



PAPER – 5: AUDITING AND ETHICS



QUESTIONS

PART – I: Multiple Choice Questions based on Case Scenarios

Case Scenario I

DS & Co., Chartered Accountants, are statutory auditors of SAR Industries Pvt Ltd, a company engaged in manufacturing business since 2018. The company is operating from rented premises and it does not have building of its own. It had upgraded its machinery last time in 2020. Except interest in this company, promoters, directors, key managerial persons and their relatives do not have interest or ownership in any other entity. Also, the company does not enter into any business dealings with promoters, directors, key managerial persons and their relatives. The directors and key managerial persons get only reasonable remuneration from the company. Though company has an internal control system in place, it has not appointed internal auditor. It is also not mandatorily required to make such an appointment under the provisions of the Companies Act, 2013.

DS & Co. have accepted audit of the above company for year 2022-23 for the first time. Promoters and directors of the company are known to engagement partner only socially for quite some time. However, it is for the first time that any type of professional work related to this company has been accepted by them.

While formulating audit plan for the company, CA D (engagement partner) has planned certain risk assessment procedures and further audit procedures consisting of tests of controls and substantive procedures in relation to different areas.

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INTERMEDIATE EXAMINATION

The following is extract of financial information of the company: -

(figures in rupees crores)

S. No.	Particulars	Year 2022-23	Year 2021-22
1.	Turnover	30.00	15.00
2.	Inventories	5.00	2.00
3.	Property, plant and equipment (Gross block)	1.25	1.25
4.	Property, plant and equipment (Net block)	1.00	1.25
5.	Gross profit	6.00	3.75
6.	Trade receivables	12.50	5.00

The PPE items consist of machinery only. While planning procedures in respect of Property, Plant and Equipment, auditor has included audit procedures like inspecting and reviewing company's plan for performing physical verification of PPE, assessing depreciation method used, verifying cost of PPE items acquired during the year with purchase bills and recalculation of depreciation charged in statement of profit and loss.

Further, while performing risk assessment procedures to identify risk of material misstatements in financial statements, engagement partner has come to notice that there is considerable variation in gross profit ratio as compared to last year. During performance of substantive procedures, he has also studied data of purchases and sales of the company during the year under audit and has also compared such data with preceding year and earlier years also.

Based on above, answer the following questions: -

- 1.1 Keeping in view description provided in the case scenario, which of the following statements is likely to be most appropriate?
- (a) Engagement partner is known socially to promoters and directors of the company. The situation mandatorily involves advocacy threat casting a doubt on auditor's independence. Irrespective of this, detection risk in engagement is low.

- (b) Engagement partner is known socially to promoters and directors of the company. The situation mandatorily involves familiarity threat casting a doubt on auditor's independence. Irrespective of this, detection risk in engagement is high.
 - (c) The situation reflected in the case scenario may not constitute threat to independence of auditor. Irrespective of this, detection risk in engagement is low.
 - (d) The situation reflected in the case scenario may not constitute threat to independence of auditor. Irrespective of this, detection risk in engagement is high.
- 1.2 CA D has included in audit plan certain procedures in respect of PPE items. Which of the following audit procedure included in audit plan is not likely to be relevant?
- (a) Inspecting and reviewing company's plan for physical verification of PPE
 - (b) Assessing depreciation method used
 - (c) Verifying cost of PPE items acquired during the year with purchase bills
 - (d) Recalculation of depreciation charged in statement of profit and loss
- 1.3 Which of the following statements is likely to be most suitable to explain the fact relating to variation in gross profit ratio as compared to last year?
- (a) Gross profit ratio has decreased in year 2022-23 as compared to year 2021-22. It may be due to the reason that sales prices may have been reduced by the company to procure more orders.
 - (b) Gross profit ratio has increased in year 2022-23 as compared to year 2021-22. It may be due to the reason that cost of materials purchased by company could have decreased.
 - (c) Gross profit ratio has decreased in year 2022-23 as compared to year 2021-22. It may be due to the reason that office staff salary

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engaged in administrative functions and office maintenance expenditure could have increased.

- (d) Gross profit ratio has decreased in year 2022-23 as compared to year 2021-22. It may be due to the reason that company has not made an allowance for obsolescence in respect of inventories during the year.

