for receipt of subsidy.
- v. Check compliance with requirements of AS 12 on “Accounting for Government Grants” i.e. whether it relates to specific amount or in the form of promoters’ contribution and accordingly accounted for as also compliance with the disclosure requirements.

d. Provision for Income Tax:

- i. Obtain the computation of income and income tax prepared by the entity and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.
- ii. (ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.
- iii. Examine relevant records and documents pertaining to advance tax, self-assessment tax and other demands.
- iv. Compute tax payable as per the latest applicable rates in the Finance Act.
- v. Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc.
- vi. Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under

Q.NO.3. How will you vouch and/or verify payment of taxes?

ANSWER:



Vouching of Payment of Taxes:

- i. Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan.
- ii. (ii) Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.
- iii. The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.
- iv. Nowadays, electronic payment of taxes is also in trend. Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards.
- v. The entity can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account Number (PAN) of the assessee on whose behalf the payment is made. This should be checked by the auditor.
- vi. It is not necessary for the entity to make payment of taxes from his own account in an authorized bank. While vouching such e-payment, the auditor should cross verify the payments of taxes through the receipted challan along with PAN No /TAN No. etc.

Q.NO.4. How would you vouch/verify the following:

a. Advertisement Expenses.

b. Sale of Scrap.

ANSWER:

a. Advertisement Expenses:

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

b. Sale of Scrap:

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

Q.NO.5. ABC Ltd. has issued shares for cash at a premium. Section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account. Advise the means in which the amount in the account can be applied.

ANSWER:

Shares Issued at Premium: In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the means in which the amount in the account can be applied. As per the section, where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account" and the provisions of this Act relating to reduction

of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.

Application of securities premium account: The securities premium account may be applied by the Company:

- a. towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
- b. in writing off the preliminary expenses of the Company;
- c. in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
- d. in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
- e. for the purchase of its own shares or other securities under section 68.

The auditor needs to verify whether the premium received on shares, if any, has been transferred to a “securities premium account” and whether the application of any amount out of the said “securities premium account” is only for the purposes mentioned above

Q.NO.6. The auditor A of ABC & Co.- firm of auditors is conducting the audit of XYZ Ltd and while performing testing of additions wanted to verify that all PPE (Property Plant and Equipment) purchase invoices are in the name of the entity he is auditing. For all additions to land, building in particular, the auditor desires to have concrete evidence about ownership. The auditor is worried about whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Advise the auditor.

ANSWER:

In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity. For all additions to land, building in particular, the auditor should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date. In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security.

In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

Q.NO.7. Write the audit Procedure for verification of existence of Trade Receivables.

ANSWER:

For Verification of Existence of Trade Receivables, the auditor should check the following :

- i. Check whether there are controls in place to ensure that invoices cannot be recorded more than once and receivable balances are automatically recorded in the general ledger from the original invoice.
Ask for a period-end accounts receivable ageing report and trace the balance as per the report to the general ledger.
- ii. Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoicewise and on FIFO basis i.e. previous bill is adjusted first.
- iii. If any large balance is due for a long time, auditor should ask for reasons and justification for the same.
- iv. A list of trade receivables selected for confirmation should be given to the entity for preparing request letters for confirmation which should be properly addressed.
- v. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.
- vi. Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample.
- vii. Where no reply is received, the auditor should perform alternate procedures regarding the balances.
- viii. Agreeing the balance to cash received subsequently;
- ix. Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (examination in depth for those balances)
- x. If there are any related party receivables, review them for collectability as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.
- xi. Check that receivables for other than sales or services are not included in the list.
- xii. Review a trend line of sales and accounts receivable, or a comparison of the two over time, to check if there are any unusual trends i.e. perform Analytical procedures. Make inquiries about reasons for changes in trends with the management and document the same in audit work papers.

Q.NO.8. MNO & Associates are the statutory auditor of Venus Ltd. for the FY 2021 -22. During the course of audit, one of the audit team members, Mr. Viaan noticed that the company has made loans totaling to Rs.50 lakhs to the promoters of the company, namely, Mr. Raj and Mr. Rajeev without specifying the period of repayment. Mr. Viaan discussed with Mr. Manik, the engagement partner, about the disclosure requirements with respect to such loans required by Schedule III to the Companies Act, 2013. What should Mr. Manik advise Mr. Viaan?

