



**Workbook**  
**Subject – Auditing and Assurance**



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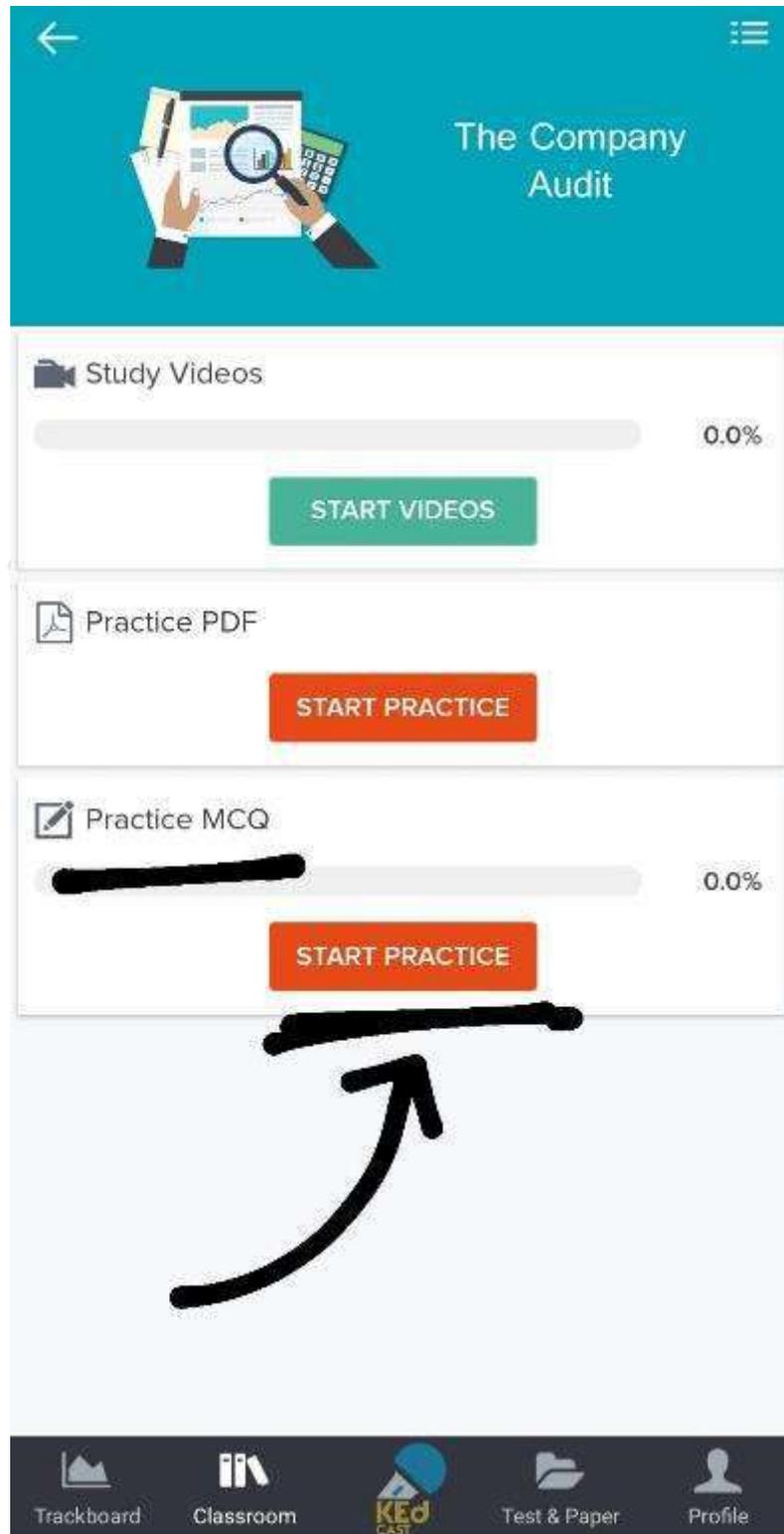
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**NOTE- MCQs are not covered in this Workbook. You can access the MCQs from your study account either on the Application or the Website.**



## Chapter 1 – The Company Audit

### Question 1

The head accountant of a company entered fake invoices of credit purchases in the books of account aggregate of ₹ 50 lakh and cleared all the payments to such bogus creditor. How will you deal as an auditor ?

### Answer

Here, the auditor of the company is required to report the fraudulent activity to the Board or Audit Committee (as the case may be) within 2 days of his knowledge of fraud. Further, the company is also required to disclose the same in Board's Report. It may be noted that the auditor need not to report the central government as the amount of fraud involved is less than ₹ 1 crore, however, reporting under CARO, 2016 is required.

### Question 2

Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard.

### Answer

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

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

### Question 3

During the audit of PQR Ltd. you as an auditor requested officers of the company to have access to secretarial records and correspondence which they refused to provide. Comment.

### Answer

Right of Access to secretarial records and correspondence:

1. Section 143(1) of the Companies Act, 2013 grants powers to the auditor that every auditor has a right of access, at all times, to the books of account and vouchers of the company kept at Registered or Head Office, branches and subsidiaries in the case of a Holding Company for conducting the audit.

2. Further, he is also entitled to require from the officers of the company such information and explanations which he considers necessary for the proper performance of his duties as Auditor. Therefore, he has a statutory right to inspect the secretarial records and correspondence.

3. In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company. It is, therefore, essential for the auditor to refer to the secretarial records and correspondence which also includes Minute book. In the absence of the same, the auditor may not be able to vouch/verify certain transactions of the company.

4. The refusal to provide access to secretarial records and correspondence shall constitute limitation of scope as far as the auditor's duties are concerned.

5. The auditor may examine whether by performing alternative procedures, the auditor can substantiate the assertions or else he shall have to either qualify the report or give a disclaimer of opinion.

#### **Question 4**

"Mr. A is offered by ABC Ltd. for appointment as cost auditor and asked to certify certain requirements before such appointment." Discuss those requirements with reference to the provisions of the Companies Act, 2013.

#### **Answer**

Cost Auditor: Rule 6 of the Companies (Cost Records and audit) rules, 2014 required the companies prescribed under the said rules to appoint an auditor within 180 days of the commencement of every financial year. However, before such appointment is made, the written consent of the cost auditor to such appointment and a certificate from him or it shall be obtained.

The certificate to be obtained from the cost auditor shall certify that the-

(1) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Companies Act, 2013, the Cost and Works Accountants Act, 1959 and the rules or regulations made thereunder;

(2) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Companies Act, 2013 so far as may be applicable;

(3) the proposed appointment is within the limits laid down by or under the authority of the Companies Act, 2013; and

(4) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

#### **Question 5**

M/s. ABC & Co. is an Audit firm, having partners CA. A, CA. B and CA. C. The firm has been offered the appointment as an Auditor of XYZ Ltd. for the Financial Year 2017-18. Mr. D, the relative of CA. A, is holding 25,000 shares (face value of ₹ 10 each) in XYZ Ltd. having market value of ₹ 90,000. Are M/s. ABC & Co. qualified to be appointed as Auditors of XYZ Ltd.?

## Answer

As per section 141(3)(d)(i), a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the instant case, M/s ABC & Co. is an audit firm having partners CA. A, CA. B and CA. C. Mr. D is a relative of CA. A and he is holding shares in XYZ Ltd. of face value of ₹ 2,50,000 (25,000 shares x rupees 10 per share). Market value of ₹ 90,000 would not be relevant.

Therefore, M/s ABC & Co. is disqualified for appointment as an auditors of XYZ Ltd. as the relative of CA. A (i.e. partner of M/s ABC & Co.) is holding the securities in XYZ Ltd. which is exceeding the limit mentioned in proviso to section 141(3)(d)(i) of the Companies Act, 2013.

## Question 6

At the AGM of HDB Pvt. Ltd., Mr. R was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to pursue his career in banking sector. The Board of Director has appointed Mr. L as the statutory auditor in board meeting within 30 days. Comment on the matter with reference to the provisions of Companies Act, 2013.

## Answer

Casual Vacancy by Resignation: As per Section 139(8), any casual vacancy in the office of an auditor shall in the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days. If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

Further, as per section 140(2) the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form with the company and the Registrar. In the instant case, R resigned after three months of his appointment as statutory auditor as he wanted to pursue his career in banking sector.

Therefore, the board of director has appointed Mr. L as the statutory auditor with in 30 days is in order subject to such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board .

