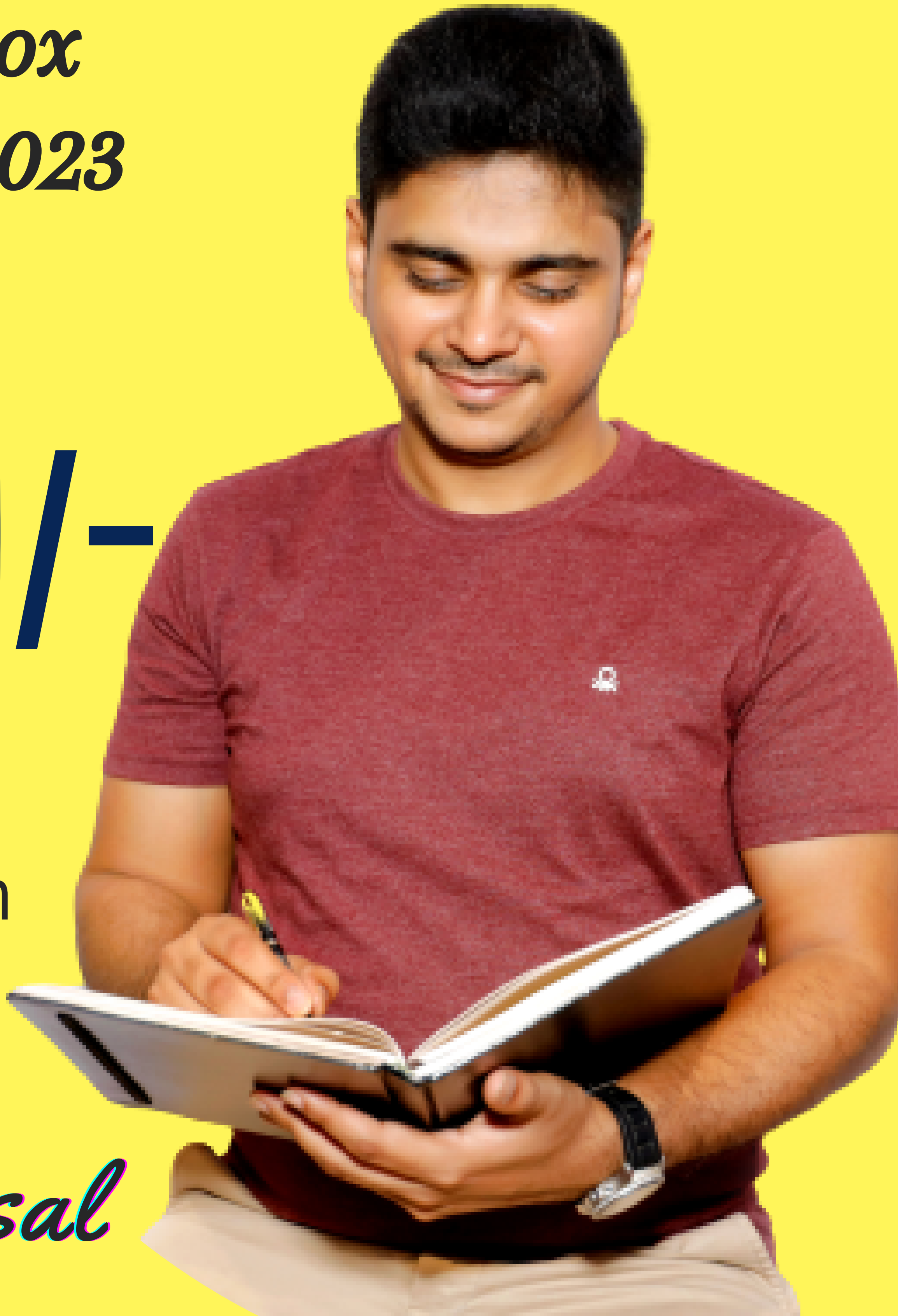
STANDARDS ON AUDITING

Last 5 Attempts QUESTIONS

CA Abhishek Bansal



STANDARDS ON AUDITING

TREND OF PAST PAPERS CA FINAL BY **CA ABHISHEK BANSAL** / WWW.LETSLEARNINDIA.IN

MAY 2023	Q1 (a) SA 570 5m	Q1 (b) SA 620 5m	Q1 (c) SA 540 4m	Q2 (a) SA 530 5m	Q4 (a) SA 540 5m			24 Marks
NOV 2022	Q1 (a) SQC - 1 5m	Q1 (b) SA 505 5m	Q2 (a) SA 320 5m	Q5 (a) SA 700+705 5m				20 Marks
MAY 2022	Q1 (a) SQC - 1 5m	Q1 (b) SA 550 5m	Q5 (c) SA 540 4m	Q6 (b) SA 230 5m				19 Marks
DEC 2021	Q5 (a) SA 505 5m	Q1 (c) SA 705 4m	Q1 (b) SA 402 5m	Q1 (a) SA 240 5m				19 Marks
JULY 2021	Q5 (b) SQC - 1 5m	Q3 (a) SA 600 5m	Q2 (a) SA 700 5m	Q1 (b) SA 705 5m	Q1 (a) SA 200+ SA 240 + SQC1 5m			25 Marks
JAN 2021	Q5 (a) 540+330 4m	Q3 (a) 315 5m	Q2 (a) 265 5m	Q1 (6) 501 5m	Q1 (c) SQC-1 5m			24 Marks
NOV 2020	Q6 (b) SA 240 5m	Q4 (a) 250 5m	Q3 (b) 265 5m	Q2 (a) 550 5m	Q1 (c) 720 4m	Q1 (b) 560 5m	Q1 (a) 5m (501)	34 Marks
NOV 2019	Q5 (c) SA 510 4m	Q2 (a) A 315/ICS 5m	Q1 (c) SQC-1 4m	Q (1) (b) SA 720 5m	Q1 (a) SA 540 5M			23 Marks
MAY 2019	Q2 (b) SA 705 4m	Q2 (a) SA 620 5m	Q1 (c) SA 705 4m	Q1 (b) SA 299 5m				18 Marks

MAY 23 SUGGESTED ANSWERS

QUESTION 1. **(5 marks)**

Joy Ltd. is an entertainment company which runs a circus and travels around the country to entertain the masses. The circus began losing its popularity over the past few years and attendance has reportedly dropped by as much as 75% in the current financial year. Animal rights activists continuously targeted the circus for its use of animal creatures like elephants in the show. The CEO noted that the audience seemed to be abandoning the circus due to their expanding entertainment options. The high cost of moving the show from city to city eventually made the business model untenable. As a result, many key managerial personnel of the company left the company, there were delays in the payment of wages and salaries, and the bank from whom the company had taken funds also decided not to extend further finance or to fund further working capital requirements of the company.

When discussed with the management, the statutory auditor understood that the company had no action plan to mitigate such circumstances (Use of going concern assumption is inappropriate). Further, all such circumstances were not reflected in the financial statements of Joy Ltd. What course of action should the statutory auditor of the company take in the auditor's report in such situation?

Ans. SA 570, "Going Concern", deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

When the use of going concern basis of accounting is inappropriate i.e., if the financial statements have been prepared using the going concern basis of accounting but in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.

