

## CA INTER SEP. 26 PRAYAS GURUKUL BATCH

### SUBJECT – AUDIT TEST (Solutions)

#### Topic : Chapter 7 & 9

**TIME : 1.5 Hrs.**

**M.M.: 50**

**Q1.** XYZ Ltd. appointed ABC & Co., Chartered Accountants, as the statutory auditors for the year ended 31 March 2025. During the course of audit, the auditor identified several misstatements relating to revenue recognition and inventory valuation.

The auditor communicated these misstatements to the appropriate level of management on a timely basis and requested management to correct them. However, management refused to correct certain misstatements stating that they were immaterial.

In this context, the auditor considered the importance of timely communication of misstatements to management and its impact on the evaluation of financial statements.

**Required:**

- (a) Explain the auditor's responsibility regarding communication of misstatements identified during the audit. [1.5 mark]
- (b) State the benefits of timely communication of misstatements to management. [2.5 marks]
- (c) What should the auditor do if management refuses to correct some or all of the misstatements? [2 marks]

**Answer:**

As per SA 450, the auditor has specific responsibilities regarding communication and evaluation of misstatements identified during the audit.

**(a) Communication of Misstatements to Management**

The auditor shall communicate on a timely basis all misstatements accumulated during the audit to the appropriate level of management, unless prohibited by law or regulation.

Further, the auditor shall request management to correct those misstatements.

**(b) Benefits of Timely Communication of Misstatements**

Timely communication of misstatements to management is important because it enables management to:

1. Evaluate whether the identified items are actually misstatements.
2. Inform the auditor if management disagrees with the auditor's view.
3. Take corrective action where necessary.

Further, correction of misstatements by management helps in:

- Maintaining accurate accounting books and records, and
- Reducing the risk of material misstatement in future financial statements arising from the cumulative effect of immaterial uncorrected misstatements relating to prior periods.

**(c) When Management Refuses to Correct Misstatements**

If management refuses to correct some or all of the misstatements, the auditor shall:

1. Obtain an understanding of management's reasons for not making the corrections; and
2. Take those reasons into account when evaluating whether the financial statements as a whole are free from material misstatement.

**Q2.** A government department has been allocated a budget for infrastructure development. During the audit, the auditor observes the following:

- (i) Some payments were processed without proper approval from the competent authority.
- (ii) A large-scale project was implemented, but no assessment has been made regarding the expected benefits were achieved or not.
- (iii) Funds were utilised from an account for which no budgetary provision was made.
- (iv) Certain expenditures were made without following the prescribed financial regulations.
- (v) There were instances of unnecessary spending that did not align with financial propriety.

Identify the different types of audits applicable to each of these observations.

**[5 Marks]**

**Answer: 1 mark for each point**

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

- (i) When payments are processed without proper approval from the competent authority, an Audit of Sanctions is required. This ensures that there is sanction, either special or general, accorded by competent authority authorising the expenditure.
- (ii) In cases where a large-scale project has been implemented without any assessment of whether the expected benefits were achieved, a Performance Audit is necessary. This type of audit ensures that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them.
- (iii) When funds were utilised from an account for which no budgetary provision was made, an Audit Against Provision of Funds is conducted. This ensures that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority.
- (iv) If expenditures are made without adhering to the prescribed financial regulations, an Audit Against Rules and Orders is applicable. This audit ensures that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority.
- (v) Instances of unnecessary spending that do not align with financial propriety fall under the scope of a Propriety Audit. It ensures that the expenditure is incurred with due regard to broad and general principles of financial propriety.

**Q3.** XYZ Ltd. is a listed company. During the audit, the auditor considered it necessary to communicate certain matters relating to auditor's independence to those charged with governance (TCWG). Accordingly, the auditor planned to provide a written communication confirming compliance with ethical requirements and details of relationships and fees charged for audit and non-audit services.

State the auditor's responsibilities in relation to communication of independence matters to those charged with governance in the case of listed entities. **[4 Marks]**

**Answer:**

In the case of listed entities, the auditor shall communicate with those charged with governance: -

- (a) A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence and [1 mark]
- (b) i. All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor and [2 mark]
- ii. The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level. [1 mark]

**Q4.** While auditing hire-purchase transactions of a business entity, the auditor needs to verify certain important aspects relating to the hire-purchase agreement and related payments. What matters should the auditor examine while checking such hire-purchase transactions? **[4 Marks]**

**Answer:**

While checking the hire- purchase transaction, the auditor may examine the following

