CHAPTER 1

Auditing Standards, Statements and Guidance Notes – An Overview

The Council of the ICAI has issued following Quality Control and Engagement Standards

S. No.	No. of Standard	Title of the Standard	*Effective Date
1	SQC 1	Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements	April 1, 2009
2	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	April 1, 2010
3	SA 210	Agreeing the Terms of Audit Engagements	April 1, 2010
4	SA 220	Quality Control for an Audit of Financial Statements	April 1, 2010
5	SA 230	Audit Documentation	April 1, 2009
6	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements	April 1, 2009
7	SA 250	Consideration of Laws and Regulations in an Audit of Financial Statements	April 1, 2009
8	SA 260	Communication with Those Charged with Governance	April 1, 2009
9	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	April 1, 2010
10	SA 299	Responsibility of Joint Auditors	April 1, 1996
11	SA 300	Planning an Audit of Financial Statements	April 1, 2008
12	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment	April 1, 2008
13	SA 320	Materiality in Planning and Performing an Audit	April 1, 2010
14	SA 330	The Auditor's Responses to Assessed Risks	April 1, 2008
15	SA 402	Audit Considerations Relating to an Entity Using a Service Organization	April 1, 2010

16	*SA 450*	*Evaluation of Misstatements Identified during the Audits*	*April 1, 2010*
17	*SA 500*	*Audit Evidence*	*April 1, 2009*
18	*SA 501*	*Audit Evidence - Specific Considerations for Selected Items*	*April 1, 2010*
19	*SA 505*	*External Confirmations*	*April 1, 2010*
20	*SA 510*	*Initial Audit Engagements-Opening Balances*	*April 1, 2010*
21	*SA 520*	*Analytical Procedures*	*April 1, 2010*
22	*SA 530*	*Audit Sampling*	*April 1, 2009*
23	*SA 540*	*Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*	*April 1, 2009*
24	*SA 550*	*Related Parties*	*April 1, 2010*
25	*SA 560*	*Subsequent Events*	*April 1, 2009*
26	*SA 570*	*Going Concern*	*April 1, 2009*
27	*SA 580*	*Written Representations*	*April 1, 2009*
28	*SA 600*	*Using the Work of Another Auditor*	*April 1, 2002*
29	*SA 610*	*Using the Work of Internal Auditors*	*April 1, 2010*
30	*SA 620*	*Using the Work of an Auditor's Expert*	*April1, 2010*
31	*SA 700***	*Forming an Opinion and Reporting on Financial Statements*	*April 1, 2011*
32	*SA 705***	*Modifications to the Opinion in the Independent Auditor's Report*	*April 1, 2011*
33	*SA 706***	*Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*	*April 1, 2011*
34	*SA 710*	*Comparative Information – Corresponding Figures and Comparative Financial Statements*	*April 1, 2011*
35	*SA 720*	*The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements*	*April 1, 2010*
36	*SA 800*	*Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework*	*April 1, 2011*
37	*SA 805*	*Special Considerations-Audits of Single Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*	*April 1, 2011*
38	*SA 810*	*Engagements to Report on Summary Financial Statements*	*April 1, 2011*

39	*SRE 2400*	*Engagements to Review Financial Statements*	*April 1, 2010*
40	*SRE 2410*	*Review of Interim Financial Information Performed by the Independent Auditor of the Entity*	*April 1, 2010*
41	*SAE 3400*	*The Examination of Prospective Financial Information*	*April 1, 2007*
42	*SAE 3402*	*Assurance Reports on Controls At a Service Organisation*	*April 1, 2011*
43	*SRS 4400*	*Engagements to Perform Agreed Upon Procedures Regarding Financial Information*	*April 1, 2004*
44	*SRS 4410*	*Engagements to Compile Financial Information*	*April 1, 2004*

* *Effective date means that the SA is effective for audits of the financial statements for periods beginning on or after the specified date*

** *"The Council, in partial modification of the decision taken by it at its 291st meeting held in December, 2009, decided that the effective date/applicability of the following Standards on Auditing a) SA 700 (Revised), "Forming an Opinion and Reporting on Financial Statements";b) SA 705, "Modifications to the Opinion in the Independent Auditor's Report";c) SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" be postponed by one year and consequently the said Standards shall now be effective/applicable for audits of financial statements for periods beginning on or after 1st April, 2012 (instead of audits of financial statements for periods beginning on or after 1st April, 2011 as was earlier decided and referred to above).*

1.1 A brief summary of each Standard issued by AASB is given below:

1.1.1 Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements"

It is a mother Standard for all other Standards and is all pervasive Standard in respect of quality control. As the name suggests, the SQC 1 contains extensive requirements in relation to establishment and maintenance of a system of quality control (QC) in the audit firms as well as even for sole practitioners. The important elements of a system of quality control discussed by the Standard include Elements of a System of Quality Control, Leadership Responsibilities for Quality Within the Firm, Ethical Requirements – Independence, Acceptance and Continuation of Client Relationships and Specific Engagements, Human Resources - Assignment of Engagement Team, Engagement Performance - Consultation, Differences of Opinion, Engagement Quality Control Review and Documentation of the Engagement Quality Control Review - Engagement Documentation.