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

In the present case, the following circumstances indicate the inability of Joy Ltd. to continue as a going concern:

- Losing popularity over the past few years.
- Animal Rights activists continuously targeting the circus.
- Audience abandoning the circus due to their expanding entertainment options.
- High Cost of moving the show from city to city making the business model untenable.
- Key Managerial Personnel leaving the Company.
- Banks decided not to extend further finance and not to fund the working capital requirements of the Company.
- Non availability of sound action plan to mitigate such circumstances.

Therefore, considering the above factors it is clear that the going concern basis is inappropriate for the Company. Further, such circumstances are not reflected in the financial statements of the Company. As such, the statutory auditor of Joy Ltd. should:

(1) Express an adverse opinion in accordance with SA 705 (Revised) and
(2) In the Basis of Adverse Opinion paragraph of the auditor's report, the statutory auditor should state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.
The auditor is also required to report as per clause (xix) of CARO 2020 that on the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date.

QUESTION 2. **(5 marks)**

HAM Ltd. is engaged in the business of manufacturing of medicines. The manufacturing process requires raw materials such as hydrochloric acid, caustic soda and other chemicals for the manufacturing of various drugs. The Company has maintained large stock of raw materials of all types of chemicals being used. The nature of raw material is such that its physical verification requires the involvement of an expert. Management hired their expert for the stock taking and auditors also involved their expert for the same purpose.
The auditor observed that the work of the auditor's expert was not adequate for the auditor's purposes and he could not resolve the matter through additional audit procedures which included further work performed by both the auditor's expert and the auditor.
Based on above, the auditor knows that it would be right to express a modified opinion in the auditor's report because he has not obtained sufficient appropriate audit evidence. But he was reluctant in doing so and issued a clean audit report and included the name of the expert in his report to reduce his responsibility for the audit opinion expressed.
Comment with respect to relevant Standard of Auditing relating to the action of the auditor of issuing clean audit report.