Further, it is also the duty of the auditor to file, within a period of 30 days from the date of resignation, a statement in the prescribed Form with the company and the Registrar in compliance with section 140(2) of the Companies Act, 2013.

## Question 7

Where a company is required to constitute an Audit Committee, all appointments of an auditor under this section shall be made after taking into account the recommendations of such committee.

Explain stating also the class of companies required to constitute Audit Committee.

## **Answer**

Applicability of section 177 i.e. Constitution of Audit Committee: Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

It is important to know that in addition to listed public companies, following classes of companies shall constitute an Audit Committee -

- (i) all public companies with a paid up capital of ten crore rupees or more;
- (ii) all public companies having turnover of one hundred crore rupees or more;
- (iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

## **Question 8**

Explain the manner and procedure of selection and appointment of auditors as per Rule 3 of Companies (Audit and Auditors) Rules, 2014

## **Answer**

Manner and procedure of selection and appointment of auditors- Rule 3 of CAAR, 2014 prescribes the following manner and procedure of selection and appointment of auditors-

(1) In case of a company that is required to constitute an Audit Committee under section 177, the committee, and, in cases where such a committee is not required to be constituted, the Board, shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

It may be noted that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.

(2) The Audit Committee or the Board, as the case may be, may call for such other information from the proposed auditor as it may deem fit.

(3) Subject to the provisions of sub-rule (1), where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment.

(4) If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.

(5) If the Board disagrees with the recommendation of the Audit Committee, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.

(6) If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation, the Board shall record reasons for its disagreement with the committee and send its own recommendation for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.

(7) The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.

### **Question 9**

CA. Donald was appointed as the auditor of PS Ltd. at the remuneration of ₹ 30,000.

However, after 4 months of continuing his services, he could not continue to hold his office of the auditor as his wife got a government job at a distant place and he needs to shift along with her to the new place. Thus, he resigned from the company and did not perform his responsibilities relating to filing of statement to the company and the registrar indicating the reasons and other facts as may be relevant with regard to his resignation.

How much fine may he be punishable with under section 140(3) for non-compliance of section 140(2) of the Companies Act, 2013?

### **Answer**

Provisions and Explanation: For non-compliance of sub-section (2) of section 140 of the Companies Act, 2013, the auditor shall be punishable with fine, which shall not be less than fifty thousand rupees or the remuneration of the auditor, whichever is less but which may extend to five lakh rupees, under section 140(3) of the said Act.

Conclusion: Thus, the fine under section 140(3) of the Companies Act, 2013 shall not be less than ₹ 30,000 but which may extend to ₹ 5,00,000.

### **Question 10**

Discuss the matters to be included in the auditor's report regarding statutory dues and repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders as per CARO, 2016.

### **Answer**

Matters to be included in the auditor's report- statutory dues and repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders (CARO, 2016) -

Clause (vii) (a) whether the company is regular in depositing undisputed statutory dues including 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 with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at 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 dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax 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 constitute a dispute).

Clause (viii) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).

### Question 11

Rano Pvt. Ltd. is a private limited Company, having paid up share capital of ₹ 45 crore but having public borrowing from nationalized banks and financial institutions of ₹ 40 crore. Advise the company on the applicability of rotation of auditors.

#### Answer

Applicability of Section 139(2) Rotation of Auditor: As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the class of companies shall mean the following classes of companies excluding one person companies and small companies-

- (I) all unlisted public companies having paid up share capital of rupees ten crore or more;
- (II) all private limited companies having paid up share capital of rupees fifty crore or more;
- (III) all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

From the above, it can be concluded that rotational provisions would not be applicable.

### Question 12

Examine the following: "Filling of a casual vacancy of auditor in respect of a company audit".

#### Answer

Filling of a Casual Vacancy

As per Section 139(8), any casual vacancy in the office of an auditor shall -

- (i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor -General of India, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

- (ii) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor -General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next 30 days.

Casual Vacancy by Resignation: As per section 140(2) the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed Form ADT-3 (as per Rule 8 of CAAR) with the company and the Registrar, and in case of the companies referred to in section 139(5) i.e. Government company, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees as per section 140(3).

### Question 13

Ashu Pvt. Ltd. has fully paid capital and reserves of ₹ 50 lakh. During the year, the company had borrowed ₹ 70 lakh each from a bank and a financial institution independently. It has the turnover of ₹ 900 lakh. Is CARO, 2016 applicable to Ashu Pvt. Ltd.?

### Answer

In the given case of Ashu Pvt. Ltd., it has paid capital and reserves of ₹ 50 lakh i.e. less than ₹ 1 crore, turnover of ₹ 9 crore i.e. less than ₹ 10 crore. However, it has maximum outstanding borrowings of ₹ 1.40 crore (₹ 70 lakh + ₹ 70 lakh) collectively from bank and financial institution.

Therefore, it fails to fulfill the condition relating to borrowings. Thus, CARO, 2016 shall be applicable to Ashu Pvt. Ltd. accordingly.



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₹ 5,900

**SINGLE GROUP**  
₹ 8,850

**BOTH GROUPS**  
₹ 17,700

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## Chapter 2 – Nature, Objective and Scope of Audit

### Question 1

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

#### Answer

Other Matters that Affect the Limitations of an Audit: In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

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

### Question 2

There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain with examples.

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

### Question 3

The person conducting audit should take care to ensure that financial statements would not mislead anybody. Explain stating clearly the meaning of Auditing.

#### Answer

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

## Analysis of the Definition

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

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

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

## Question 4

The auditor evaluated, in respect of T Ltd., whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. Auditor's evaluation included consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. Advise the qualitative aspects of the entity's accounting practices.

## Answer

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:
  - (i) The selective correction of misstatements brought to management's attention during the audit
  - (ii) Possible management bias in the making of accounting estimates.
4. SA 540 addresses possible management bias in making accounting estimates.

Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

### **Question 5**

Principal aspects to be considered by an auditor while conducting an audit of final statements of accounts.

#### **Answer**

Aspects to be covered in an audit: The principal aspects to be covered in an audit concerning final statements of account are the following:

- (i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions.
- (ii) Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.
- (iii) Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.
- (iv) Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.
- (v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.
- (vi) Comparison of the balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.
- (vii) Verification of the title, existence and value of the assets appearing in the balance sheet.
- (viii) Verification of the liabilities stated in the balance sheet.
- (ix) Checking the result shown by the profit and loss and to see whether the results shown are true and fair.
- (x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.
- (xi) Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

### **Question 6**

The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements.

#### **Answer**

Ethical Requirements Relating to an Audit of Financial Statements: The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise the Code of Ethics for Professional Accountants (IESBA Code) related to an audit of financial statements.

The Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements :

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

### **Question 7**

The engagement team of FRN & Co.- Auditors of Bank of Baroda held discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements.

The discussion between the members of the engagement team and the audit engagement partner are being done on the susceptibility of the bank's financial statements to material misstatements.

These discussions are ordinarily done at the planning stage of an audit.

Analyse and Advise the matters to be discussed in the engagement team discussion.

### **Answer**

The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference. The discussion provides:

- An opportunity for more experienced engagement team members, including the audit engagement partner, to share their insights based on their knowledge of the bank and its environment.
- An opportunity for engagement team members to exchange information about the bank's business risks.
- An understanding amongst the engagement team members about effect of the results of the risk assessment procedures on other aspects of the audit, including decisions about the nature, timing, and extent of further audit procedures.

The discussion between the members of the engagement team and the audit engagement partner should be done on the susceptibility of the bank's financial statements to material misstatements.

These discussions are ordinarily done at the planning stage of an audit.

The engagement team discussion ordinarily includes a discussion of the following matters:

Errors that may be more likely to occur;

Errors which have been identified in prior years;

Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;

Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;

Need to maintain professional skepticism throughout the audit engagement;

Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

### **Question 8**

Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. Explain stating also the qualities of Auditor.

### **Answer**

It is not enough to realise what an auditor should be. He is concerned with the reporting on financial matters of business and other institutions. Financial matters inherently are to be set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, Code of ethics mentions integrity, objectivity and independence as one of the fundamental principles of professional ethics.

He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. The Companies Act need special mention but mercantile law, specially the law relating to contracts, is no less important. Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.

He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the sine qua non of the practice of auditing. He must know thoroughly all accounting principles and techniques.

Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, "an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true".

### **Question 9**

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

## Answer

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

(i) **The Nature of Financial Reporting:** The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made.

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

1. There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.

2. Fraud may involve sophisticated and carefully 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.

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

(iii) **Timeliness of Financial Reporting and the Balance between Benefit and**

**Cost:** The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative.

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

(iv) **Other Matters that Affect the Limitations of an Audit:** In the case of certain subject matters, limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

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

## Question 10

M/s Sureshchandra & Co. has been appointed as an auditor of SC Ltd. for the financial year 2014-15. CA. Suresh, one of the partners of M/s Sureshchandra & Co., completed entire routine audit work by 29th May, 2015. Unfortunately, on the very next morning, while roving towards office of SC Ltd. to sign final audit report, he met with a road accident and died. CA. Chandra, another

partner of M/s Sureshchandra & Co., therefore, signed the accounts of SC Ltd., without reviewing the work performed by CA. Suresh.

Required

State with reasons whether CA. Chandra is right in expressing an opinion on financial statements the audit of which is performed by another auditor.

### Answer

Relying on Work Performed by Another Auditor: As per SA 220 "Quality Control for an Audit of Financial Statements", an engagement partner taking over an audit during the engagement may apply the review procedures such as the work has been performed in accordance with professional standards and regulatory and legal requirements; significant matters have been raised for further consideration; appropriate consultations have taken place and the resulting conclusions have been documented and implemented; there is a need to revise the nature, timing and extent of work performed; the work performed supports the conclusions reached and is appropriately documented; the evidence obtained is sufficient and appropriate to support the auditor's report; and the objectives of the engagement procedures have been achieved.

Further, one of the basic principles, which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried, is that when the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. This is the fundamental principle which is ethically required as per Code of Ethics.

However, the auditor should carefully direct, supervise and review work delegated. He should obtain reasonable assurance that work performed by other auditors/experts and assistants is adequate for his purpose.

In the given case, all the auditing procedures before the moment of signing of final report have been performed by CA. Suresh. However, the report could not be signed by him due to his unfortunate death. Later on, CA. Chandra signed the report relying on the work performed by CA. Suresh. Here, CA. Chandra is allowed to sign the audit report, though, will be responsible for expressing the opinion. He may rely on the work performed by CA. Suresh provided he further exercises adequate skill and due care and review the work performed by him.

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**NOV20**

**CONCEPT**  
EDUCATION

<b>SINGLE SUBJECT</b> ₹ 5,900	<b>SINGLE GROUP</b> ₹ 11,800	<b>BOTH GROUPS</b> ₹ 21,240
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## Chapter 3 – Audit Strategy, Planning and Programme

### Question 1

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

### Answer

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

### Example

Sales are evidenced by:

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

### Question 2

Overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. The process of establishing the overall audit strategy assists the auditor to determine such matters as for example - the resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters. Explain the other three such matters.

### Answer

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

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

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

1. The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
2. The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of

other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;

3. When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and

4. How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

### **Question 3**

"An adequate planning benefits the audit of financial statements." Discuss.

#### **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:

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

### **Question 4**

M & Co. was appointed as auditor of IGI Ltd.. As an auditor what are the factors that would be considered in the development of overall audit plan?

#### **Answer**

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

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.

- The setting of materiality levels for audit purposes.
- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- The degree of reliance he expects to be able to place on accounting system and internal control.
- Possible rotation of emphasis on specific audit areas.
- The nature and extent of audit evidence to be obtained.
- The work of internal auditors and the extent of their involvement, if any, in the audit.
- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.
- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- Establishing and coordinating staffing requirements.

### Question 5

An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention two points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations.

### 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.

### Question 6

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

#### Answer

##### Periodic Review of The Audit Programme

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

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

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

### **Question 7**

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.

Discuss stating the the process of establishing the overall audit strategy that would assist the auditor to determine key matters.

#### **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.

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

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

### **Question 8**

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. Discuss stating the factors that may affect the identification of an appropriate benchmark

#### **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 9**

Surya and Chand Ltd is a manufacturing company engaged in the production of miscellaneous electrical goods. Trilochan and Co. has been appointed as the auditors to carry out its audit. Auditor thinks that Planning an audit would involve establishing the overall audit strategy for the engagement and developing an audit plan. Also,

Adequate planning benefits the audit of financial statements in several ways. Analyse and Advise explaining the benefits of adequate planning.

### **Answer**

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

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

### **Question 10**

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

### **Answer**

The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.

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

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

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



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**SINGLE GROUP ₹ 8,850**

**SINGLE SUBJECT ₹ 5,900**

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## Chapter 4 – Audit Documentation and Evidence

### Question 1

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

#### Answer

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

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

### Question 2

Define the following :

- (i) Positive confirmation request
- (ii) Negative confirmation request
- (iii) Non-response
- (iv) Exception

#### Answer

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

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

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

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

### Question 3

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

Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

#### Example

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

### Question 4

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

#### Answer

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

- (a) Discuss the matter with management and, where appropriate, those charged with governance.
- (b) Determine whether the financial statements need amendment and, if so,
- (c) Inquire how management intends to address the matter in the financial statements.

### Question 5

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to

responses to inquiries, written representations are audit evidence. Explain stating clearly objectives of the auditor regarding written representation.

### **Answer**

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence.

Written representations are requested from those responsible for the preparation and presentation of the financial statements.

Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

### **The objectives of the auditor regarding written representation**

The objectives of the auditor are:

#### **(a) To obtain written representations**

To obtain written representations from management. Also that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

#### **(b) To support other evidence**

To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and

#### **(c) To respond appropriately**

To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

### **Question 6**

There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements. Analyse and explain stating the responsibility of auditor in this regard.

### **Answer**

#### **Responsibilities of the Auditor**

There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements.

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.

The auditor needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

- (a) Achieve a true and fair presentation; or
- (b) Are not misleading (for compliance frameworks).

In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether fraud risk factors are present as required by SA 240. This is because fraud may be more easily committed through related parties.

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- Management may be unaware of the existence of all related party relationships.
- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.
- Planning and performing the audit with professional skepticism as required by SA 200 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

### Question 7

On the basis of which assumption the financial statements of a company are prepared. Explain. Also describe the objectives of the auditor regarding going concern.

### Answer

#### Going Concern Basis of Accounting

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Objectives of the auditor regarding going concern are :

- (i) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
- (ii) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations, if determined necessary by the auditor or required by other SAs; and
- (iii) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

### Question 8

External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. Analyse and Explain.

### Answer

External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items.

For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no “side agreement” exists that may be relevant to an entity’s revenue cut-off assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- Bank balances and other information relevant to banking relationships.
- Accounts receivable balances and terms.
- 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 purchased 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.

### Question 9

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

### Answer

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

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

- (a) The auditor’s assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
- (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

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

### **Question 10**

“Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability”. Explain. Also state clearly generalisations about the reliability of audit evidence.

#### **Answer**

Reliability of Audit Evidence: SA 500 on “Audit Evidence” provides that 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. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management’s expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- (1) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- (2) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- (3) Audit evidence obtained directly by the auditor (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).
- (4) 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).
- (5) 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 11**

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

#### **Answer**

Inquiry – Audit Procedure to obtain Audit Evidence: Inquiry consists of seeking information of knowledgeable persons, both financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. 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.



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The logo for Koncept Education features a stylized blue figure holding a book, followed by the word "KONCEPT" in large, blue, sans-serif capital letters, and "EDUCATION" in smaller, blue, sans-serif capital letters below it.

## Chapter 5 – Risk Assessment and Internal Control

### Question 1

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

### Answer

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, authorisation, 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 standardised 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 honoured its commitments in the past.

### Question 2

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.

### Question 3

Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. Analyse and explain giving examples.

#### 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:

- 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 4

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

#### Answer

**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 5**

"The Auditor should examine the efficacy of various internal controls over advances, to determine the nature, timing and extent of his substantive procedures." Discuss briefly.

### **Answer**

Evaluation of Internal Controls over Advances: 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:

- (i) 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.
- (ii) All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
- (iii) The compliance with the terms of sanction and end use of funds should be ensured.
- (iv) 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.
- (v) 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.
- (vi) 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.
- (vii) 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.
- (viii) Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
- (ix) The accounts should be kept within both the drawing power and the sanctioned limit.
- (x) 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.
- (xi) 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 6**

"A multinational co. wants to appoint you to carry the statutory audit." Discuss with reference to SA 330 the substantive procedures to be performed to assess the risk of material misstatement.