1.4 CA D has also studied purchases and sales data of the company during the year and has also compared such data with preceding year and earlier years also. It is an example of _____?

- (a) Ratio analysis forming part of substantive analytical procedures
- (b) Trend analysis forming part of substantive analytical procedures
- (c) Reasonable test forming part of substantive analytical procedures
- (d) Structural modelling forming part of substantive analytical procedures

1.5 Considering case scenario in totality, identify which of following combination of Standards is not proper for their likely relevance in performing and completing above engagement?

- (a) SQC 1, SA 220, SA 501, SA 505
- (b) SA 550, SA 510, SA 220, SA 610
- (c) SA 700, SA 510, SA 220, SA 500
- (d) SQC 1, SA 700

Case Scenario - 2

CA M. Raja has accepted offer of appointment of auditor of an entity. As business carried on by the entity is new to him, he wants to gain an understanding about the entity and its environment including its internal control. In this regard, he has performed procedures to obtain audit evidence about design and implementation of relevant controls. He has performed various procedures like inquiry, inspection and observation in this regard.

He wants reasonable assurance that accounting system is adequate and that all accounting information which should be recorded has, in fact, been recorded.

Further, during the course of audit, he has noticed as under: -

- As required by the management, bank reconciliation is required to be performed monthly. However, the same is not carried out as stipulated due to time constraints faced by accountant.
- The entity has a system of procuring its raw material supplies on the basis of valid purchase orders issued by the entity. However, purchase orders are not numbered in a sequence properly.
- Wage sheets are not verified by a responsible official as required by management.
- Staff of the entity is responsible for bringing cash from centers in nearby areas to entity's premises from where it is deposited into entity's bank account. However, concerned officer has not renewed insurance for cash in transit.

Based on above, answer the following questions: -

- 2.1 The auditor has performed procedures to obtain audit evidence about design and implementation of controls. Which of the following procedures is more reliable to obtain audit evidence relating to application of a control?
- (a) Observing application of control
 - (b) Inspecting documentation pertaining to control
 - (c) Inquiry about application of control
 - (d) Studying design of control
- 2.2 Examination and evaluation of internal control is indispensable for CA M. Raja. It provides him necessary comfort relating to completeness of accounting information. However, review of internal controls of the entity will not enable him to know_____
- (a) whether errors or frauds are likely to be located in ordinary course of operations of business
 - (b) whether an effective internal audit department is operating
 - (c) whether his opinion needs modification
 - (d) whether any administrative control has bearing on his work

- 2.3 As regards weaknesses identified by the auditor in control system, which of the following represent(s) significant deficiencies in internal control?
- (a) Not performing bank reconciliation timely and not verifying wage sheets by responsible official only
 - (b) Not performing bank reconciliation timely and lack of proper sequence in purchase orders only
 - (c) Not performing bank reconciliation timely, lack of proper sequence in purchase orders, not verifying wage sheets by responsible official and lack of insurance for cash in transit
 - (d) Lack of insurance for cash in transit only
- 2.4 Which of the following is most appropriate regarding auditor's responsibility in accordance with SA 265?
- (a) To communicate significant deficiencies in internal control to management
 - (b) To communicate significant deficiencies in internal control along with explanation of their potential effects to management
 - (c) To communicate significant deficiencies in internal control along with explanation of their potential effects, to provide sufficient information to understand context of communication to management and express opinion on effectiveness of internal control
 - (d) To communicate significant deficiencies in internal control along with explanation of their potential effects and to provide sufficient information to understand context of communication to management

General MCQs

1. CA Muskan is auditor of two concerns viz. Well Star Homes and Well Star Stores. The partners in both the firms are common. While auditing financial statements of Well Star Homes, she has noticed that few expenditure bills pertaining to Well Star Stores have been entered in its books. Which assertion of Well Star Homes is disproved in above situation?