Ans. As per SA 620, "Using the work of an Auditor's Expert", if the auditor concludes that the work of the auditor's expert is not adequate for the auditor's purposes and the auditor cannot resolve the matter through the additional audit procedures, which may involve further work being performed by both the expert and the auditor, or include employing or engaging another expert, it may be necessary to express a modified opinion in the auditor's report in accordance with SA 705 because the auditor has not obtained sufficient appropriate audit evidence.
In addition, the auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the audit opinion.
If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion. In such circumstances, the auditor may need the permission of the auditor's expert before making such a reference.

In the given case, the auditor cannot reduce his responsibility by referring the name of auditor's expert and thereby issuing a clean report. The auditor should have issued a modified report and could have given reference to the work of an auditor's expert in that report if such reference was relevant to understanding of a modification to the auditor's opinion but even in that case the auditor should have indicated in his report that such reference of an auditor's expert does not reduce his responsibility for that opinion.

QUESTION 3. **(5 marks)**

M/s ABC Limited is engaged in the business of construction of infrastructure and housing projects. While preparing the financial statements for the year ended 31.03.2023, management has made various accounting estimates and confirmed to the auditor that all necessary accounting estimates have been recognized, measured and disclosed in the financial statements are in accordance with the applicable financial reporting framework. The auditor during the course of audit observed some changed circumstances giving rise to the need for an accounting estimate. Inquiries of same were sought from the management. Can you list down some circumstances, change of which will result in inquiries from the management?

Ans. **As per SA 540,** "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. SA 315 deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment processes.

QUESTION 4. **(5 marks)**

While conducting audit of PC Ltd., CA. T decided to use sampling technique to test the trade receivables at the planning stage. He directed his team members to divide the whole population of trade receivables balances to be tested in a few separate groups called 'strata'. He directed to treat each stratum as if it was a separate population and divided the trade receivables balances of PC Ltd. for the Financial Year 2022 -23 into groups on the basis of personal judgment as follows:

Sl. No.	Particulars
1	(a) Balances in excess of ` 50,00,000;
2	(b) Balances in the range of ` 40,00,001 to ` 50,00,000;
3	(c) Balances in the range of ` 30,00,001 to ` 40,00,000;
4	(d) Balances in the range of ` 20,00,001 to ` 30,00,000;
5	(e) Balances in the range of ` 10,00,001 to ` 20,00,000;
6	(f) Balances ` 10,00,000 and below

From the above mentioned groups, CA. T directed to pick up different percentage of items for examination from each of the group. One of the team members, Mr. Neel, wants to use some other technique of sampling for the above purpose as the concept of stratification is not clear to him. You are required to explain the concept of stratification and its uses to Mr. Neel.

Ans. **Concept of Stratification**: Stratification is the process of dividing a population into sub- populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

Uses of Stratification

1.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.

2. 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.

3. 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).

QUESTION 5. **(5 marks)**

BETA Ltd is engaged in the Construction business since year 2001. The auditor understands that a thorough construction estimate is vital to the viability of any construction business and requested the information related to financing and operating estimated costs from the management to review the outcome of accounting estimates included in the prior period financial statements and their subsequent re-estimation for the purpose of current period.

The management refused to provide the information to the auditor as it believed that the judgments and estimates made in the prior periods were based on the information available at that time, and the review of the prior period information should not be done by the auditor in the current financial year. With reference to the relevant SA, comment on whether the contention of management is correct or not.

Ans. As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.

The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time.

In the given case, the management is not correct in refusing the relevant information to the auditor.

NOV 22 SUGGESTED ANSWERS

QUESTION 1. **(5 marks)**

AP & Associates, Chartered Accountants, are Statutory Auditors of XP Limited for the last four years. XP Limited is engaged in the manufacture and marketing of FMCG Goods in India. During 2021-22, the Company has diversified and commenced providing software solutions in the area of "e-commerce" in India as well as in certain European countries. AP & Associates, while carrying out the audit for the current financial year, came to know that the company has expanded its operations into a new segment as well as new geography. AP & Associates does not possess necessary expertise and infrastructure to carry out the audit of this diversified business activities and accordingly wishes to withdraw from the engagement and client relationship. Discuss the issues that need to be addressed before deciding to withdraw.