## **Answer**

Substantive procedures to be performed to assess the risk of material misstatement:

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

1. This requirement reflects the facts that:

(i) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and

(ii) there are inherent limitations to internal control, including management override.

2. Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.

- Only tests of details are appropriate.

- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

3. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. SA 520, "Analytical Procedures" establishes requirements and provides guidance on the application of analytical procedures during an audit.

4. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

5. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory.

6. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing.

## **Question 7**

Briefly discuss the limitations of Internal Control.

## **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 8

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

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

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

### Answer

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

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

What is included in Control Environment?

The control environment includes:

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

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

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

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

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

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

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

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

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

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

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

### Question 9

SWM is proprietorship firm engaged in the manufacturing of different kind of yarns. It sells its finished products both in the domestic as well as in the international market. The company is making total turnover of Rs. 30 crores. It has also availed cash credit limit of Rs. 3 crores from Dena Bank. In the year 2018-19. Proprietor of the firm is worried about the financial position of the company and is under the impression that since he is out of India, therefore firm might not run well.

He approaches an Internal Auditor about as to what would be covered in Audit. Advise regarding principal aspects (any four) to be covered in getting accounts audited.

### Answer

The principal aspect to be covered in an audit concerning final statements of account are the following:

(i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions.

(ii) Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.

(iii) Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.

(iv) Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

(v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.

(vi) Comparison of the balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.

(vii) Verification of the title, existence and value of the assets appearing in the balance sheet.

(viii) Verification of the liabilities stated in the balance sheet.

(ix) Checking the result shown by the profit and loss and to see whether the results shown are true and fair.

(x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.

(xi) Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

### **Question 10**

IT poses specific risks to an entity's internal control. Explain

#### **Answer**

IT also poses specific risks to an entity's internal control, including, for example:

- ◆ Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- ◆ Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- ◆ The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- ◆ Unauthorised changes to data in master files.
- ◆ Unauthorised changes to systems or programs.
- ◆ Failure to make necessary changes to systems or programs.
- ◆ Inappropriate manual intervention.
- ◆ Potential loss of data or inability to access data as required.

### **Question 11**

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. Explain stating clearly the auditor's responsibility for reporting on internal financial controls over financial reporting.

#### **Answer**

**Auditors' Responsibility for Reporting on Internal Financial Controls over Financial Reporting in India**

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.

**Objectives of an auditor in an audit of internal financial controls over financial reporting:** The auditor's objective in an audit of internal financial controls over financial reporting is, "to express an opinion on the effectiveness of the company's internal financial controls over financial reporting." It is carried out along with an audit of the financial statements.

Reporting under Section 143(3)(i) is dependent on the underlying criteria for internal financial controls over financial reporting adopted by the management. However, any system of internal controls provides only a reasonable assurance on achievement of the objectives for which it has been established. Also, the auditor shall use the concept of materiality in determining the extent of testing such controls.

Rule 8(5)(viii) of the Companies (Accounts) Rules, 2014 requires the board report of all companies to state the details in respect of adequacy of internal financial controls with reference to the financial statements.

The inclusion of the matters relating to internal financial controls in the directors responsibility statement is in addition to the requirement of the directors stating that they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the 2013 Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.

### **Question 12**

A Flow Chart is a graphic presentation of each part of the company's system of internal control. Explain elaborating each and every aspect about flow chart.

#### **Answer**

**A Flow Chart:** It is a graphic presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form.

It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

It is also necessary for the auditor to study the significant features of the business carried on by the concern; the nature of its activities and various channels of goods and materials as well as cash, both inward and outward; and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.



**BOTH GROUPS ₹ 21,240**

**SINGLE GROUP ₹ 11,800**

**SINGLE SUBJECT ₹ 5,900**

USE CODE

**NOV20**

\*EXCLUSIVE OFFER FOR CA INTERMEDIATE STUDENTS APPEARING IN NOVEMBER 2020. ON SINGLE GROUP AND BOTH GROUPS VIEWS ARE UNLIMITED BUT ON SINGLE SUBJECT VIEWS ARE LIMITED TO 1.5 TIMES

## Chapter 6 – Fraud and Responsibilities of the Auditor in this regard

### Question 1

Discrepancies in the accounting records, including transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy is one of the example of circumstances that indicate the possibility of fraud. Explain at least four other such examples relating to discrepancies in the accounting records.

### Answer

#### Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorized balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties.
- Tips or complaints to the auditor about alleged fraud.

### Question 2

Auditor of A Ltd while conducting audit in the course of the performance of his duties as auditor, believes with reasons that “an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed”. Analyse and also explain the manner of reporting the matter to the Central Government.

### Answer

**Reporting to the Central Government:** As per sub-section (12) of section 143 of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed.

In this regard, Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been prescribed. Sub-rule (1) of the said rule states that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of ` 1 crore or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

#### The manner of reporting the matter to the Central Government is as follows:

(a) the auditor shall report the matter to the Board or the Audit Committee, as the case may be, immediately but not later than 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days;

(b) on receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments (on such reply or observations of the Board or the Audit Committee) to the Central Government within 15 days from the date of receipt of such reply or observations;

(c) in case the auditor fails to get any reply or observations from the Board or the Audit Committee within the stipulated period of 45 days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;

(d) the report shall be sent to the Secretary, Ministry of Corporate Affairs in a sealed cover by Registered Post with Acknowledgement Due or by Speed Post followed by an e-mail in confirmation of the same;

(e) the report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and

(f) the report shall be in the form of a statement as specified in Form ADT-4.

### **Question 3**

Write any five circumstances of conflicting or missing evidence that indicate the possibility of fraud.

#### **Answer**

Conflicting or missing evidence, including:

- (i) Missing documents.
- (ii) Documents that appear to have been altered.
- (iii) Significant unexplained items on reconciliations.
- (iv) Unusual discrepancies between the entity's records and confirmation replies.
- (v) Large numbers of credit entries and other adjustments made to accounts receivable records.
- (vi) Missing or non-existent cancelled cheques in circumstances where cancelled cheques are ordinarily returned to the entity with the bank statement.
- (vii) Missing inventory or physical assets of significant magnitude.
- (viii) Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.

### **Question 4**

Write the circumstances that indicate the possibility of fraud due to problematic or unusual relationship between the auditor and management.

#### **Answer**

Problematic or unusual relationships between the auditor and management, including:

1. Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
2. Undue time pressures imposed by management to resolve complex or contentious issues.

3. Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
4. Unusual delays by the entity in providing requested information.
5. Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques.
6. Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.
7. An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
8. An unwillingness to address identified deficiencies in internal control on a timely basis.
9. Unwillingness by management to permit the auditor to meet privately with those charged with governance
10. Accounting Policy that appears to be variance with industry norms
11. Frequent changes in accounting estimates that do not appear to result from changed circumstances
12. Tolerance of variations in the entity's code of conduct

#### **Question 5**

Explain how would you deal as an auditor if, as a result of a misstatement resulting from fraud or suspected fraud, you encounter exceptional circumstances that bring into question your ability to continue performing the audit.

#### **Answer**

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

### Question 6

Misappropriation of Assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways. Analyse and Explain

### Answer

Misappropriation of Assets:

It involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).

### Example

Vineet is a manager in Zed Ex Ltd. He is having authority to sign cheques up to ₹ 10,000.

While performing the audit, Rajan, the auditor, noticed that there were many cheques of ₹ 9,999 which had been signed by Vineet. Further Vineet had split large payments (amounting to more than ₹ 10,000 each, into two or more cheques less than ₹ 10,000 each so that he may authorize the payments). This raised suspicion in the auditor.

The auditor found that the cheques of ₹ 9,999 were deposited in Vineet's personal account i.e. Vineet had misappropriated the amount.

Splitting the cheques into lower amounts involves manipulation of accounts.

The fraud was committed by an employee.

- Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

### Question 7

The scope of auditor's inquiry under clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016 is restricted to frauds 'noticed or reported' during the year. Explain.

### Answer

Reporting under Companies (Auditor's Report) Order, 2016 [CARO, 2016]: The auditor is also required to report under clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

The scope of auditor's inquiry under clause (x) of paragraph 3 of Companies (Auditor's Report) Order, 2016 is restricted to frauds 'noticed or reported' during the year. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of SA 240, "The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements".