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- (a) Completeness
 - (b) Accuracy
 - (c) Occurrence
 - (d) Classification
2. CA X is nearing completion of audit procedures during course of audit of a company. He has found nothing unusual till now. The company is earning handsome profits since last many years and there is little debt burden on it. It is also in the process of expanding its business by taking loan from a bank. The bank has also granted "in-principle" approval for lending money to the company. Which of the following statements is most appropriate in evaluation of going concern assumption being followed by management?
- (a) Appropriateness of management's assessment in relation to going concern assumption may be made by auditor without performing detailed evaluation procedures.
 - (b) Appropriateness of management's assessment in relation to going concern assumption would be made by auditor by performing detailed evaluation procedures.
 - (c) Appropriateness of going concern assumption would be made by auditor directly by skipping management's assessment.
 - (d) Appropriateness of going concern assumption would be made by auditor by necessarily examining cash flow forecast.
3. CA Piyush is offered appointment as statutory auditor of branch of a bank. He has also taken housing loan of ₹75 lakhs from the same bank. Identify threat to independence involved.
- (a) Advocacy threat
 - (b) Self-interest threat
 - (c) Self-review threat
 - (d) Familiarity threat
4. A Chartered Accountant finds during the course of statutory audit of a company that management is not serious about findings of internal

audit reports. No action has been taken on findings of internal auditor and reports for last two quarters are gathering dust.

He has further found that management has not disclosed information relating to transactions with another company. However, he has assiduously gathered that it is a related party by going through annual reports of past years and searching online database on MCA portal.

The described situation most appropriately denotes_____?

- (a) Objectivity
 - (b) Professional knowledge
 - (c) Independence
 - (d) Professional skepticism
5. You have been appointed as statutory auditor of a company for the first time. It has become very important for you to understand the company and its environment. Which of the following activities are not expected to be included in your attempts to know about the company and its environment?
- (a) Gaining a knowledge about debt structure of the company
 - (b) Evaluating whether company's accounting policies are appropriate for its business
 - (c) Understanding business risks faced by the company
 - (d) Gathering evidence about valuation of trade receivables of the company

PART II – Descriptive Questions

Chapter 1 - Nature, Objective and Scope of Audit

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

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

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

Chapter 2 - Audit Strategy, Audit Planning and Audit Programme

3. Preliminary engagement activities include certain activities to be performed by an auditor while planning an audit. Discuss such activities briefly. How performing such activities assists an auditor?
4. The assistant of CA K is assigned responsibility of drafting "audit programme" relating to purchases appearing in financial statements of "Broad Industries", a partnership firm. The said firm is a GST registered tax payer and is engaged in manufacturing of packing boxes from a special type of paper taxable under GST. Help him by drafting a sample audit programme for purchases.

Chapter 3 – Risk Assessment and Internal Control

5. Satranga Foods Private Limited is engaged in manufacturing of pickles. The auditors of the company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that misstatements in revenue recognition are not identified by planned audit procedures. Identify and explain that particular risk in detail.
6. IT related risks can have an impact on audit. In what different ways, such risks can have an impact on audit of financial statements?

Chapter 4 – Audit Evidence

7. CA Kanika audited books of accounts of Engineering Ltd. for the financial year 2022-2023. The auditor used an audit procedure according to which all the documents and records maintained by the company were checked in detail to obtain audit evidence. Explain the audit procedure used by the auditor. Comment on reliability of audit evidence obtained by performing such an audit procedure in some situations.
8. CA J is conducting statutory audit of Gemini Ltd engaged in manufacturing of pharma products. The company is fairly large one and has a well-functioning internal audit department. While considering sending out external confirmation requests to trade receivables outstanding as on date of financial statements, CA J has delegated the process of choosing trade receivables, designing requests and receiving responses from customers to internal audit department. The responses are also received on the mail id of internal audit department. Is the approach of CA J proper?
9. The newly appointed auditor of BTN Limited wants to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. What audit procedures should he perform for this purpose?
10. SPR Ltd has been into the media business since 2001. During the F.Y 2022-2023, many notices were received by the company for hurting public sentiments and financial claims were filed against the company. As an auditor of the company, you requested the management for arranging the meeting with company's external legal counsel. Management is of the view that such meetings are necessary in certain circumstances only. Can you list down such circumstances?

Chapter 5 - Audit of Items of Financial Statements

11. Proceedings have been initiated against False Limited for holding benami property under law relating to prohibition of benami transactions and the rules made thereunder but such property is not recorded in books of accounts. As a consultant to the company, what

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will you advise the company as far as disclosure requirements are concerned in financial statements in relation to said proceedings?