ANSWER:

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

- a. repayable on demand or
- b. without specifying any terms or period of repayment

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

Q.NO.9. What are the disclosures requirements as per Part I of Schedule III to the Companies Act with respect to the cash & cash equivalents held by a company?

ANSWER:

The following are the disclosure requirements as per Schedule III to the Companies Act, 2013, with respect to the cash & cash equivalents held by the company:

Cash and cash equivalents

- i. Cash and cash equivalents shall be classified as:
 - a. Balances with banks;
 - b. Cheques, drafts on hand;
 - c. Cash on hand;
 - d. Others (specify nature)
- ii. Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
- iii. Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
- iv. Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
- v. Bank deposits with more than 12 months' maturity shall be disclosed separately.

Q.NO.10. Mercury Ltd. is a company engaged in the manufacture of floor mats. The company sells its goods on credit. The debtors balance as on 31.03.2022 amounted to Rs.20 cr. What is the disclosure requirement as per Schedule III to the Companies Act 2013, with respect to the ageing schedule of debtors of the company?

ANSWER:

The following are the disclosure requirement as per Schedule III to the Companies Act 2013, with respect to the ageing schedule of debtors of the company:

Trade Receivables ageing schedule

						(Amount in Rs.)
Particulars	Outstanding for following periods from due date of payment#					
	Less than 6 months	6 months - 1 year	1-2 years	2-3 years	More than 3 years	Total
i. Undisputed Trade receivables – considered good						
ii. Undisputed Trade Receivables – considered doubtful						
iii. Disputed Trade Receivables considered good						
iv. Disputed Trade Receivables considered doubtful						

similar information shall be given where no due date of payment is specified, in that case disclosure shall be from the date of the transaction.

Unbilled dues shall be disclosed separately.

Q.NO.11. You are the statutory auditor of Jupiter Ltd. for the FY 2022-23. During the course of audit, you noticed that the company has PPE under construction i.e. Capital Work in Progress. What disclosures should the company give with respect to the ageing schedule of such capital work in progress as required by Schedule III to the Companies Act, 2013?

ANSWER:

Capital-Work-in Progress

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

CWIP ageing schedule

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

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

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

(Amount in Rs.)				
CWIP	Less than 1 year	1-2 years	2-3 years	More than 3 years
Project 1				
Project 2				

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

Q.NO.12. The auditor of Saturn Ltd. wants to verify whether the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2023. What audit procedures should the statutory auditor of the company perform?

ANSWER:

The statutory auditor of Saturn Ltd. should perform the following audit procedures to verify if the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2023. The auditor should:

- vouch recorded purchases to underlying documentation (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file).
- evaluate the consigned goods.
- examine client correspondence, sales and receivables records, purchase documents.
- determine existence of collateral agreements.
- review consignment agreements.
- review material purchase commitment agreements.
- examine invoices for evidence of ownership i.e. the invoices shall be in the name of the client.
- obtain confirmation for significant items of inventory.

For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.

QUESTIONS FROM RTP'S, MTP'S, QP'S

Question 1:

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

(MTP NOV'22, RTP MAY'22)

ANSWER

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 2:

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.

(MTP MAY'23)

ANSWER

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 3:

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.

(MTP MAY'22, RTP MAY 22, PYP MAY '23)

ANSWER

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

- i. 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.
- ii. 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 CA Inter (New) | P5 Auditing and Ethics | Comprehensive Question Bank | CA Ram Harsha

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 4:

XYZ Ltd made huge additions to Intangible assets during the period 01-04-2021 to 31-03-2022 i.e period under audit. You have been appointed as an auditor and you want to verify the additions made to intangible assets during the period. Suggest the audit procedure to verify the additions to intangible assets. (MTP MAY'22, SEP 22)

ANSWER

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 5:

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

- i. the criteria regarding classification of liability into current liability and non-current liability.
- ii. Classification of Reserves and Surplus

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

(MTP MAY'22)

ANSWER

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 6:

Reserves are a vital source of financing by internal means. Explain and also discuss the meaning of reserves along with revenue reserve and capital reserve. (MTP NOV'22)

ANSWER

Reserves are the amounts appropriated out of profits that are not intended

- to meet any liability,
- contingency,
- commitment or
- diminution in the value of assets known to exist as at the date of the Balance Sheet.

Reserves are a vital source of financing by internal means. They are held for the purpose of distribution of dividend or financing the expansion of the company or strengthening the company financially. The company utilizes the reserves according to the nature and type of such reserve. The reserves can be segregated as revenue or capital reserves.