The Standard is recommendatory from April 1, 2008 and mandatory from April 1, 2009.

1.1.2 SA 200(Revised): Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing-it establishes the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with SAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the SAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the SAs. It has to be adapted as necessary in the circumstances when applied to audits of other historical financial information. This SA requires that the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

The SAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:

- *Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control (further expounded in SA 315 and SA 330).*
- *Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks (further expounded in SA 500 and SA 501).*
- *Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained (further expounded in SA 700, SA 705, SA 706 and SA 720).*

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.3 SA 210(revised): Agreeing the Terms of Audit Engagements- It is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 26, "Terms of Audit Engagements" issued by the Institute in 2003. The revised Standard deals with the auditor's responsibilities in agreeing the terms of audit engagement with management and, where appropriate, those charged with governance. SA 210 establishes certain preconditions for an audit, responsibility for which rests with management or those charged with governance. SA 210 also deals with the requirements relating to preconditions for an audit, agreement on audit engagement terms, recurring audits, acceptance of a change in the terms of the audit engagement and additional considerations in engagement acceptance. The appendices to revised SA 210 contain the illustrative example of an audit engagement letter and the factors determining the acceptability of general purpose frameworks.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.4 SA 220 (Revised): Quality Control for an Audit of Financial Statements- SA 220 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 17, "Quality Control for Audit Work" issued by the Institute in 1999. The revised Standard deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer. Revised SA 220 also deals with the aspects relating to leadership responsibilities for quality on audits, relevant ethical requirements, acceptance and continuance of client relationships and audit engagement, assignment of engagement teams, engagement performance, monitoring and documentation requirements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010

1.1.5 SA 230 (Revised): Audit Documentation: SA 230 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 3, "Documentation" issued by the Institute in 1985. The new Standard deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. SA 230 also deals with the requirements of timely preparation of audit documentation, documentation of the audit procedures performed and audit evidence obtained and assembly of the final audit file. SA 230 also outlines about vesting of property of working papers with the Auditor. SQC 1 read with SA 230 spells out two essential principles viz. period of maintaining working papers and assembly of audit file by the auditor.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.6 SA 240 (Revised): The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements-The Standard adopts a risk-based approach to auditor's responsibility relating to fraud in an audit of financial statements. It, therefore, explains how the principles enunciated in SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" and SA 330, "The Auditor's Responses to Assessed Risks" would be applied in case of consideration of fraud in an audit of financial statements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.7 SA 250 (Revised): Consideration of Laws and Regulations in an Audit of Financial Statements- SA 250 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 21, "Considerations of Laws and Regulations in an Audit of Financial Statements" issued by the Institute in 2001. The revised Standard deals with the auditor's responsibility to consider laws and regulations when performing an audit of financial statements. Revised SA 250 also deals with the effect of laws and regulations, responsibility of management for compliance with laws and regulations, responsibility of the auditor, audit procedures and reporting of identified or suspected non-compliance and documentation requirements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.8 SA 260 (Revised): Communication with Those Charged with Governance-SA 260 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 27, "Communications of Audit Matters with Those Charged with Governance" issued by the Institute in 2003. This Standard deals with the auditor's responsibility to communicate with those charged with governance in relation to an audit of financial statements. SA 260 also describes the requirements regarding communication with those charged with governance and regarding matter to be communicated and documentation required. This standard also spells out the distinction between the Management and Those Charged with Governance.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.9 SA 265: Communicating Deficiencies in Internal Control to Those Charged with Governance and Management-SA 265 is a new Standard on Auditing which deals with the auditor's responsibility to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified in an audit of financial statements. SA 265 defines the terms "Deficiency in internal control" and "Significant deficiency in internal control". This SA also deals with the aspects like determination of whether deficiencies in internal control have been identified, whether it is significant deficiencies in internal control and communicating deficiencies in internal control. This standard somehow supplements the concept of 'Letter of Weakness.'