Ans. Acceptance and Continuance of Client Relationships and Specific Engagements: As per SQC 1, "Quality Control for Firms that Perform Audit and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements", the firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will undertake or continue relationships and engagements only where it is competent to perform the engagement and has the capabilities, time and resources to do so.

In the given case, AP & Associates, Chartered Accountants, statutory auditors of XP Limited for the last four years, came to know that the company has expanded its operations into a new segment as well as new geography. AP & Associates does not possess necessary expertise for the same, therefore, AP & Associates wish to withdraw from the engagement and client relationship. Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship **address issues that include the following**

- Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.
- Considering whether there is a professional, regulatory or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- Documenting significant issues, consultations, conclusions and the basis for the conclusions.

AP & Associates should address the above issues before deciding to withdraw.

QUESTION 2. **(5 marks)**

During the audit of Star Ltd. a company engaged in the production of paper, the auditor received certain confirmation for the balances of trade payables outstanding in the balance sheet through external confirmation by "Negative Confirmation Request". In the list of trade payables, there are number of small balances except one which is an old outstanding of ` 20 lakhs for which no confirmation was received. Comment with respect to Standards of Auditing relating to the confirmation process and how to deal the non-receipt of confirmation

Ans. External Confirmation: As per SA 505, "External Confirmation", negative confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations.

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

Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise.

In the instant case, the auditor sent the negative confirmation requesting the trade payables having outstanding balances in the balance sheet while doing audit of Star Limited. One of the old outstanding of ` 20 lakh has not sent the confirmation on the credit balance. In case of non-response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non-response for negative confirmation request does not means that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request.

QUESTION 3. **(5 marks)**

CA. B was appointed as the auditor of SRT Limited for the financial year 2021 -22. During the course of planning for the audit, CA. B intends to apply the concept of materiality for the financial statements as a whole. Please guide him with respect to the factors that may affect the identification of an appropriate benchmark for this purpose.

What benchmark should be adopted by CA. B, if SRT Limited is engaged in:

(i) the manufacture and sale of air conditioners and is having regular profits.

(ii) the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic.

Ans. Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole: As per SA 320, determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

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

- The elements of the financial statements (for 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 (for 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 (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

In case if SRT Limited is engaged in manufacture and sale of air conditioner, and is having regular profits: CA. B, the auditor may consider profit before tax /Earnings.

In case if SRT Limited is engaged in the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic: CA. B, the auditor may consider Revenue or Gross Profit as benchmarking. Alternatively, CA B, the auditor may consider the criteria relevant for audit of the entities doing public utility programs/ projects, Total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

QUESTION 4. **(5 marks)**

CA. Uma is the Statutory Auditor of RJ Ltd. for the financial year 2021-22. The company is engaged in the production of electronic products. During the course of audit, CA. Uma obtained certain audit evidence of incorrect disclosure of related party transactions and structured finance deals which was not considered with the affirmation leading to misstatement in the financial statements. Discuss how CA Uma should deal with the situation in the auditor's report and the different options which can be considered?

Ans. Auditor's duties in case of inconsistency in Audit evidence: SA 705 "Modifications to the Opinion in the Independent Auditor's Report", deals with auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(b) The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Further, the auditor shall modify the opinion in the auditor's report when the auditor concludes that based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement:

In the present case, during the course of the audit, CA Uma obtained certain audit evidence which was not consistent with the affirmation made in financial statements. Therefore CA Uma should modify his report in accordance with SA 705.

Conclusion:

Since CA Uma has obtained audit evidence which is inconsistent with the affirmations made in the financial statements. CA Uma should modify his opinion as per the circumstances of the case.

- CA Uma shall express Qualified opinion when, having obtained sufficient appropriate audit evidence, he concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements.
- CA Uma shall express an Adverse opinion, where the auditor, having obtained sufficient appropriate evidence, concludes that misstatements, individually, or in the aggregate, are both material and pervasive to the financial statements.