Revenue reserves represent profits that are available for distribution to shareholders or below purposes such as:

- To supplement divisible profits in lean years, to finance an extension of business,
- to augment the working capital of the business or
- to generally strengthen the company's financial position.

Capital Reserve represents a reserve which does not include any amount regarded as free for distribution. They can be utilized only for certain limited purposes.

Example

Securities premium, capital redemption reserve.

It may be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve shall also be in the nature of a capital reserve.

Question 7:

Explain how you would verify Employee Benefit Expense incurred by a Company. (MTP NOV'22)

ANSWER

The auditor shall verify that:

- i. Employee benefit expense has been incurred during the period in respect of the personnel employed by the entity. Employee benefit expense does not include the cost of any unauthorized personnel.
- ii. Employee benefit expenses in respect of all personnel have been fully accounted for.
- iii. Employee benefit expenses recognized during the period relates to the current accounting period
- iv. only.
- v. Employee benefit expense has been measured. calculated accurately.
Any adjustments such as tax deduction at source have been correctly reconciled and accounted for.
- vi. Employee benefit expense has been fairly allocated between:
 - Operating expenses incurred in production activities;
 - General and administrative expenses; and
 - Cost of personnel relating to any self-constructed assets other than inventory.

Question 8:

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. (MTP NOV'22)

ANSWER

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 as fully paid bonus shares;
- b. in writing off the preliminary expenses of the Company;
- c. in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
- d. in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
- e. for the purchase of its own shares or other securities under section 68.

Question 9:

The auditor has to ensure whether PPE has been valued appropriately and as per generally accepted accounting policies and practices and also the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Explain how the auditor will verify the same. (MTP NOV'22)

ANSWER

The auditor has to ensure whether PPE has been valued appropriately and as per generally accepted accounting policies and practices.

The value of fixed assets. PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of PPE would be shown at higher amounts.

The auditor should:

- Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non-depreciable like freehold land;
- Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 - Impairment of Assets.

To verify whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements

- In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity.
- For all additions to land and building in particular, the auditor should check the conveyance deed. sale deed to verify whether the entity is the legal and valid owner or not.
- The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date.
- In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security.
- In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

Question 10:

Explain how you would verify rent expense incurred by a Company.

(MTP NOV'22)

ANSWER

Rent expense can be verified by:

Obtaining a month wise expense schedule along with the rent agreements.

- Verifying if expense has been recorded for all 12 months and whether the rent amount is as per the underlying agreement.
- Giving specific consideration to the escalation clause in the agreement to verify if the rent was required to be recorded on a straight line basis during the period under audit.
- Also, verifying if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity.

Question 11:

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

(MTP NOV'22)

ANSWER

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

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

Question 12:

What are the required disclosures for cash & Cash equivalents to be made by the company as per Schedule III (Part I) to Companies Act, 2013?

(MTP MAY'23, RTP MAY 23)

ANSWER

The following are the required disclosures for cash & Cash equivalents to be made by the company as per Schedule III (Part I) to Companies Act, 2013:

Cash and cash equivalents

- i. Cash and cash equivalents shall be classified as:
 - a. Balances with banks;
 - b. Cheques, drafts on hand;
 - c. Cash on hand;
 - d. Others (specify nature)
- ii. Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
- iii. Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.
- iv. Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.
- v. Bank deposits with more than 12 months' maturity shall be disclosed separately.

Question 13:

Study mate Limited is a company engaged in the manufacture of stationery items. The company sells its goods on credit. The debtors as on 31.03.2022, amounted to ₹ 10 crores. What is the disclosure requirement for the company with respect to the ageing schedule of the trade receivables in terms of Schedule III (Part I) to the Companies Act, 2013? (MTP MAY'23)

ANSWER

The following is the disclosure requirement for Study mate Limited with respect to the ageing schedule of the trade receivables in terms of Schedule III (Part I) to the Companies Act, 2013

Trade Receivables ageing schedule

(Amount in ₹)						
Particulars	Outstanding for following periods from due date of payment#					Total
	Less than 6 months	6 months-1 year	1-2 years	2-3 years	More than 3 years	
i. Undisputed Trade receivables – considered good						
ii. Undisputed Trade Receivables – considered doubtful						
iii. Disputed Trade Receivables considered good						
iv. Disputed Trade Receivables considered doubtful						

similar information shall be given where no due date of payment is specified, in that case disclosure shall be from the date of the transaction.