Audit Procedures and Reporting under CARO:

(1) While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.

(2) The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon.

The auditor should enquire from the management about any frauds on the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees including officers of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.

(3) The auditor should obtain written representations from management that:

(i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;

(ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

A summary of such items should be included in or attached to the written representation;

(iii) it has

(a) disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and

(b) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

(4) Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management

that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items constitute misstatements because [description of reasons]."

The auditor should consider if any fraud has been reported by them during the year under section 143(12) of the Act and if so whether that same would be reported under this Clause. It may be mentioned here that section 143(12) of the Act requires the auditor has reasons to believe that a fraud is being committed or has been committed by an employee or officer. In such a case the auditor needs to report to the Central Government or the Audit Committee. However, this Clause will include only the reported frauds and not suspected fraud.

(5) Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:

(i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered.

(ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.

(iii) While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.

### **Question 8**

There are many ways for cash defalcation, one of which is by suppressing cash receipts. List out few techniques of how the receipts are suppressed.

### **Answer**

By suppressing cash receipts:

Few techniques of how receipts are suppressed are:

(1) Teeming and Lading: Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

(2) Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.

(3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.

(4) Not accounting for cash sales fully.

(5) Not accounting for miscellaneous receipts, e.g., sale of scrap, quarters allotted to the employees, etc.

(6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

### Question 9

What do you understand by term 'fraud'? Provide its meaning as given under the standard on auditing (SA) 240.

### Answer

Meaning of Fraud: The SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" defines the term 'fraud' as an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.



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## Chapter 7 – Audit in an Automated Environment

### Question 1

Explain some of the commonly used methods for testing in an automated environment.

### Answer

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

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

### Question 2

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 check completeness of data and population that is used in either test of controls or substantive audit tests. Explain in detail stating all the relevant points.

### Answer

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

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

### Question 3

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

- (i) CAATs
- (ii) Data Analytics
- (iii) Database
- (iv) Information Systems
- (v) Privileged access

### **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 4**

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

### **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 5**

Explain the meaning of automated environment. Also discuss the key features of an automated environment.

### **Answer**

An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems – also known as Information Systems (IS) or Information Technology (IT) systems.

Nowadays, it is very common to see computer systems being used in almost every type of business.

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

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

- Enables faster business operations
- Accuracy in data processing and computation
- Ability to process large volumes of transactions
- Integration between business operations
- Better security and controls
- Less prone to human errors
- Provides latest information
- Connectivity and networking capability

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.

For example, 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.

Similarly, there are several other aspects that an auditor should consider to determine the level of automation and complexity of a business environment which we will look at in the following sections.

### Question 6

Discuss the impact of IT related risks on Substantive Audit, Controls and Reporting.

### Answer

Impact of IT related risks i.e. on Substantive Audit, Controls and Reporting: The above risks, if not mitigated, could have an impact on audit in different ways. Let us understand how:

Impact on substantive audit	Impact on controls	Impacts on reporting
cannot rely on data obtained from systems	cannot rely on automated controls, system calculations and accounting procedures built into applications	communication to those charged with governance
system data and reports should be tested substantively for completeness and accuracy	cannot rely on IT dependent manual controls	modified auditors report
more audit evidence is needed	system data and reports should be tested substantively for completeness and accuracy	
	more substantive audit work is needed	

- First, we 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 we obtain from systems for the purpose of audit has to be thoroughly tested and corroborated for completeness and accuracy.

- Second, we 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.
- 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.

In all the above scenarios, it is likely that the auditor will be required to obtain more audit evidence and perform additional audit work. The auditor should also be able to demonstrate how the risks were identified and what audit evidence was obtained and validated to address these IT risks.

Here, we should remember that as the complexity, automation and dependence of business operations on IT systems increases, the severity and impact of IT risks too increases accordingly. The auditor should apply professional judgement in determining and assessing such risks and plan the audit response appropriately.



## Chapter 8 – Audit Sampling

### Question 1

Explain the sampling method which involves selection of a block(s) of contiguous items from within the population. Also give example.

### Answer

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

### Example

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

### Question 2

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

### Answer

The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement but this projection may not be sufficient to determine an amount to be recorded. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population. However, the effect of any such misstatement, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous misstatements.

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

### Question 3

While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel but for other expenses, an auditor generally prefers to verify other attributes." Mention those attributes.

### Answer

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

- (i) Whether the expenditure pertained to current period under audit;
- (ii) Whether the expenditure qualified as a revenue and not capital expenditure;

- (iii) Whether the expenditure had a valid supporting like travel tickets, insurance policy, third party invoice etc.;
- (iv) Whether the expenditure has been classified under the correct expense head;
- (v) Whether the expenditure was authorised as per the delegation of authority matrix;
- (vi) Whether the expenditure was in relation to the entity's business and not a personal expenditure

#### **Question 4**

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

Explain stating the examples of factors (any four) that the auditor may consider when determining the sample size for tests of controls.

#### **Answer**

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

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

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

- ◆ When there is an increase in the extent to which the auditor's risk assessment takes into account relevant controls. The more assurance the auditor intends to obtain from the operating effectiveness of controls, the lower the auditor's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the auditor's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the auditor is required to perform tests of controls.

Other things being equal, the greater the reliance the auditor places on the operating effectiveness of controls in the risk assessment, the greater is the extent of the auditor's tests of controls (and therefore, the sample size is increased). Thus, sample size will increase.

- ◆ If there is an increase in the tolerable rate of deviation. Then sample size will decrease, as lower the tolerable rate of deviation, larger the sample size needs to be.

- ◆ When there is an increase in the expected rate of deviation of the population to be tested then sample size will increase, as higher the expected rate of deviation, larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the auditor's consideration of the expected rate of deviation include the auditor's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected control deviation rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement.

◆ An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population will increase the sample size. Thus, the greater the level of assurance that the auditor desires that the results of the sample are in fact indicative of the actual incidence of deviation in the population, the larger the sample size needs to be.

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

### **Question 5**

Discuss the factors that should be considered for deciding upon the extent of checking on a sampling plan.

#### **Answer**

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

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

### **Question 6**

The auditor shall evaluate the results of the sample and whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. Explain

#### **Answer**

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.

For tests of controls, an unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. For tests of details, an unexpectedly high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balance is materially misstated, in the absence of further audit evidence that no material misstatement exists.

In the case of tests of details, the projected misstatement plus anomalous misstatement, if any, is the auditor's best estimate of misstatement in the population. When the projected misstatement plus anomalous misstatement, if any, exceeds tolerable misstatement, the sample does not provide a reasonable basis for conclusions about the population that has been tested. The closer the projected misstatement plus anomalous misstatement is to tolerable misstatement, the more likely that actual misstatement in the population may exceed tolerable misstatement. Also, if the

projected misstatement is greater than the auditor's expectations of misstatement used to determine the sample size, the auditor may conclude that there is an unacceptable sampling risk that the actual misstatement in the population exceeds the tolerable misstatement. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if additional audit evidence is obtained.

In case the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or 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 7**

XYZ Ltd is engaged in trading of electronic goods and having huge accounts receivables. For analysing the whole accounts receivables, auditor wanted to use sampling technique. In considering the characteristics of the population from which the sample will be drawn, the auditor determines that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value - weighted sampling techniques. Advise the auditor in accordance with SA 530.

### **Answer**

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

**Stratification:** Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.

The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population.

For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then

combined when considering the possible effect of misstatements on the total class of transactions or account balance.

**Value-Weighted Selection:** When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units. One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

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

### **Question 8**

What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 "Audit Sampling".

### **Answer**

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

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

Some of the important methods of selecting the sample are discussed below -

(1) **Random Sampling:** Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below-

(i) **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. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum. It is considered that random number tables are simple and easy to use and also provide assurance that the bias does not affect the selection. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range.

(ii) **Stratified Sampling:** This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.

(2) **Interval Sampling or Systematic Sampling:** Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

(3) Monetary Unit Sampling: It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(4) Haphazard sampling: Haphazard selection, in which the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

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



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## Chapter 9 – Analytical Procedures

### Question 1

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. Explain the other relevant points in this context.

### Answer

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:

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

### Question 2

Explain the commonly used technique in the comparison of current data with the prior period balance or with a trend in two or more prior period balances.