MAY 22 SUGGESTED ANSWERS

QUESTION 1. **(5 marks)**

PQR & Associates, Chartered Accountants, is a partnership firm having 3 partners CA P, CA Q and CA R. PQR & Associates are appointed as Statutory Auditors of ABC Limited, a listed entity for the financial year 2021-22 and CA P is appointed as Engagement Partner for the audit of ABC Limited. Before issuing the Audit Report of ABC Limited, CA P asked CA R to perform Engagement Quality Control Review and is of the view that his responsibility will be reduced after review by CA R. Whether the contention of CA P is correct? What are the aspects that need to be considered by CA R while performing Engagement Quality Control Review for audit of financial statements of ABC Limited?

Ans. As per SQC 1, "Quality Control for Firms that Perform Audit and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements", the review does not reduce the responsibilities of the engagement partner. Hence, contention of CA. P that after engagement quality control review by CA. R, his responsibility will be reduced, is not correct.

However, CA. R needs to consider the following aspect while performing Engagement Quality Control Review for audit of financial statements of a listed entity ABC Ltd.:

1. The engagement team's evaluation of the firm's independence in relation to the specific engagement.
2. Significant risks identified during the engagement and the responses to those risks.
3. Judgments made, particularly with respect to materiality and significant risks.
4. Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
5. The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
6. The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
7. Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.
8. The appropriateness of the report to be issued.

Engagement quality control reviews for engagements other than audits of financial statements of listed entities may, depending on the circumstances, include some or all of these considerations.

QUESTION 2. **(5 marks)**

JKL Limited is engaged in the business of Construction and real estate having various projects across states. M/s YT & Co, Chartered Accountants have been appointed as Statutory Auditors. Audit Team from M/s YT & Co for audit of JKL Limited comprises of CA Z-Engagement Partner, CA Q, a paid assistant and 3 Articled Assistants. During preliminary verification, CA Z observed that huge amount of sub-contract payments were made to M/s JB Associates, a partnership firm in which Director of JKL Limited is a managing partner. The engagement team discussed that SA 315 and SA 240 shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the JKL Limited's related party relationships and transaction. Highlight the matters that are to be addressed in the discussion by CA Z with engagement team members with reference to the relevant Standard on Auditing.

Ans. As per SA 550 "Related Parties", the engagement team discussion that SA 315 and SA

240 require shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.

Accordingly matters that are to be addressed in the discussion by CA Z among the engagement team include:

1. The nature and extent of the entity's relationships and transactions with related parties (using, for example, the auditor's record of identified related parties updated after each audit).
2. An emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
3. The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (e.g., a complex organisational structure, use of special - purpose entities for off-balance sheet transactions, or an inadequate information system).
4. The records or documents that may indicate the existence of related party relationships or transactions.
5. The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirements), and the related risk of management override of relevant controls.
6. In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:
   (a) how special-purpose entities controlled by management might be used to facilitate earnings management.
   (b) how transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.

QUESTION 3. **(4 marks)**

CA Harry is appointed as a Statutory Auditor of Delist Limited for the financial year 2021-22. M/s Delist Limited is a listed entity at National Stock Exchange and the financial statements are to be drawn up in compliance with Ind AS. M/s Delist Limited made certain fair value accounting estimates on complex financial instruments which are not traded in an active and open market. CA Harry is concerned with identification and assessment of the risks of material misstatement for accounting estimates. Guide him with regard to the estimation making process adopted by management with reference to the relevant Standard on Auditing.

Ans. As per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", CA. Harry shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates:

The estimation making process adopted by the management including-

(1) The method, including where applicable the model, used in making the accounting estimates.
(2) Relevant controls.
(3) Whether management has used an expert?
(4) The assumption underlying the accounting estimates.
(5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
(6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.

QUESTION 4. **(5 marks)**

You are the team leader of 10 members for an audit of a Multinational Company. All the team members are concerned about audit documentation in order to provide evidence that the audit complies with SAs. Hence, the team members wish to document every matter concerned. In your opinion it is neither necessary nor practicable for the auditor to document every matter considered or professional judgement made in an audit. Further you feel that it is unnecessary for the auditor to document separately compliance with matters for which compliance is demonstrated by documents included within the audit file. Illustrate by giving examples with reference to relevant Standard on Auditing.

Ans. SA 230, "Audit Documentation", provides evidence that the audit complies with SAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit.

For example,

(i) the existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.

(ii) the existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management, or where appropriate, those charged with governance.