Unbilled dues shall be disclosed separately.

Question 14:

Name the assertion that the auditor will check by performing the following audit procedures.

- a. **Employees benefit expense in respect of all personnel have been fully accounted for.**
- b. **Discounts on sales has been properly adjusted. accounted for.**
- c. **Employee benefit expense recorded during the period relates to the current accounting period only.** (MTP MAY'23)

ANSWER

- a. Completeness
- b. Measurement
- c. Cut Off

Question 15:

CA Mehta is the statutory auditor of ABC Ltd. While performing testing of additions during the year, he wanted to verify that:

- i. **All PPE (property, plant and equipment) are in the name of the entity he is auditing.**
- ii. **For all additions to land and building in particular, the auditor desires to have concrete about the ownership.**
- iii. **The auditor wants to know whether the entity has valid legal ownership rights over the PPE, where it is kept as security for any borrowings.**

Advise the auditor on the audit procedure to be undertaken by him to establish the Rights and Obligations of the entity over the PPE. (MTP MAY'23)

ANSWER

Audit procedure to establish Rights and Obligations of the entity over PPE:

- i. **In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, CA Mehta, the statutory auditor of ABC Ltd, while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity. Verify whether the PPE additions have been approved by authorized personnel.**
- ii. **For all additions to land, building in particular, CA Mehta, the statutory auditor of ABC Ltd, should obtain copies of conveyance deed. sale deed to establish whether the entity is mentioned to be the legal and valid owner.**
- i. **The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date.**
- ii. **In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, CA Mehta, the statutory auditor of ABC Ltd**

should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security.

- iii. In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

Question 16:

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

Dividends are recognized in the statement of profit and loss only when the amount of dividend can be measured reliably. (MTP NOV'23)

ANSWER

Incorrect: Dividends are recognised in the statement of profit and loss only when:

- the entity's right to receive payment of the dividend is established;
- 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.

Question 17:

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

			(₹)
	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

Indicate different assertions in respect of account balances at period end.

State specific assertions relating to the above extract of financial statement. (MTP NOV'23)

ANSWER

- Assertions about account balances at the period end:
 - Existence – assets, liabilities, and equity interests exist.
 - Rights and obligations – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - Completeness – all assets, liabilities and equity interests that should have been recorded have been recorded.
 - 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.
- The specific assertions are as follows:
 - the firm owns the plant and machinery;
 - the historical cost of plant and machinery is ₹ 4 lacs;
 - 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 ₹ 1,66,000 to date on which ₹ 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 18:

Discuss the audit procedures generally required to be undertaken by the auditor while auditing Goods sent out on Sale or Return Basis. (MTP NOV'23)

ANSWER

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 19:

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? (MTP NOV'23)

ANSWER

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 20:

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

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

(MTP NOV'23)

ANSWER

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 21:

Depreciation and amortisation expense generally constitute an entity's significant part of overall expenses and have direct impact on the profit/loss of the entity. What are the attributes, the Auditor needs to consider while verifying Depreciation and amortisation expense. (MTP NOV'23)

ANSWER

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 amortisation expense:



- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- 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 22:

The auditor of Saturn Ltd. wants to verify whether the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2023. What audit procedures should the statutory auditor of the company perform? (MTP NOV'23)

ANSWER

The statutory auditor of Saturn Ltd. should perform the following audit procedures to verify if the company has valid legal ownership rights over the inventories recorded in the balance sheet as on 31.03.2023. The auditor should:

- vouch recorded purchases to underlying documentation (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file).
- evaluate the consigned goods.
- examine client correspondence, sales and receivables records, purchase documents.
- determine existence of collateral agreements.
- review consignment agreements.
- review material purchase commitment agreements.
- examine invoices for evidence of ownership i.e. the invoices shall be in the name of the client.
- obtain confirmation for significant items of inventory.

For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.

Question 23:

While verifying the legal and professional expenses of the client company, what audit procedures should the auditor perform? (MTP MARCH '23)

ANSWER



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 24:

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**

(RTP MAY '22)

ANSWER

- a. Recovery of Bad Debts written off:** Recovery of bad debts written off is verified with reference to relevant correspondence and proper authorisation.