### Answer

**Trend analysis** – A commonly used technique 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.

### Question 3

Explain techniques available as substantive analytical procedures.

### Answer

Techniques available as substantive analytical procedures : The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Substantive analytical procedures generally take one of the following forms:

- Trend analysis — A commonly used technique 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.

- For example, Financial ratios may include:

- Trade receivables or inventory turnover

- Freight expense as a percentage of sales revenue

- 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.

- 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).

#### Question 4

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, explain how would the auditor investigate such differences.

#### 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:

(i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses: Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

(ii) Performing other audit procedures as necessary in the circumstances: The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

#### Question 5

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

#### 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 6

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Explain stating the purpose of analytical procedures with examples.

### Answer

#### Purpose of Analytical Procedures

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical procedures are used for the following purposes:

- (i) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
- (ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

For instance, establishing the relationship that exists between certain balances included in the Balance Sheet and the Statement of Profit and Loss and comparing them with those that existed between the same set of balances in the previous year's reconciling the physical balances of assets with the relevant financial record; obtaining of account from the bankers, account receivables and account payables and reconciling with relevant balances in books of account; confirming amounts of outstanding income and expenses by preparing reconciliation statements, etc. These are helpful in the detection of unusual state of affairs and mistakes in accounts.

#### Example:

In XYZ Ltd., after applying analytical procedures as comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio. Therefore, it became necessary for the auditor to make further enquiries as it may be due to pilferage of inventories/ misappropriation of a part of the sale proceeds/ a change in the cost of sales without a corresponding increase in the sales price.

Likewise, on verifying the balances of sundry account receivables and account payables by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of an account receivable is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him. Also whether in the case of account payable, the discrepancy is

due to failure to afford him credit for one or more consignments of goods supplied by him or failure to debit him with an amount of remittance.

Similarly, by taking inventories of raw materials and stores at the end of the year any excesses or shortages therein shall be detected. The investigation of their causes might disclose that the shortages were the result of a misappropriation of inventory or that the excess were due to requisitions having been entered before the inventories were issued.

In the same way, by reconciling the amounts of interest and dividends collected with the amounts which had accrued due and that which are outstanding for payment, the mistake, if any, in the adjustment of such an income would be detected.

The overall tests can be extended for making inter-firm and intra-firm comparison of trading results.

For example, 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 for the same period of another entity engaged in the same trade and working under similar circumstances, it would be possible to find out the cause of the variation in the rate of profitability that exists.

Similarly, it would also be possible to compare the balances on 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. 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. 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.

An abnormal fall in the cost of manufacture or that in the administrative cost, apart from economy in expenses, there could be no provision or less provision for expenses incurred in the year. When it is suspected, the auditor should compare the entries in the outstanding book with those in the previous year. He must also check the vouchers for one month immediately before the close of the following years. To verify that none of the expenses in the accounts under audit have been charged to the accounts of the following years.

Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss. For instance the cost of importing goods which are subjected to an ad valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of excise duty paid. Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, e.g., commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

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

### **Question 7**

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**

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.



## Chapter 10 – Audit of Items of Financial Statements

### Question 1

What does the Valuation assertion mean in respect of Assets, liabilities and equity balances? Explain with the help of example in respect of Inventory.

### Answer

**Meaning of Valuation Assertion**– Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

**Example of Inventory explaining the valuation assertion is given hereunder:** Inventory has been recognized at the lower of cost and net realizable value in accordance with AS 2 - Inventories. Any costs that could not be reasonably allocated to the cost of production (e.g. general and administrative costs) and any abnormal wastage have been excluded from the cost of inventory. An acceptable valuation basis (eg. FIFO, Weighted average etc.) has been used to value inventory as at the period-end.

### Question 2

Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP), also commonly referred to as accounting standards (AS). In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable accounting standards. Explain with example stating the relevant assertions involved in this regard. Also explain financial statement audit.

### Answer

Companies prepare their financial statements in accordance with the framework of generally accepted accounting principles (Indian GAAP), also commonly referred to as accounting standards (AS).

A financial statement audit comprises the examination of an entity's financial statements and accompanying disclosures by an independent auditor. The result of this examination is a report by the auditor, attesting to the truth and fairness of presentation of the financial statements and related disclosures.

In preparing financial statements, Company's management makes implicit or explicit claims (i.e. assertions) regarding:

- completeness;
- cut-off;
- existence/ occurrence;
- valuation/ measurement;
- rights and obligations; and
- presentation and disclosure

of assets, liabilities, equity, income, expenses and disclosures in accordance with the applicable accounting standards.

### Example

If Company X's balance sheet shows building with carrying amount of ₹ 50 lakh, the auditor shall assume that the management has claimed/ asserted that:

- The building recognized in the balance sheet exists as at the period- end (existence assertion);
- Company X owns and controls such building (Rights and obligations assertion);
- The building has been valued accurately in accordance with the measurement principles (Valuation assertion);
- All buildings owned and controlled by Company X are included within the carrying amount of ₹ 50 lakh (Completeness assertion).

### Question 3

Write the audit procedures to be performed as an auditor for valuation (assertion) of Finished goods and goods for resale.

#### Answer

Audit procedure for valuation of finished goods and goods for resale

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

### Question 4

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

- (i) Interest income from fixed deposits.
- (ii) Dividend income.

(iii) Gain/(loss) on sale of investment in Mutual funds.

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

### **Answer**

For verifying interest income on fixed deposits:

- Obtain a listing of fixed deposits opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period. Verify the arithmetical accuracy of the interest calculation made by the entity by multiplying the deposit amount with the applicable rate and number of days during the period under audit.
- For deposits still outstanding as at the period- end, trace the same to the direct confirmation obtained from the respective bank/ financial institution.
- Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity.
- Also, obtain a copy of Form 26AS (TDS withholding by the bank/ financial institution) and reconcile the interest reflected therein to the calculation shared by client.

(ii) Dividend Income: For Dividends, verify that the same are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established, provided it is probable that the economic benefits associated with the dividend will flow to the entity and the amount of the dividend can be measured reliably.

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

Disclosure Requirements: Ensure whether the following disclosures as required under Ind AS compliant Schedule III to Companies Act, 2013 have been made:

Whether 'other income' has been classified as:

- o Interest income
- o Dividend income
- o Other non-operating income (net of expenses directly attributable to such income)

### **Question 5**

Mention any five attributes to be considered by an auditor while verifying for a depreciation and amortisation expenses.

### **Answer**

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

- Obtain the understanding of entity's accounting policy related to depreciation and amortisation.
- Ensure that the Company's policy for charging depreciation and amortisation is as per the relevant provisions of Companies Act and 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 has been properly identified.
- Whether the most appropriate depreciation method for each separately depreciable component has been used.

### Question 6

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

### Answer

Expenses which are essentially of a Revenue Nature, if incurred for creating an asset or adding to its value for achieving higher productivity, are regarded as expenditure of a capital nature. Examples of capital expenditure are-

- (i) Material and wages- capital expenditure when expended on the construction of a building or erection of machinery.
- (ii) Legal expenses- capital expenditure when incurred in connection with the purchase of land or building.
- (iii) Freight- capital expenditure when incurred in respect of purchase of plant and machinery.
- (iv) Repair- Major repairs of a fixed asset that increases its productivity.
- (v) Wages- Wages paid on installation costs incurred in Plant & machinery.
- (vi) Interest- Interest paid for the qualification period as per AS-16 i.e. before the asset is constructed.

Whenever, therefore, a part of the expenditure, ostensibly of a revenue nature, is capitalised it is the duty of the auditor not only to examine the precise particulars of the expenditure but also the considerations on which it has been capitalised.

### Question 7

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

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

- (i) Indicate assertions in respect of transactions and events for the period relating to Fixed Assets.
- (ii) State specific assertions relating to the above extract of financial statement

## **Answer**

(i) Assertions about transactions and events for the period relating to fixed assets :

(1) Occurrence—transactions and events relating to fixed assets have been recorded, have occurred and pertain to the entity.

(2) Completeness—all transactions and events relating to fixed assets that should have been recorded have been recorded.

(3) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.

(4) Cut-off—transactions and events have been recorded in the correct accounting period.

(5) Classification—transactions and events have been recorded in the proper accounts.