12. Droma Shoes Private Limited was established in year 2022-23 for manufacturing of footwear. As funds were needed to carry on its business activities - including for purchase of different raw materials, incurring of regular expenses like power and fuel and payment of wages etc., it had got sanctioned a credit facility amounting to ₹ 2 crores repayable on demand from a bank against primary security of its current assets and collateral security of residential house of one of its directors. Duly signed guarantee documents by directors in favour of bank also form part of bank's loan documentation. Account statement of above facility downloaded from bank's website shows debit balance of ₹ 1.85 crores as on 31st March, 2023. The operations in above credit facility are satisfactory. In this regard: -
- (i) Identify nomenclature of such credit facility given by banks. How would above amount of ₹ 1.85 crores be reflected and classified in financial statements of company as on 31.3.23?
 - (ii) Also state specific disclosure requirements of Schedule III of Companies Act, 2013 in relation to above.
13. Following is extract of notes to accounts of financial statements of STU Private Limited listing some ratios. Discuss, whether disclosure, given in following manner meets requirements of Schedule III of the Companies Act, 2013. Ignore other ratios which are not listed in extract given below:

Name of ratio	31.3.2023	31.3.2022
Current ratio	2.50	2.30
Inventory turnover ratio	3.00	6.00
Trade receivables turnover ratio	1.75	5.00
Net profit ratio (in%)	13%	10%

Chapter 6 – Audit Documentation

14. Rajni, a CA student, has understood that SA 230 requires auditor to prepare audit documentation on a timely basis. While reading about SQC 1, she notices that time limit for completion of final audit file is ordinarily not more than 60 days after the date of auditor's report. She

finds it to be puzzling. Unable to comprehend, she seeks your guidance. Guide her.

15. Discussing meaning of completion memorandum, elaborate upon its importance.

Chapter 7 – Completion and Review

16. CA K is statutory auditor of DEMA Private Limited for the year 2022-23. The company has three plants in India. He is nearing completion of audit procedures relating to financial statements for the year under audit and has yet to sign audit report. Meanwhile, a huge fire had broken out in one of plants of the company located near Nashik on 25th June, 2023 damaging substantial part of machinery and work-in-process resulting in loss of about ₹ 5 crores. Unaware of the incident, he is in process of finalizing his report in first fortnight of July 2023. State few audit procedures to be performed by him to obtain sufficient appropriate evidence for identifying such events. Also explain auditor's responsibilities in this situation.
17. Kundan, a CA student, is part of an engagement team conducting audit of an entity. The audit procedures are nearing completion. He notices that engagement partner has asked for a cash flow forecast from management for next twelve months from date of financial statements. Keeping in view above, answer the following: -
- (i) Discuss likely purpose of engagement partner in the above situation. Elaborate upon significance of such testing being performed by engagement partner.
 - (ii) State any two audit procedures in relation to cash flow forecast likely to be performed by engagement partner.

Chapter 8 – Audit Report

18. Mention some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph.
19. CA. S, while conducting audit of an entity is facing the following issues: -
- (i) He has not been provided with necessary support for attending inventory count process of entity as at year end.

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

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

How should the auditor proceed in such a situation?

Chapter 9 – Special Features of Audit of Different Type of Entities

- 20. Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. Explain.
- 21. From a lessee's perspective, highlight main differences between an operating lease and finance lease only in relation to accounting treatment and tax benefits.

Chapter 10 – Audit of Banks

- 22. While conducting statutory audit of branch of a nationalized bank, it is noticed by CA Z that credit facilities granted to a borrower consisting solely of term loan have been classified as "Sub-standard Asset" during the year 2022-23 due to failure of borrower to pay EMIs on time. Such EMIs were outstanding for more than 90 days and account was, therefore, classified as "Sub-Standard Asset". CA Z has also agreed to above asset classification made by branch management.

What are CA Z's responsibilities regarding verification of compliance with income recognition norms by branch in respect of above credit facilities?

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23. While verifying provisions of advances of a branch of MCO Bank as part of statutory branch audit, CA Z notices that credit facilities consisting of term loan to KRT Enterprises have been classified under doubtful asset (D1) category. The outstanding balance in above term loan account as on 31.3.2023 is ₹ 50 lakhs. Value of security held in account is ₹ 40 lakhs. The branch has made provision of ₹ 7.50 lakhs. Is provision made by branch proper? Discuss.