- 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-
- i. 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.
 - ii. 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.
 - iii. The copy of certificate/report containing full particulars of the amount of loss should also be verified.
 - iv. 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:**
- i. 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.
 - ii. Examine relevant records and documents pertaining to payment of advance income tax and self assessment tax.
 - iii. 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.
 - iv. The penal interest charged for non-payment should be debited to the interest account.
 - v. 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.
 - vi. 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 25:

Name the assertions for the following audit procedures:

- i. Year end inventory verification.
- ii. Depreciation has been properly charged on all assets.
- iii. The title deeds of the lands disclosed in the Balance Sheet are held in the name of the company.
- iv. All liabilities are properly recorded in the financial statements.
- v. Related party transactions are shown properly. (RTP NOV'22, MTP NOV '23)

ANSWER

- i. Year-end inventory verification: Existence Assertion.
- ii. Depreciation has been properly charged on all assets: Valuation Assertion.
- iii. Title deed of lands disclosed in the Balance Sheet are held in the name of the Company: Rights & Obligations Assertion.
- iv. All liabilities are properly recorded in the financial statements: Completeness.
- v. Related party transactions are shown properly: Presentation & Disclosure.

Question 26:

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

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 27:

CA Saurabh is the statutory auditor of UVW Ltd. for the FY 20 -21. While verifying the purchases made by UVW Ltd., CA Saurabh decided to perform analytical procedures to obtain audit evidence regarding the overall reasonableness of purchase quantity and price of purchases. What analysis should CA Saurabh perform? (RTP MAY '23)

ANSWER

CA Saurabh should perform following analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price:

Consumption Analysis: He should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from the management if any significant variations are found.

Stock Composition Analysis: He should collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with previous year and ask for reasons from management in case of significant variations.

Ratios: He should compare the creditors' turnover ratios and stock turnover ratios of the current year with previous years.

He should review quantitative reconciliation of closing stocks with opening stock, purchases and consumption.

Question 28:

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 29:

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 30:

M.s MP & Co, Chartered Accountants, have been appointed as auditors of LMP Private Limited. The partner of the firm asked the Audit assistant to carry out the 'examination-in- depth' of the payment made to a creditor. Advise him about the documents to be verified. (RTP NOV '23)

ANSWER

Examination – in depth of the payment made to creditor: The Audit Assistant of M.s MP & Co., should verify the following documents of LMP Private Limited in case of payment to a creditor is to be verified “in depth”:

- i. The invoice and statement of account received from the supplier.
- ii. The entry in the inventory record showing that the goods were received.
- iii. The Goods Received Note and Inspection Certificate showing that the goods on receipt were verified and inspected.
- iv. The copy of the original order and authority showing that the goods in fact were ordered by an authority which was competent to do so.

Question 31:

- 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



- 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 32:

While verifying the PPE of the client entity, the auditor also needs to consider whether the PPE has been valued appropriately and as per the generally accepted accounting principles and practices.

Explain.

(RTP MAY '23)

ANSWER

While verifying the PPE of the client entity, the auditor also needs to consider whether the PPE has been valued appropriately and as per the generally accepted accounting principles and practices. The auditor should:

- Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non-depreciable like freehold land;
- Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 - Impairment of Assets.

Question 33:

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

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 34:

S& Co., Chartered Accountants, are appointed as the auditors of ABC Ltd. CA S, the engagement partner, has come across the following while verifying equity share capital of the company:

- i. He noticed that some of the equity shares are held by promoters.
- ii. Some shares are issued as sweat equity shares to the employees. What is the meaning of sweat equity shares?

What are the disclosure requirements of such promoter's shareholding? (PYP NOV 22)

ANSWER

Meaning of Sweat Equity & Disclosure of shares held by Promoters:

Meaning Sweat Equity Shares: According to Section 54 of the Companies Act, 2013, the employees may be compensated in the form of ‘Sweat Equity Shares’.

“Sweat Equity Shares” mean 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.

Disclosure requirements of such promoter's shareholding: A company shall disclose Shareholding of Promoters* as below:

Shares held by promoters at the end of the year				% Change during the year***
S. No.	Promoter Name	No. of shares	% of total shares**	

* Promoter here means promoter as defined in the Companies Act, 2013.

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

*** percentage change shall be computed with respect to the number at the beginning of the year or if issued during the year for the first time then with respect to the date of issue.]

Question 35:

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.

(PYP NOV 22)

ANSWER

Attributes for verifying other expenses like Power and Fuel, Repair etc.:

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

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

- 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 36:

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?