(iii) An auditor's report containing an appropriately qualified opinion demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the SAs.

(iv) In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:

- For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with SAs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.
- Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the SAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussion required by SA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".

DEC 21 SUGGESTED ANSWERS

QUESTION 1. **(5 marks)**

Mr. Agarwal, in the course of audit of PQ Limited, wants to perform external confirmation procedures to obtain audit evidence. Guide Mr. Agarwal, listing out the factors that may assist him in determining whether external confirmation procedures are to be performed as substantive audit procedures.

Ans. Factors that may assist Mr. Agarwal, the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

(i) The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.

(ii) The ability or willingness of the intended confirming party to respond – for example, the confirming party:
- May not accept responsibility for responding to a confirmation request;
- May consider responding too costly or time consuming;
- May have concerns about the potential legal liability resulting from responding;
- May account for transactions in different currencies; or
- May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

(iii) The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

QUESTION 2. **(4 marks)**

CA Madhu is the statutory auditor of Lakshmi Ltd. for the Financial year 2020 -21. In respect of loans and advances of ` 75 Lakh given to Srinian Pvt. Ltd., the Company has not furnished any agreement to CA Madhu and in absence of the same, he is unable to verify the terms of repayment, chargeability of interest and other terms.

Justify the type of opinion which CA Madhu should give in such situation. Also, Draft an appropriate Opinion paragraph and Basis of opinion paragraph.

Ans. In the present case, with respect to loans and advances of ` 75 Lacs given to Sriman Pvt. Limited, the Company has not furnished any agreement to CA Madhu. In the absence of such an agreement, CA Madhu is unable to verify the terms of repayment, chargeability of interest and other terms. For an auditor, while verifying any loans and advances, one of the most important audit evidence is the loan agreement. Therefore, the absence of such document in the present case, tantamount to a material misstatement in the financial statements of the company. However, the inability of CA Madhu to obtain such audit evidence is though material but not pervasive so as to require him to give a disclaimer of opinion.

Thus, in the present case, CA Madhu should give a qualified opinion

The relevant extract of the Qualified Opinion Paragraph and Basis for Qualified Opinion paragraph is as under:

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the financial statements of Lakshmi Limited give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as on 31.03.2021 and profit/ loss for the year ended on that date.

Basis for Qualified Opinion

The Company is unable to furnish the loan agreement with respect to loans and advances of ` 75 Lacs given to Sriman Pvt Limited. Consequently, in the absence of such an agreement, we are unable to verify the terms of repayment, chargeability of interest and other terms.

QUESTION 3. **(5 marks)**

In the course of audit of Tech limited you observed that processing of accounting data was given to a third party on account of certain considerations like cost reduction, own computer working to full capacity. Tech Limited used a service organisation to record transactions and process related data. As an auditor, what would be your considerations regarding the nature and extent of activities undertaken by service organisation so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk.
Discuss with reference to relevant Standard on Auditing.

Ans. As per SA 402 "Audit Considerations relating to an Entity using a Service Organization", when obtaining an understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organization in the user entity's operations, including:

(i) The nature of the services provided by the service organization and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;

(ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organization;

(iii) The degree of interaction between the activities of the service organisation and those of the user entity; and

(iv) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organization.

"Based on above, the auditor will assess the effect on the audit risk and take necessary steps while conducting the audit".

QUESTION 4. **(5 marks)**

M/s Kumar & Co., Chartered Accountants were appointed as statutory auditors of PC limited for the financial year 2020-21. During the course of audit, one of the partners CA Kumar observed that there is misappropriation of assets in the form of theft of entity's inventory and is perpetrated by employees in relatively small and immaterial amounts. CA Kumar is concerned with the existence of certain circumstances for increasing the susceptibility of assets to misappropriation.
Guide CA Kumar with respect to Risk factors related to misstatements arising from misappropriation of assets with reference to relevant Standard on Auditing.

Ans. Guidance to CA Kumar with respect to risk factors that relate to misstatements arising from misappropriation of assets as per SA 240 is:

As per **SA 240, "The Auditor's Responsibilities Relating to Fraud in an auditof Financial Statements",** misappropriation of assets involves the theft of 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 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).

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization.

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

(i) Known or anticipated future employee layoffs.

(ii) Recent or anticipated changes to employee compensation or benefit plans.

(iv) Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

(i) Large amounts of cash on hand or processed.