Chapter 11 – Ethics and Terms of Audit Engagements

24. CA X has been offered audit of financial statements of TDK Industries, a partnership firm. Prior to accepting proposed offer, he insists upon obtaining an agreement of management regarding acknowledgment of its responsibility of having a proper process in place to ensure that financial statements prepared are free from material misstatements. However, management is of the view that it is auditor's duty to detect material misstatements in financial statements and such an insistence by auditor is totally uncalled for. Whose view is proper? Also discuss reasons for arriving at your conclusion. What should be likely proper course of action for CA X in above situation?
25. "SA 220 is premised on the basis that the firm is subject to SQC 1". What do you understand by given statement in context of audit quality?



SUGGESTED ANSWERS/HINTS

Answer Key- Case Scenario - 1

Question No.	Answer
1.1	(d) The situation reflected in case scenario may not constitute threat to independence of auditor. Irrespective of this, detection risk in engagement is high.
1.2	(c) Verifying cost of PPE items acquired during the year with purchase bills
1.3	(a) Gross profit ratio has decreased in year 2022-23 as compared to year 2021-22. It may be due to the reason that sales prices

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	may have been reduced by the company to procure more orders.
1.4	(b) Trend analysis forming part of substantive analytical procedures
1.5	(b) SA 550, SA 510, SA 220, SA 610

Answer Key- Case Scenario - 2

Question No.	Answer
2.1	(a) Observing application of control.
2.2	(c) whether his opinion needs modification
2.3	(c) Not performing bank reconciliation timely, lack of proper sequence in purchase orders, not verifying wage sheets by responsible official and lack of insurance for cash in transit
2.4	(d) To communicate significant deficiencies in internal control along with explanation of their potential effects and to provide sufficient information to understand context of communication to management.

General MCQs

1. (c) Occurrence
2. (a) Appropriateness of management's assessment in relation to going concern assumption may be made by auditor without performing detailed evaluation procedures.
3. (b) Self-interest threat
4. (d) Professional skepticism
5. (d) Gathering evidence about valuation of trade receivables of the company

Descriptive Answers

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

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

An analysis of above brings out following points clearly: -

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

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

Audit of financial statements is carried out by the auditor with professional competence and skills in accordance with Standards on Auditing. Audit procedures are applied in accordance with SAs, audit evidence is obtained and evaluated. On the basis of that, conclusions are drawn and opinion is formed. It leads to high level of assurance which is called as reasonable assurance but it is not absolute assurance.

- (2) Misstatements in financial statements can occur due to fraud or error or both. The auditor seeks to obtain reasonable assurance whether financial statements as a whole are free from material misstatements caused by fraud or error. He has to see effect of misstatements on financial statements as a whole, in totality.
- (3) Obtaining reasonable assurance that financial statements as a whole are free from material misstatements enables the auditor to express an opinion on whether the financial statements are

prepared, in all material respects, in accordance with an applicable financial reporting framework.

- (4) The opinion is reported and communicated in accordance with audit findings through a written report as required by Standards on Auditing.

Therefore, perception of both assistants is not proper. Auditor of financial statements does not seek to provide guarantee that financial statements are free from material misstatements caused by frauds or errors. He obtains reasonable assurance.

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

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

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

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

Some examples of Standards on Auditing are:

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

Examples of Standards on Review engagements are

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

3. Preliminary engagement activities

Preliminary engagement activities include following activities: -

- (A) Performing procedures regarding the continuance of the client relationship
- (B) Evaluating compliance with ethical requirements, including independence
- (C) Establishing an understanding of terms of engagement

Performing preliminary engagement activities assists auditor in identifying and evaluating events or circumstances that may affect auditor's ability to plan and perform audit engagement.

4. Sample audit programme pertaining to purchases

Name of Concern	:	Broad Industries
Financial Year	:	20XX-XX
Prepared by	:	Name of person with date

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Reviewed by : Name of person with date

Approved by : Name of person with date

S.no.	Nature of Procedure	Extent of Check	Basis of Sample	Done by
(a)	Vouch few purchase invoices of paper from purchase records of concern.			
(b)	Trace these invoices into account books of concern.			
(c)	Verify few purchase invoices of paper on GST portal.			
(d)	Trace few purchase invoices of paper in stock records to ensure that these have been added to stocks of raw material.			