(PYP NOV 22)

ANSWER



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 37:

A Ltd. has traded for 50.00 Lacs in "TETRA", a virtual currency, during the F.Y. 2021 -2022 and earned a profit of 20.00 Lacs on it. What disclosure requirements are prescribed for such type of transactions done by the company?

(PYP NOV 22)

ANSWER

Disclosure of Crypto Currency or Virtual Currency:

Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:

- a. profit or loss on transactions involving Crypto currency or Virtual Currency
- b. amount of currency held as at the reporting date,
- c. deposits or advances from any person for the purpose of trading or investing in Crypto Currency. virtual currency.

Question 38:

Amortization represents systematic allocation of the depreciable amount of an item of Property, Plant and Equipment (PPE) over its useful life. (PYP May '23)

ANSWER

Incorrect: Depreciation represents systematic allocation of the depreciable value of an item of PPE over its useful life whereas amortisation represents systematic allocation of the depreciable amount of an intangible asset over its useful life.

Question 39:

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? (PEP MAY' 23)

ANSWER



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 40:

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? (PYP MAY '23)

ANSWER

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.

Completeness

4. Obtain the underlying working and the basis for each of the provisions made from the management and verify whether the same is complete and accurate.
5. The auditor shall obtain a written representation from the management that it has made all the provisions which were required to be made as per the recognized accounting principles.

Question 41:

Prudent Enterprises Private Limited has incurred and fully spent for the first time Corporate Social Responsibility (CSR) expenditure amounting to Rs. 14.50 lacs in pursuance to provisions of section 135 of Companies Act, 2013. The expenditure was spent for women empowerment programmes through an implementing agency (not a related party). As per law provisions, it was required to spend Rs. 14.00 lacs during the year. Discuss how such information is required to be disclosed in accordance with requirements of Schedule III to the Companies Act, 2013 in financial statements of the company

ANSWER:

In the given situation, following information is required to be disclosed in accordance with requirements to Schedule III to the Companies Act, 2013:

(a) amount required to be spent by the company during the year Rs.14.00 lacs	
(b) amount of expenditure incurred	Rs.14.50 lacs
(c) shortfall at the end of the year	NIL
(d) total of previous years shortfall	NA
(e) reason for shortfall	NA
(f) nature of CSR activities - Women empowerment activities through implementing agency	
(g) details of related party transactions, e.g., contribution to a trust controlled by	NIL

the company in relation to CSR expenditure as per relevant Accounting Standard	
(h) where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately	NIL

Question 42:

You are part of engagement team conducting audit of an entity engaged in manufacturing business. State few audit procedures you would undertake to perform to verify that recorded sales in financial statements represent goods actually sold during the period and recorded sales are not overstated

ANSWER:

Following audit procedures can be performed to perform to verify that recorded sales in financial statements represent goods actually sold during the period and recorded sales are not overstated.

- Check whether a single sales invoice is recorded twice or a cancelled sales invoice has been recorded.
- Test check few invoices with their relevant entries in sales journal.
- Obtain confirmation from few customers to ensure genuineness of sales transaction
- Check whether any fictitious customers and sales have been recorded.
- Verify whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure
- Whether unearned revenue recorded as earned.
- Whether any substantial uncertainty exists about collectability
- Whether customer obligations are contingent on other (financing, resale, etc.).
- Review sequence of sales invoices
- Review journal entries for unusual transactions
- Calculate the ratio of sales return to sales and compare it with previous year and enquire for the reasons for unusual variation.

Question 43:

WTE Private Limited is engaged in business of manufacturing a product liable to GST @ 5%. The input raw materials for manufacturing this product are liable to GST @ 12% and 18%. As a result, at the end of financial year, ITC on inputs amounting to Rs. 60 lacs is accumulated in Electronic Credit ledger and refundable to company under provisions of GST law. How would above amount of Rs. 60 lacs be reflected and classified in balance sheet of company? State few audit procedures to be performed by you for verification of abovesaid balance.

ANSWER:

In the given situation, Rs. 60 lacs is accumulated in Electronic credit ledger of WTE Private Limited as finished product is liable to lower GST rate whereas input raw materials for manufacturing carry higher GST rate. It is refundable to company by virtue of provisions of GST law. The above balance would be reflected and classified under current assets. Within current assets, it would be classified into "Other current assets".