(ii) The specific assertions are as follows:

(1) the firm owns the plant and machinery;

(2) the historical cost of plant and machinery is Rs. 4 lacs;

(3) the plant and machinery physically exists;

(4) the asset is being utilised in the business of the company productively;

(5) total charge of depreciation on this asset is Rs. 1,66,000 to date on which Rs. 26,000 relates to the year in respect of which the accounts are drawn up; and

(6) the amount of depreciation has been calculated on recognised basis and the calculation is correct

## **Question 8**

Explain with examples the audit procedure to establish the existence of intangible fixed assets as at the period- end.

## **Answer**

Since an Intangible Asset is an identifiable non-monetary asset, without physical substance, for establishing the existence of such assets, the auditor should verify whether such intangible asset is in active use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Example- for verifying the existence of software, the auditor should verify whether such software is in active use by the entity and for the purpose, the auditor should verify the sale of related services/ goods during the period under audit, in which such software has been used.

Example- For verifying the existence of design/ drawings, the auditor should verify the production data to establish if such products for which the design/ drawings were purchased, are being produced and sold by the entity.

In case any intangible asset is not in active use, deletion should have been recorded in the books of account post approvals by the entity's management and amortization charge should have ceased to be charged beyond the date of deletion.

### **Question 9**

Explain the difference between reserves and provisions.

#### **Answer**

Difference between Reserves and Provisions

- The difference between the two is that provisions are amounts set aside to meet specific/ identified liabilities or diminution in recoverable value of assets. These must be provided for regardless of the fact whether the Company has earned profit or not.
- Reserves on the other hand, represent amounts appropriated out of profits, held for equalising the dividends of the company from one period to another or for financing the expansion of the company or for generally strengthening the company financially.
- If we examine the Balance Sheet of a company, at a given time, and deduct the total liabilities to outside trade payables from the value of assets shown therein, the difference between the two figures will represent the net worth of the company based on the book values of assets as on that date. The same shall include the capital contributed by the shareholders as well as total undistributed profit held either to the credit of the Statement of Profit and Loss or to reserves; the reserves again will be segregated as revenue or capital reserves.

### **Question 10**

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

#### **Answer**

Shares Issued at discount: According to section 53 of the Companies Act, 2013, 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.

Any share issued by a company at a discounted price shall be void. Where a company contravenes the provisions of this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees, or with both.

The auditor needs to 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.

### **Question 11**

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

#### **Answer**

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

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

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

### **Question 12**

How would you vouch/verify Sale of Scrap.

#### **Answer**

Sale of Scrap:

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

### **Question 13**

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) 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 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.

(vi) It is not necessary for the assessee to make payment of taxes from his own account in an authorized bank. While vouching such E-payment, the auditor should cross verify the payments of taxes through the receipted challan along with PAN No./TAN No. etc

#### **Question 14**

How will you vouch/verify Goods sent on consignment

#### **Answer**

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 distinctly under inventories.

#### **Question 15**

How will you vouch and/or verify Goods sent out on Sale or Return Basis.

#### **Answer**

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) See that price of such goods is unloaded from the sales account and the trade receivable's record. Refer to 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 close of the year either have been received back subsequently 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 close of the year lying with the party, has been included in the closing inventory.

## Chapter 11 – Audit Report

### Question 1

The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section.

### Answer

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

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

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

### Question 2

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required.

### Answer

In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:

- (i) The selective correction of misstatements brought to management's attention during the audit.

### Example

- Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
- The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives.

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

### Question 3

"An auditor is required to make specific evaluations while forming an opinion in an audit report." State them.

#### Answer

Specific Evaluations by the auditor: In particular, the auditor shall evaluate whether :

- (i) The financial statements adequately disclose the significant accounting policies selected and applied;
- (ii) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- (iii) The accounting estimates made by management are reasonable;
- (iv) The information presented in the financial statements is relevant, reliable, comparable, and understandable;
- (v) 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
- (vi) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

### Question 4

Define Emphasis of Matter Paragraph and how it should be disclosed in the Independent Auditor's Report?

#### Answer

Emphasis of Matter paragraph: A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (i) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";
- (ii) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
- (iii) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

### Question 5

What constitutes a 'true and fair' view, is the matter of an auditor's judgement in the particular circumstances of a case. In order to ensure 'true and fair' view, auditor has to review certain points. Mention any such 5 (five) points in brief.

## **Answer**

True and Fair View: To ensure true and fair view, an auditor has to see:

- (i) that the assets are neither undervalued or overvalued, according to the applicable accounting principles,
- (ii) no material asset is omitted;
- (iii) the charge, if any, on assets are disclosed;
- (iv) material liabilities should not be omitted;
- (v) the profit and loss account and balance sheet discloses all the matters required to be disclosed;
- (vi) accounting policies have been followed consistently; and
- (vii) all unusual, exceptional or non-recurring items have been disclosed separately.

## **Question 6**

State the matters to be included in the auditor's report as per CARO, 2016, regarding:

- (i) Private Placement of Preferential Issues.
- (ii) Utilisation of IPO and further public offer.

## **Answer**

(i) The auditor is required to report as per clause xiv of paragraph 3 of CARO 2016, whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review and if so, as to whether the requirement of section 42 of the Companies Act, 2013 have been complied with and the amount raised have been used for the purposes for which the funds were raised. If not, provide the details in respect of the amount involved and nature of non-compliance;

(ii) It is duty of the auditor to report as per clause ix of paragraph 3 of CARO 2016, whether moneys raised by way of initial public offer or further public offer (including debt instruments) and term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported.

## **Question 7**

The Auditor is fully satisfied with the audit of an entity in respect of its systems and procedures and wants to issue a report without any hesitation. What type of opinion can be given and give reasoning.

## **Answer**

Unqualified Opinion:

1. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements.
2. An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.

3. An unqualified opinion also indicates that:

- (i) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;
- (ii) the financial statements comply with relevant statutory requirements and regulations;
- (iii) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

### **Question 8**

The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework.

There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. Explain clearly stating the essential audit reporting differences between the approaches. Also define comparative information and audit procedures regarding comparative information.

### **Answer**

The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework.

There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

The essential audit reporting differences between the approaches are:

- (a) For corresponding figures, the auditor's opinion on the financial statements refers to the current period only; whereas
- (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

Definition of Comparative information – The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

Audit Procedures regarding comparative information

The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

- (a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and
- (b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

## Chapter 12 – Audit of Banks

### Question 1

In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also. Analyse and Explain.

### Answer

#### Reversal of Income:

If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognized as income in the previous year(s).

Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired whether there are any communications from borrowers pointing out differences in interest charge and whether appropriate action has been taken in this regard.

### Question 2

In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense. Analyse and explain stating the audit approach and procedure in regard to interest expense.

### Answer

In carrying out an audit of interest expense, the auditor is primarily concerned with assessing the overall reasonableness of the amount of interest expense by analysing ratios of interest paid on different types of deposits and borrowings to the average quantum of the respective liabilities during the year. In modern day banking, the entries for interest expenses are automatically generated through a batch process in the CBS system.

- The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material.
- The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences. The auditor should obtain general ledger break-up for the interest expense incurred on deposits

(savings and term deposits) and borrowing each month/quarter. The auditor should analyse month on month (or quarter on quarter) cost analysis and document the reasons for the variances as per the benchmark stated. He should examine whether the interest expense considered in the cost analysis agrees with the general ledger. The auditor should understand the process of computation of the average balance and re-compute the same on sample basis.

• The auditor should, on a test check basis, verify the calculation of interest and ensure that:

(a) Interest has been provided on all deposits upto the date of the balance sheet;

(b) Interest rates are in accordance with the bank's internal regulations, the RBI directives and agreements with the respective deposit holder;

(c) Interest on savings accounts are in accordance with the rules framed by the bank/RBI in this behalf.

(d) Interest on inter-branch balances has been provided at the rates prescribed by the head office/RBI.

The auditor should ascertain whether there are any changes in interest rate on saving accounts and term deposits during the period. The auditor should obtain the interest rate card for various types of deposits and analyse the interest cost for the period accordingly. The auditor should examine the completeness that interest has been accrued on the entire borrowing portfolio and the same should agree with the general ledgers. The auditor should re-compute the interest accrual i.e., by referring to the parameters like frequency of payment of interest amount, rate of interest, period elapsed till the date of balance sheet, etc from the term sheet, deal ticket, agreements, etc and ensure that the recomputed amount is tallying with the amount as per books of accounts without any significant difference.