5. There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. Such a risk is referred to as "detection risk".

SA 200 defines detection risk as the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

For example, auditor of a company uses certain audit procedures for the purpose of obtaining audit evidence and reducing audit risk, but still there will remain a risk that audit procedures used by the auditor may not be able to detect a misstatement which by nature is material, then that risk is known as detection Risk.

Detection risk comprises sampling and non-sampling risk.

- (a) **Sampling risk** is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. It simply

means that the sample was not representative of the population from which it was chosen.

(b) **Non-sampling risk** is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. Like an auditor may reach an erroneous conclusion due to application to some inappropriate audit procedure.

6. IT related risks can have an impact on audit in different ways discussed as under: -

Impact on substantive checking

Inability to address IT risks may lead to non-reliance of data obtained from systems. In such a case, all information, data, and reports would have to be tested thoroughly for their completeness and accuracy. It could lead to increased substantive checking i.e. detailed checking.

Impact on controls

It can lead to non-reliance on automated controls, system calculations and accounting procedures built into applications. It may result in additional audit work.

Impact on reporting

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

7. Audit Procedure:

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

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

Example of inspection used as a test of controls is inspection of records for evidence of authorisation.

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

8. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:
- (a) Determining the information to be confirmed or requested;
 - (b) Selecting the appropriate confirming party;
 - (c) Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
 - (d) Sending the requests, including follow-up requests when applicable, to the confirming party.

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

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

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

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

10. Circumstances when it becomes necessary to meet with company's external legal counsel:

In the given case of SPR Ltd., Auditor requested the management for meeting with SPR's external legal counsel.

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

This may be the case, **for example**, where:

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

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

- 11. Disclosure in case of Benami Properties held by the Company:** Where any proceedings have been initiated or pending against the company for holding any benami property under the relevant law relating to prohibition of such transactions, the company shall disclose the following: -
- (a) Details of such property, including year of acquisition
 - (b) Amount thereof
 - (c) Details of Beneficiaries
 - (d) If property is not in the books, then the fact shall be stated with reasons
 - (e) Where there are proceedings against the company under this law as an abettor of the transaction or as the transferor, then the details shall be provided
 - (f) Nature of proceedings, status of same and company's view on same.
- 12. (i)** The type of credit facilities referred to in above situation given by banks to meet working capital requirements of business which are repayable on demand are known as "cash credit facilities/overdraft" facilities. The amount of ₹1.85 crores outstanding as on 31st March, 2023 reflects borrowings of the company and it would be classified as "short-term borrowings" as loans repayable on demand from banks under current liabilities in balance sheet of the company. Borrowings shall further be subclassified as secured.
- (ii)** Specific disclosure requirements of short-term borrowings under Schedule III to Companies Act, 2013 in given situation are as under: -
- Nature of security i.e. primary security of current assets and collateral security of residential house belonging to a director shall be specified.

- As loans have been guaranteed by directors, the aggregate amount of such loans shall be disclosed.

To be disclosed as Additional Regulatory Information

Since the Company has borrowings from bank on the basis of security of current assets, it shall also disclose the following:-

- whether quarterly returns or statements of current assets filed by the Company with banks or financial institutions are in agreement with the books of accounts.
- if not, summary of reconciliation and reasons of material discrepancies, if any to be adequately disclosed.

- 13.** The disclosure given in the question does not meet requirements of Schedule III to Companies Act, 2013.

Schedule III requires that the company shall explain the items included in numerator and denominator for computing the ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

In the given table, the company has not explained the items included in numerator and denominator for computing ratios. Further, variations in ratios as compared to preceding year are as under: -

Name of ratio	31.3.23	31.3.22	Variation
Current ratio	2.50	2.30	8.69%
Inventory turnover ratio	3.00	6.00	50%
Trade receivables turnover ratio	1.75	5.00	65%
Net Profit ratio (in%)	13%	10%	30%

As calculated above, there is change in inventory turnover ratio, trade receivables turnover ratio and net profit ratio by more than 25% as compared to preceding year. Therefore, explanations for such changes have also to be provided where there are changes by more than 25% as compared to preceding year.

- 14.** SA 230 requires that the auditor shall prepare audit documentation on a timely basis. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates

the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized.

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

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

- 15.** Completion memorandum is a summary that describes the significant matters identified during the audit and how they were addressed.

Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

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

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

- Inquiry of management whether any subsequent events have occurred
- Reading minutes of the meetings of owners, management that have been held after date of financial statements and inquiring about

matters discussed at such meetings for which minutes are not available

- Reading entity's latest subsequent interim financial statements
- Obtaining Written representations from management in accordance with SA 580

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

17. In the given situation, the engagement partner has asked for a cash flow forecast from management for next twelve months from date of financial statements. The audit procedures are also nearing completion.

Therefore, purpose of engagement partner in requiring a cash flow forecast is to obtain sufficient appropriate audit evidence regarding and to conclude on appropriateness of management's use of going concern basis of accounting in preparation of its financial statements. Further, his purpose is also to conclude on basis of audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast a significant doubt on ability of entity to continue as a going concern, and to report in accordance with SA 570.

The significance of testing going concern assumption is due to its effect on preparation of financial statements. When the use of going concern is considered as appropriate, assets and liabilities are recorded on the basis that entity will be able to realize its assets and discharge liabilities in normal course of business. In case it is not so viewed, financial statements are prepared on liquidation basis. Hence, testing such an assumption provides evidence to auditor whether use of such assumption is appropriate or not.

Two audit procedures in relation to cash flow forecast likely to be performed

- Evaluate reliability of underlying data generated to prepare the forecast

- Determine whether there is adequate support for assumptions underlying the forecast

18. Examples of circumstances to include Emphasis of Matter Paragraph:

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

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

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

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

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

If auditor withdraws from such an engagement, before withdrawing, auditor shall communicate to those charged with governance any

matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

- 20.** Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will minimize the leakage as far as possible. Evidence of their success is provided by the preparation of regular perhaps weekly, trading accounts for each sales point and a detailed scrutiny of the resulting profit percentages, with any deviation from the anticipated form being investigated. The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.

The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order.

The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities. If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts. As a result, the scope of his audit tests will necessarily be increased and, in the event of a material margin discrepancy being unexplained, he will have to consider qualifying his audit report.

21. Accounting treatment

Operating lease is generally treated like a renting arrangement. Lease payments are treated as operating expenses and asset does not appear as asset in lessee's balance sheet. Finance lease is treated like a loan arrangement. Hence, asset ownership is considered of that of lessee and thus appears on the balance sheet of the lessee.

Tax benefits

Operating lease payment is considered like an expense just as in case of renting. However, no depreciation can be claimed by lessee. In case of

finance lease, lessee can claim both interest and depreciation as it is treated like a loan.

22. RBI norms stipulate that if any advance account becomes NPA as at close of any year, the entire interest accrued or credited to income account in past periods should be reversed or provided for, if the same is not realized.

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

In the given case, account has turned Sub-standard asset which is a type of NPA. Therefore, auditor should make compliance of above norms relating to income recognition.

23. The provision for advances falling in D1 category is required @ 25% of secured portion and 100% of unsecured portion. Therefore, provision in above case is arrived as under: -

Outstanding balance as on 31.3.23	50 lakhs
Less: Value of security	40 lakhs

Unsecured portion	10 lakhs

Therefore, outstanding balance of ₹ 50 lakhs is secured to the tune of ₹40 lakhs and balance ₹ 10 lakhs is unsecured.

Provision calculation

25% of secured part	i.e., 25% of ₹ 40 lakhs	₹ 10 lakhs
100% of unsecured part	i.e., 100% of ₹ 10 lakhs	₹ 10 lakhs

Required provision		₹ 20 lakhs

Therefore, provision made by branch is not proper. It should have made provision of ₹20 lakhs instead of ₹ 7.50 lakhs.

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

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

- (A) Establishing whether the preconditions for an audit are present and
- (B) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

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

In the given situation, CA X is insisting only upon obtaining agreement of management regarding acknowledgment of its responsibility for internal control to enable preparation of financial statements that are free from material misstatements in accordance with SA 210. Design, implementation and maintenance of internal control to ensure preparation of reliable financial statements that are free from material misstatements is management's responsibility. He is insisting on obtaining agreement of management regarding acknowledgment of its responsibility. Therefore, CA X's view is proper.

In case management does not provide such agreement acknowledging its responsibility, the auditor shall not accept proposed audit engagement unless required by law or regulation.

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

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

Therefore, SA 220 is premised on the basis that the firm is subject to SQC 1. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement.

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