Few audit procedures to be performed for verification of above balance are:

- In relation to balances with statutory authorities like GST input credit, prepare a reasonability analysis with respect to purchases by applying the applicable rate to the purchases and in case of any variance with the asset recorded by the entity, reasons for variance should be requested from the entity.
- Obtain copies of statutory GST returns filed on GST portal.
- In case refundable amount as on balance sheet date is still outstanding, verify whether the amount recorded as per books of account tallies with the claim made with the authorities subsequently by going to GST portal.
- In case refundable amount as on balance sheet date is received subsequently, verify it from Bank statement.

Question 44:

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

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

Trade receivables ageing schedule.

Outstandings for following periods from due date of payment

(in Rs. lacs)

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

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

(MTP MAY 24)

ANSWER:

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

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



Question 45:

Being statutory auditor of JAL Limited, a company engaged in manufacturing of chemicals, CA Gopika has understood that company is expected to have material work-in-progress as on 31st March, 2024.

State few audit procedures to verify existence and valuation assertions for work-in-progress.

(MTP MAY 24)

ANSWER:

Audit procedures to verify existence and valuation assertions for work- in-progress are as under: -

- Attend inventory count in accordance with SA 501 and understand how work in progress is arrived at.

- Evaluate work of management expert, if any, in this regard.
- Ascertain how the various stages of production/ value additions are measured and in case estimates are made, understand the basis for such estimates.
- Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity.
- Ensure that material costs exclude any abnormal wastage factors.

Question 46:

While verifying cash and cash equivalents of a company, CA D engagement partner, is very particular that Bank reconciliation statement (BRS) prepared by the management in respect of bank account maintained by the company is proper to rule out misstatements in cash and cash equivalents reflected in the financial statements of the company. The company does not use net banking and prefers to issue cheques to its creditors and receives substantial payments locally through account payee cheques. Which aspects need to be taken care of and verified by CA D in respect of BRS? (MTP SEP 24)

ANSWER:

CA D should ensure that BRS is signed by the authorized personnel so that he is able to assign responsibility in case of any errors.

Verification of BRS shall entail the following: -

- Tallying the balance as per bank book to the bank confirmation/ statement.
- Checking of all material reconciling items included under cheques issued but presented for payment to the underlying bank book forming part of books of account. In addition, the auditor should request for bank statements of subsequent period and should verify if the cheques issued have subsequently been cleared by the bank. For all cases where cheques have become stale i.e. 3 months or more have lapsed since the issue date, the same should not appear in the BRS and should instead be taken back to liabilities.
- Checking of all material reconciling items included under cheques deposited but not credited by bank by requesting for bank deposit slips, duly acknowledged by bank and verifying if the balances were credited by bank subsequently by tallying to the bank statement of subsequent period. For any instances related to cheques not cleared beyond reasonable time, the auditor should seek brief descriptions from the management and in case such explanations are found to be unsatisfactory, the auditor should verify the revenue recognition related to such parties was in order and as per the Company's revenue recognition policy.
- Checking of all material reconciling items included under amounts or charges debited/ credited by bank but not accounted for by requesting for bank statements for the period under audit and tallying the same. If the amounts are found to be material, the auditor should ensure that the management records the adjustments for the same in its books of account.

Question 47:

BOTS is a manufacturing entity having material Property, Plant and Equipment (PPE) items in its financial statements. The auditor of the entity wants to verify that PPE items have been valued appropriately as per generally accepted accounting policies and practices. Comment on significance of such verification. Suggest a few audit procedures in this regard.

(MTP SEP 24)

ANSWER:

It is a common understanding that the value of fixed assets/ PPE depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the entity for earning revenue during a given period. Unless this cost in the form of depreciation is charged to the accounts, the profit or loss would not be correctly ascertained, and the values of PPE would be shown at higher amounts. Therefore, such verification is significant.

Audit procedures that the auditor should follow to verify that the PPE items have been valued appropriately as per generally accepted accounting policies and practices are: -

- Verify that the entity has charged depreciation on all items of PPE unless any item of PPE is non-depreciable like freehold land
- Assess that the depreciation method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity. It could be Straight line method, diminishing value method, unit of production method, as applicable.
- The auditor should also verify whether the management has done an impairment assessment to determine whether an item of property, plant and equipment is impaired as per the requirements of AS 28 Impairment of Assets.