(ii) Inventory items that are small in size, of high value, or in high demand.

(iii) Easily convertible assets, such as bearer bonds, diamonds, or computer chips.

(iv) Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

(i) Inadequate segregation of duties or independent checks.

(ii) Inadequate oversight of senior management expenditures, such as travel and other reimbursements.

(iii) Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.

(iv) Inadequate job applicant screening of employees with access to assets.

(v) Inadequate record keeping with respect to assets.

(vi) inadequate system of authorization and approval of transactions (for example, in purchasing).

(vii) Inadequate physical safeguards over cash, investments, inventory, or fixed assets.

(viii) Lack of complete and timely reconciliations of assets.

(ix) Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.

(x) Lack of mandatory vacations for employees performing key control functions.

(xi) Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.

(xii) Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations

(i) Disregard for the need for monitoring or reducing risks related to misappropriations of assets.

(ii) Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.

(iii) Behaviour indicating displeasure or dissatisfaction with the entity or its treatment of the employee.

(iv) Changes in behaviour or lifestyle that may indicate assets have been misappropriated.

(v) Tolerance of petty theft.

JULY 21 SUGGESTED ANSWERS

QUESTION 1. **(5 marks)**

HK & Co. Chartered Accountants have been auditors of SAT Ltd (a listed entity) for the last 8 financial years. CA. H, partner of the firm, has been handling the audit assignment very well since the appointment. The audit work of CA. H and her team is reviewed by a senior partner CA. K to assure that audit is performed in accordance with professional standards and regulatory and legal requirements. CA. K was out of India for some personal reasons, so this year CA. G has been asked to review the audit work. In your opinion, what areas CA. G should consider at the time of review. List any four areas and also comment whether firm is complying with Standard on Quality Control or not.

Ans. Compliance with Standard on Quality Control on review of audit work –

As per SQC 1, an engagement quality control review for audits of financial statements of listed entities includes considering the following:

(i) The work has been performed in accordance with professional standards and regulatory and legal requirements;

(ii) Significant matters have been raised for further consideration;

(iii) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;

(iv) There is a need to revise the nature, timing and extent of work performed;

(v) The work performed supports the conclusions reached and is appropriately documented;

(vi) The evidence obtained is sufficient and appropriate to support the report; and

(vii) The objectives of the engagement procedures have been achieved.

The firm should establish policies and procedures:

(i) Setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time; and

(ii) For all audits of financial statements of listed entities, requiring the rotation of the engagement partner after a specified period in compliance with the Code.

The familiarity threat is particularly relevant in the context of financial statement audits of listed entities. For these audits, the engagement partner should be rotated after a pre- defined period, normally not more than seven years.

From the facts given in the question and from the above stated paras of SQC 1, it can be concluded that firm is not complying with SQC 1 as Engagement Partner H is continuing for more than 7 years.

QUESTION 2. **(5 marks)**

PQ Limited, a listed entity, headquartered in Mumbai and is having 15 branches all over India. The Company is in the business of buying paddy grown by farmers directly and processing to produce final products for selling in domestic as well as international markets. PQ Limited appointed four firms of Chartered Accountants for audit of i ts head office and branches. Your firm is one of those firms. It was agreed that your firm will act as Principal auditor. 'What factors will be considered by you while accepting the position of Principal auditor ?

Ans. Factors to be considered while accepting the position of Principal auditor –

SA 600 – Using the work of Another Auditor -

While accepting the position of Principal Auditor, the auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor.

For this purpose, the auditor would consider:

(a) the materiality of the portion of the financial information which the principal auditor audits;

(b) the principal auditor's degree of knowledge regarding the business of the components;

(c) the risk of material misstatements in the financial information of the components audited by the other auditor; and

(d) the performance of additional procedures as set out in this SA regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

QUESTION 3. **(5 marks)**

MN & Associates, Chartered Accountants have been appointed as statutory Auditors of Cotton Ltd. for the F.Y 2020-2021. The Company is into the business of yarn manufacturing. For this purpose, cotton ginning is also done within the factory premises. Raw cotton is purchased from local market and processed in-house. The Company received a notice from the State Government to deposit market development fee for the last 5 years to the tune of ` 10.00 crores. The Company and all other organizations in the same business have not deposited the market development fee, taking shelter of an old circular issued by the Government. The trade association met with the government officials to resolve the matter and agreed to deposit the same prospectively. However, the matter relating to payment of development fee for the last 5 years is pending before the Government as at the end of the financial year. The Company, however, disclosed the same in notes to accounts, as contingent liability, without quantifying the effect and proper explanation. If the liability is provided in the books of accounts, entire reserves will be wiped off. Auditor seeks your guidance as to how this disclosure affects them while forming an opinion on financial statements.