### Question 3

"Ramjilal & Co. had been allotted the branch audit of a nationalized bank for the year ended 31st March, 2018. In the audit planning, the partner of Ramjilal & Co., observed that the allotted branches are predominantly based in rural areas and major portion of the advances were for agricultural purpose."

Now he needs your assistance on the following points so as to incorporate them in the audit plan:

(i) for determination of NPA norms for agricultural advances

(ii) for accounts where there is erosion in the value of security/frauds committed by the borrowers.

### Answer

(i) NPA norms for Agricultural Advances: As per the guidelines, Agricultural Advances are of two types, (1) Agricultural Advances for "long duration" crops and (2) Agricultural Advances for "short duration" crops

The "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State.

The following NPA norms would apply to agricultural advances (including Crop Term Loans):

- A loan granted for short duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for two crop seasons and,

- A loan granted for long duration crops will be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

(ii) Accounts where there is erosion in the value of security / frauds committed by borrowers

Not prudent to follow stages of asset classification. It should be straightaway classified as doubtful or loss asset as appropriate.

(i) Erosion in the value of security can be reckoned as significant when the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be. Such NPAs may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.

(ii) If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset. It may be either written off or fully provided for by the bank.

#### **Question 4**

Mr. A approaches a bank for financial assistance for his upcoming project. The Bank Branch Manager, after verifying the proposal, is agreeable to financing Mr. A, but asks for the security to be offered to the bank. Discuss the nature of securities required to be offered to the bank.

#### **Answer**

Nature of Security:

I. 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.

II. Collateral security is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following.

- Personal Security of Guarantor
- Goods / Stocks / Debtors / Trade Receivables
- Gold Ornaments and Bullion
- Immovable Property
- Plantations (For Agricultural Advances)
- Third Party Guarantees
- Banker's General Lien
- Life Insurance Policies
- Stock Exchange Securities and Other Instruments

### Question 5

The auditor should examine the efficacy of various internal controls over advances in case of Banks to determine the nature, timing and extent of his substantive procedures. Explain what is included in the internal controls over advances.

### Answer

Evaluation of Internal Controls over Advances: 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 6

Your firm of Chartered Accountants has been appointed as the Auditor of two branches of OBC which are located in the Industrial area. Considering that the location of the branches of bank in industrial area, these would be “advances oriented branches and audit of advances would require the major attention of the auditors. Advise how would you proceed to obtain evidence in respect of audit of advances.

## Answer

**Audit of Advances:** Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

- a. Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.
- b. Advances represent amount due to the bank.
- c. Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.
- d. There are no unrecorded advances.
- e. The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.
- f. The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
- g. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

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.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts however need to be examined in detail unless the amount involved is insignificant.

Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.

## Chapter 13 – Audit of Different Types of Entities

### Question 1

Explain the powers and duties of auditors under the Multi -State Co-operative Societies Act, 2002.

### Answer

Section 73 of the Multi-State Co-operative Societies Act, 2002 discusses the powers and duties of auditors. According to this, every auditor of a Multi -State co-operative society shall have a right of access at all times to the books accounts and vouchers of the Multi-State co-operative society, whether kept at the head office of the Multi - State co-operative society or elsewhere, and shall be entitled to require from the officers or other employees of the Multi- State co-operative society such information and explanation as the auditor may think necessary for the performance of his duties as an auditor.

As per section 73(2), the auditor shall make following inquiries:

- (a) Whether loans and advances made by the Multi-State co-operative society on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the Multi -State co-operative society or its members,
- (b) Whether transactions of the Multi-State co-operative society which are represented merely by book entries are not prejudicial to the interests of the Multi-State co-operative society,
- (c) Whether personal expenses have been charged to revenue account, and
- (d) Where it is Stated in the books and papers of the Multi-State co-operative society that any shares have been allotted for cash, whether cash has actually, been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet as correct regular and not misleading.

### Question 2

As per Multi-state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi-State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account. Explain

### Answer

As per sub-section (3) & (4) of section 73 of Multi- state Co-operative Societies Act, 2002, the auditor shall make a report to the members of the Multi -State co-operative society on the accounts examined by him and on every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State cooperative society in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanation given to him, the said account give the information required by this act in the manner so required, and give a true and fair view:

- (a) In the case of the balance-sheet, of the state of the Multi-State co-operative society's affairs as at the end of its financial year; and
- (b) In the case of the profit and loss account, of the profit or loss for its financial year. The auditor's report shall also state:

(i) Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.

(ii) Whether, in his opinion, proper books of account have been kept by the Multi- State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi - State co-operative society not visited by him.

(iii) Whether the report on the accounts of any branch office audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.

(iv) Whether the Multi-State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.

Where any of the matters referred to in sub-section (3) or (4) is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer.

### **Question 3**

Write basic standards set for Expenditure Audit of Government.

#### **Answer**

The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision funds authorised by competent authority fixing the limits within which expenditure can be incurred. These standards are—

(i) that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the audit against 'rules and orders'.

(ii) that there is sanction, either special or general, accorded by competent authority 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 4**

State the objectives of audit of Local Bodies.

#### **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 5**

State six important advantages of audit of accounts of a Partnership firm.

#### **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 6**

Advise any six special points in an audit of hospital.

#### **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 authorisation.

(10) Depreciation: See that depreciation has been written off against all the assets at the appropriate rates.

(11) Registers: Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

(12) Inventories: Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.

(13) Management Representation and Certificate: Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

### **Question 7**

Explain the duties of the Comptroller and Auditor General of India.

### **Answer**

Duties of the C&AG:

(i) Compile and submit Accounts of Union and States - The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. The Comptroller and Auditor General shall, from the accounts compiled by him or [by the Government or any other person responsible in that behalf] prepare in each accounts (including, in the case of accounts compiled

by him, appropriation accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union

Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union Territory having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

The C&AG Act of 1971 has provisions for relieving him of this responsibility to give information and render assistance to the Union and States: The Comptroller and Auditor General shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

(ii) General Provisions Relating to Audit - It shall be the duty of the Comptroller and Auditor General—

(a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

(b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

(c) to audit and report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) Audit of Receipts and Expenditure - Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

Where the grant or loan to a body or authority from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly in a financial year is not less than rupees twenty-five lakhs and the amount of such grant or loan is not less than seventy-five per cent of the total expenditure of that body or authority, such body or authority shall be deemed, for this purpose to be substantially financed by such grants or loans as the case may be.

(iv) Audit of Grants or Loans - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

(v) Audit of Receipts of Union or States - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit and report thereon.

(vi) Audit of Accounts of Stores and Inventory - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

(vii) Audit of Government Companies and Corporations - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The Comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

### Question 8

You have been appointed as an auditor of an NGO, briefly state the points on which you would concentrate while planning the audit of such an organisation?

Answer

While planning the audit of an NGO, the auditor may concentrate on the following:

- (i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.
- (ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions related to the statutes.
- (iii) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.
- (iv) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
- (v) Examination of minutes of the Board/Managing Committee/Governing Body/Management and Committees thereof to ascertain the impact of any decisions on the financial records.
- (vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
- (vii) Setting of materiality levels for audit purposes.
- (viii) The nature and timing of reports or other communications.
- (ix) The involvement of experts and their reports.
- (x) Review the previous year's Audit Report.

## Question 9

What are the special steps involved in conducting the audit of an Educational Institution?

### 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.

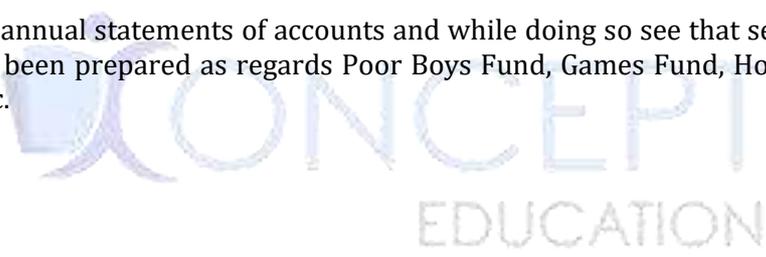
(xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(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.





**BOTH GROUPS ₹ 17,700**

**BOTH GROUPS ₹ 21,240**

**SINGLE GROUP ₹ 8,850**

**SINGLE GROUP ₹ 11,800**

**SINGLE SUBJECT ₹ 5,900**

**SINGLE SUBJECT ₹ 5,900**

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