Question 48:

Proceedings have been initiated against False Limited for holding benami property under law relating to prohibition of benami transactions and the rules made thereunder but such property is not recorded in books of accounts. As a consultant to the company, what will you advise the company as far as disclosure requirements are concerned in financial statements in relation to said proceedings?

(RTP MAY 24)

ANSWER:

Disclosure in case of Benami Properties held by the Company: Where any proceedings have been initiated or pending against the company for holding any benami property under the relevant law relating to prohibition of such transactions, the company shall disclose the following: -

- (a) Details of such property, including year of acquisition
- (b) Amount thereof
- (c) Details of Beneficiaries
- (d) If property is not in the books, then the fact shall be stated with reasons
- (e) Where there are proceedings against the company under this law as an abetter of the transaction or as the transferor, then the details shall be provided

(f) Nature of proceedings, status of same and company's view on same.

Question 49:

Droma Shoes Private Limited was established in year 2022-23 for manufacturing of footwear. As funds were needed to carry on its business activities - including for purchase of different raw materials, incurring of regular expenses like power and fuel and payment of wages etc., it had got sanctioned a credit facility amounting to Rs. 2 crores repayable on demand from a bank against primary security of its current assets and collateral security of residential house of one of its directors. Duly signed guarantee documents by directors in favour of bank also form part of bank's loan documentation. Account statement of above facility downloaded from bank's website shows debit balance of Rs. 1.85 crores as on 31st March, 2023. The operations in above credit facility are satisfactory. In this regard: -

(v) Identify nomenclature of such credit facility given by banks. How would above amount of Rs.1.85 crores be reflected and classified in financial statements of company as on 31.3.23?

(vi) Also state specific disclosure requirements of Schedule III of Companies Act, 2013 in relation to above. (RTP MAY 24)

ANSWER:

(i) The type of credit facilities referred to in above situation given by banks to meet working capital requirements of business which are repayable on demand are known as "cash credit facilities/overdraft" facilities. The amount of Rs.1.85 crores outstanding as on 31st March, 2023 reflects borrowings of the company and it would be classified as "short-term borrowings" as loans repayable on demand from banks under current liabilities in balance sheet of the company. Borrowings shall further be subclassified as secured.

(ii) Specific disclosure requirements of short-term borrowings under Schedule III to Companies Act, 2013 in given situation are as under: -

- Nature of security i.e. primary security of current assets and collateral security of residential house belonging to a director shall be specified.
- As loans have been guaranteed by directors, the aggregate amount of such loans shall be disclosed.

To be disclosed as Additional Regulatory Information

Since the Company has borrowings from bank on the basis of security of current assets, it shall also disclose the following:-

- (a)** whether quarterly returns or statements of current assets filed by the Company with banks or financial institutions are in agreement with the books of accounts.
- (b)** if not, summary of reconciliation and reasons of material discrepancies, if any to be adequately disclosed.

Question 50:

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

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

(RTP MAY 24)

ANSWER:

The disclosure given in the question does not meet requirements of Schedule III to Companies Act, 2013.

Schedule III requires that the company shall explain the items included in numerator and denominator for computing the ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

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

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

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

Question 51:

The financial statements of XYZ Limited show long-term borrowings from the banks, financial institutions, leasing, and hire purchase companies. Additionally, the company has issued debentures to its 1000 members to raise funds in accordance with the provisions of the Companies Act, 2013. The money raised by issuing debentures is also reflected in long-term borrowings. As the statutory auditor of XYZ Limited, CA X wants to verify that all borrowings on the balance sheet represent valid claims by banks or other third parties. Suggest a few audit procedures in this regard.

ANSWER:

The audit procedures required to be undertaken by CA X while auditing borrowings is as follows:

- Review board minutes for approval of new lending agreements. During review, ensure that new loan agreements or bond issuances were authorized. Ensure that significant debt commitments are approved by the board of directors.
- Check the details of loans recorded (interest rate, nature and repayment terms) to the loan agreement. Verify that borrowing limits, if any, imposed by the agreements are not exceeded.
- Roll out and obtain independent balance confirmations (SA 505) in respect of all the borrowings from the lender (banks/ financial institutions etc.).
- Verify the details of leases and hire purchase creditors recorded to underlying contracts/agreements.
- In case of Debentures, examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants.
- When debt is retired, ensure that a discharge is received on assets securing the debt.
- Obtain Written Representation that all the liabilities which have been recorded represent a valid claim by the lenders.