- 1) Hire purchase agreement is in writing and is signed by all parties. [1 mark]
- 2) Hire purchase agreement specifies clearly- [2 mark]
  - a) The hire-purchase price of the goods to which the agreement relates;
  - b) The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;
  - c) The number of instalments by which the hire- purchase price is to be paid, the amount of each of those instalments, and the date, or the mode of determining the date, upon which it is payable.
  - d) The goods to which the agreement relates, in a manner sufficient to identify them.
- 3) Ensure that installment payments are being received regularly as per the agreement. [1 mark]

- Q5.** No inspection under Section 79 of Multi-State Co-operative Societies Act, 2002 shall be made unless a notice has been given to the multi-state co-operative society. Explain stating clearly when and how such inspection can be made. Also state the powers available with the Central Registrar in this regard along with provisions relating to communication of the inspection report under the said section. **[6 Marks]**

**Answer:**

Inspection of Multi-State Co-operative societies under Section 79

- 1) When: The Central Registrar may, on a request from [2 marks]
    - i. federal co-operative to which a Multi-State Co-operative society is affiliated or
    - ii. a creditor or
    - iii. not less than one-third of the members of the board or
    - iv. not less than one-fifth of the total number of members of a Multi-State co-operative society
  - 2) How: By general or special order in writing in this behalf inspect or direct any person authorized by him by order in writing in this behalf to make an inspection into the constitution, working and financial condition of a Multi-State co-operative society. [ 0 mark]
  - 3) Opportunity of being heard: No inspection shall be made unless a notice of not less than fifteen days has been given to the multi-state co-operative society. [1 marks]
  - 4) Powers available: The Central Registrar or the person authorized by him shall have the following powers: [ 2 marks]
    - a. He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and may, in the event of serious irregularities discovered during inspection, take them into custody and shall have power to verify the cash balance of the society and subject to the general or special order of the central registrar to call a meeting of the society where such general meeting is, in his opinion necessary.
    - b. Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.
  - 5) Inspection Report: A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection. [1 marks]
- Q6.** You have been appointed as an auditor of ABC Hotel, a three star hotel, for Financial Year 2022-23. As an auditor what are the special points that need to be considered in verifying the Inventories in the nature of food and beverages? **[5 Marks]**

**Answer: [ 1 mark for each point]**

Verification of inventories in the nature of food and beverages: The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores' areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed. Therefore, following may be noted in this regard:

- a) All movement and transfer of inventories must be properly documented.
- b) Areas where inventories are kept must be kept locked and the key retained by the departmental manager
- c) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.
- d) Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.
- e) The auditor should ensure that all inventories are valued at the year end and that he should himself be present at the year-end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories.

- Q7.** During the audit of XYZ Ltd., the auditor identified certain events and conditions such as continuous losses and liquidity problems which may cast significant doubt on the company's ability to continue as a going concern. Management has prepared the financial statements on a going concern basis and has also made certain disclosures regarding these conditions and their plans to overcome the situation.

In another situation, the auditor identified some adverse events, but based on the audit evidence obtained, he concluded that no material uncertainty exists regarding the entity's ability to continue as a going concern.

What should the auditor evaluate regarding the adequacy of disclosures in both the above situations? **[5 Marks]**

**Answer:**

1. When a material uncertainty exists:

If the auditor concludes that management's use of the going concern basis of accounting is appropriate but a material uncertainty exists, the auditor shall determine whether the financial statements:

- (a) Adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with those events or conditions. [2 mark]
- (b) Clearly disclose that a material uncertainty exists related to such events or conditions and that the entity may be unable to realize its assets and discharge its liabilities in the normal course of business. [1 mark]

2. When events or conditions exist but no material uncertainty exists: [2 mark]

If events or conditions are identified that may cast doubt on going concern but the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether the financial statements provide adequate disclosures about these events or conditions as required by the applicable financial reporting framework.

- Q8.** XYZ Ltd. appointed M & Co., Chartered Accountants, as the statutory auditors for the year ended 31 March 2025. During the course of audit, the auditor obtained various audit evidence regarding preparation of financial statements and information provided by management.

However, the auditor decided to obtain written representations from management regarding its responsibilities for preparation of financial statements and completeness of information provided to the auditor.

Further, the auditor also asked management to reconfirm its acknowledgement and understanding of its responsibilities, because the finance director who had originally signed the audit engagement letter had resigned during the year.

Explain why written representations about management responsibilities are necessary and whether the auditor's action of asking management to reconfirm its responsibilities is appropriate. [5 Marks]

**Answer:**

1. Need for Written Representations about Management Responsibilities

As per SA 580, written representations are necessary because audit evidence obtained during the audit is not sufficient without confirmation from management that it has fulfilled its responsibilities. [1 mark]

The reasons are as follows:

2. Confirmation of Management's Responsibilities

The auditor cannot conclude solely from other audit evidence that management has fulfilled its responsibilities regarding preparation and presentation of financial statements. [.5 mark]

3. Confirmation of Completeness of Information [1.5 mark]

The auditor cannot determine whether management has provided all relevant information and transactions unless management confirms the same.