Ans. Forming an opinion and reporting on financial statements –

As per Ind AS 37, "Provisions, Contingent Liabilities and Contingent Assets", an entity should disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable .

(a) an estimate of its financial effect, measured in the standard;

(b) an indication of the uncertainties relating to the amount or timing of any outflow; and

(c) the possibility of any reimbursement.

SA – 700 - Forming an opinion and reporting on financial statements:

The auditor shall evaluate whether in view of the requirements of the applicable financial reporting framework –

(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 the 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.

If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with SA 705.

In the present case, auditor may consider modifying his opinion considering the financial effect of liability not disclosed properly.

QUESTION 4. **(5 marks)**

ABC Ltd. has been dealing in tyres since 1995. The Company envisaged to expand its business and wanted to manufacture the tyres besides trading. Accordingly, the machinery was imported, installed and manufacturing operations commenced. The Government also gave certain incentives like power subsidy, land acquisition subsidy, etc. After 2 years of operations, Company received a notice from the Income Tax authorities to pay tax on incentive received in the form of power subsidy. The demand notice was served for ` 150.00 Lakhs.

The Company, however, filed an appeal with higher tax authorities against the demand and the matter is undecided as on 31.03 .2021. Legal team of the Company anticipated that tax liability might mature. The Company has not made a provision of anticipated ta x liability. Considering the provisions of Companies Act, 2013, how an auditor of ABC Ltd. should see this matter and report in audit report, if required?

Ans. Audit report - Legal team anticipated tax liability but the company did not make any provision for that -

The Council of the Institute of Chartered Accountants of India has taken note of the fact that there is a practice prevalent whereby companies do not make provision for tax even when such a liability is anticipated. It has expressed the view that on an overall consideration of the relevant provisions of law, non-provision for tax (where a liability is anticipated) would amount to contravention of the provisions of Sections 128 and 129 of the Companies Act, 2013.

Accordingly, it is necessary for the auditor to qualify his report and such qualification should bring out the manner in which the accounts do not disclose a "true and fair" view of the state of affairs of the company and the profit or loss of the company.

Applying the above to the facts given in the question, auditor should qualify his report.

An example of the manner in which the report on the balance sheet and the Statement of Profit and Loss may be qualified in this respect is given below: "The company has not provided for taxation in respect of its profits and the estimated aggregate amount of taxation not so provided for is ` ....including.............for the Year ended on ....To the extent of such non-provision for the year, the profits of the Company for the financial year under report have been overstated and to the extent of such aggregate non-provision, the reserves of the company appearing in the said balance sheet have been over-stated and the current liabilities and provisions appearing in the said balance sheet have been understated".

QUESTION 5. **(5 marks)**

M/s SG & Co. Chartered Accountants were appointed as Statutory Auditors of XYZ Limited for the F.Y 2020-2021. The Company implemented internal controls for prevention and early detection of any fraudulent activity. Auditors carried out test of controls and found out no major observations. After the completion of audit, audit report was submitted by the auditors and audited results were issued. Fraud pertaining to the area of inventory came to light subsequently for the period covered by audit and auditors were asked to make submission as to why audit failed to identify such fraud. Auditors submitted that because of inherent limitations of audit, it is not possible to get persuasive evidence of certain matters like fraud. Do you think auditor made correct statement? Also discuss certain subject matters or assertions where it is difficult to detect material misstatements due to potential effects of inherent limitations.

Ans. Certain assertions or subject matters where it is difficult to detect material misstatements due to potential effects of inherent limitations –

As per SA 200 - "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" and as per SQC 1 because of 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 SAs.

Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less-than-persuasive audit evidence.

Whether the auditor has performed an audit in accordance with SAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in the light of the overall objectives of the auditor.

In view of above, it can be concluded that auditors did not give correct statement.

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

(i) Fraud, particularly fraud involving senior management or collusion.

(ii) The existence and completeness of related party relationships and transactions.

(iii) The occurrence of non-compliance with laws and regulations.

(iv) Future events or conditions that may cause an entity to cease to continue as a going concern.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