4. Reconfirmation of Management's Responsibilities [2 marks]

The auditor may also ask management to reconfirm its acknowledgement and understanding of its responsibilities in written representations.

This is particularly appropriate when:

- 1. The persons who originally signed the audit engagement letter are no longer responsible.
- 2. The terms of engagement were prepared in a previous year.
- 3. There is indication that management misunderstands its responsibilities.
- 4. Changes in circumstances make reconfirmation appropriate.

5. Conclusion of the Case [1 mark]

In the given case, since the finance director who signed the engagement letter has resigned, the auditor's decision to obtain written representations and reconfirm management responsibilities is appropriate and in accordance with SA 580.

- Q9.** ABC Ltd. appointed PQR & Co., Chartered Accountants, as the statutory auditors for the year ended 31 March 2025. During the audit, the auditor identified several deficiencies in the internal control system of the company.

Some of the deficiencies were significant deficiencies, while others were less severe but still important for management's attention.

The auditor decided to communicate the significant deficiencies to TCWG in writing. Further, the auditor also planned to communicate certain deficiencies to management at an appropriate level of responsibility.

**Required:**

Explain the auditor's responsibility regarding communication of deficiencies in internal control identified during the audit to TCWG as well as Management. [5 Marks]

**Answer:**

As per SA 265, the auditor has the responsibility to communicate deficiencies in internal control identified during audit.

1. Communication to Those Charged With Governance (TCWG) [1 mark]  
The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.
2. Communication to Management  
The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis:
  - (a) Significant deficiencies in writing [2 marks]  
Significant deficiencies that the auditor has communicated or intends to communicate to TCWG should also be communicated to management in writing, unless it would be inappropriate to communicate directly to management in the circumstances.
  - (b) Other deficiencies [2 marks]  
Other deficiencies in internal control identified during the audit that have not been communicated by other parties and which, in the auditor's professional judgment, are important enough to merit management's attention, should also be communicated to management.

**Q10. Answer the following MCQs :** [1 Mark each]

1. Which of the following LLPs is required to get its accounts audited?
  - (a) Turnover ₹35 lakh and Contribution ₹30 lakh
  - (b) Turnover ₹50 lakh and Contribution ₹20 lakh
  - (c) Turnover ₹60 lakh and Contribution ₹30 lakh**
  - (d) Turnover ₹38 lakh and Contribution ₹24 lakh
2. During the audit of a government transport corporation, the auditor examined the financial as well as operational performance of the organisation. The audit focused on analysing whether the organisation was using its resources properly and also identified opportunities for improving economy, efficiency and effectiveness in its operations and programmes. The above situation represents which type of audit?
  - (a) Performance Audit
  - (b) Efficiency Audit
  - (c) Effectiveness Audit
  - (d) Efficiency-cum-Performance Audit**
3. While evaluating internal control deficiencies during an audit, the auditor considers several factors. Which of the following is not an indicator of a significant deficiency in internal control?
  - (a) Identification of management fraud that was not prevented by the entity's internal control.
  - (b) Evidence that management failed to implement remedial action on previously communicated significant deficiencies.
  - (c) Susceptibility to loss or fraud of the related asset or liability.**
  - (d) Evidence of management's inability to oversee the preparation of financial statements.
4. XYZ Ltd. had already issued its financial statements along with the auditor's report. Subsequently, a significant event was identified that required amendment of the previously issued financial statements. Accordingly, the financial statements were amended and the auditor issued a new auditor's report on the amended financial statements. In such circumstances, what should the auditor include in the new or amended auditor's report?
  - (a) A Key Audit Matter paragraph explaining the amendment of financial statements.
  - (b) An Emphasis of Matter or Other Matter paragraph referring to the note explaining the reason for amendment of previously issued financial statements and to the earlier auditor's report.**
  - (c) A Qualified Opinion explaining the amendment in financial statements.
  - (d) The auditor is not required to mention anything in the auditor's report regarding the amendment since management has already disclosed the matter in the financial statements.
5. Which of the following is not a feature of a Finance Lease?
  - (a) Substantially all risks and rewards relating to the asset are transferred to the lessee.
  - (b) Lease generally relates to long-term assets such as plant & machinery, land or office buildings.
  - (c) Ownership of the asset remains with the lessor for the entire lease period and there is normally no option of transfer to the lessee.**
  - (d) Lessee may have an option to acquire ownership of the asset at the end of the lease period.