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.10 SA 299: Responsibility of Joint Auditors - This SA deals with the professional responsibilities which the auditors undertake in accepting appointments as joint auditors. The SA, inter alia, lays down that the joint auditors should, normally, by mutual discussion, divide the audit work among themselves. The division of work among joint auditors as also the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity. The SA also states that each joint auditor is responsible only for the work allotted to him, whether or not he has prepared a separate report on the work performed by him. The SA describes the areas for which joint auditors are jointly and severally responsible. As per the SA, each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with generally accepted audit procedures. It also deals with the reporting responsibilities of the joint auditors. This standard very specifically states that the majority opinion would not be binding upon the other joint auditor(s)

The SA became effective for all audits relating to accounting periods commencing on or after April 1, 1996.

1.1.11 SA 300 (Revised): Planning an Audit of Financial Statements-This Standard on Auditing (SA) deals with the auditor's responsibility to plan an audit of financial statements. As per this SA the objective of the auditor is to plan the audit so that it will be performed in an effective manner.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

1.1.12 SA 315: Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment-The Standard deals with the auditor's responsibility to obtain an understanding of the entity and its environment and using that understanding to identify and assess the risks of material misstatement at the financial statement level and assertion level.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

1.1.13 SA 320 (Revised): Materiality in Planning and Performing an Audit-SA 320 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 13, "Audit Materiality" issued by the Institute in 1997. The revised Standard deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. This SA also deals with the requirements of determining materiality and performance materiality when planning the audit, revision as the audit progresses and documentation requirements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.14 SA 330: The Auditor's Responses to Assessed Risks-SA 330 is a new Standard on Auditing which deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with SA 315 at the financial statement level and assertion level. This SA also deals with the aspects relating to overall responses to assessed risks, audit procedures responsive to the assessed risks of material misstatement at the assertion level, adequacy of presentation and disclosure, evaluating the sufficiency and appropriateness of audit evidence and documentation requirements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2008.

1.1.15 SA 402 (Revised): Audit Considerations Relating to an Entity Using a Service Organisation -SA 402 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 24, "Audit Considerations Relating to Entities Using Service Organisations" issued by the Institute in 2002. The revised Standard deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organizations. SA 402 also deals with the aspects like obtaining an understanding of the services provided by a service organisation, including internal control, responding to the assessed risks of material misstatement, Type 1 and Type 2 reports, fraud, non-compliance with laws and regulations and uncorrected misstatements in relation to activities at the service organisation and reporting by the user auditor.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.16 SA 450: Evaluation of Misstatements Identified During the Audit-SA 450 is a new Standard on Auditing which deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. SA 450 defines the terms "Misstatement" and "Uncorrected misstatements". This SA also deals with the aspects like accumulation of identified misstatements, consideration of identified misstatements as the audit progresses, communication and correction of misstatements, evaluating the effect of uncorrected misstatements, written representation and documentation.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.17 SA 500 (Revised): Audit Evidence-SA 500 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 5, "Audit Evidence" issued by the Institute in 1988. The revised Standard is quite detailed in terms of audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. This SA also deals with the requirements of obtaining sufficient appropriate audit evidence, how information to be used as audit evidence, how to select items for testing to obtain audit evidence and procedures in case of inconsistency in, or doubts over reliability of, audit evidence.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.18 SA 501 (Revised): Audit Evidence—Specific Considerations for Selected Items-SA 501 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 34, "Audit Evidence – Additional Considerations for Specific Items" issued by the Institute in 2005. The revised Standard deals with specific considerations by the auditor in obtaining sufficient appropriate audit evidence in accordance with SA 330, SA 500 (Revised) and other relevant SAs, with respect to certain aspects of inventory, litigation and claims involving the entity, and segment information in an audit of financial statements. Revised SA 501 also deals with the requirements and application of the aspects relating to inventory, litigation and claims and segment information.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.19 SA 505 (Revised): External Confirmations-SA 505 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 30, "External Confirmations" issued by the Institute in 2003. The revised Standard deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of SA 330. Revised SA 505 also deals with the requirements and application of the aspects relating to external confirmation procedures, management's refusal to allow the auditor to send a confirmation request, results of the external confirmation procedures, negative confirmations and evaluating the evidence obtained.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.20 SA 510 (Revised): Initial Audit Engagements- Opening Balances-SA 510 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 22, "Initial Engagements- Opening Balances" issued by the Institute in 2001. The revised Standard establishes the principles regarding audit of opening balances in case of initial engagements, i.e., when the financial statements are audited for the first time or when the financial statements for the preceding period were audited by another auditor. This SA also deals with the audit procedures and audit conclusions and reporting requirements in case of initial audit engagements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.21 SA 520 (Revised): Analytical Procedures-SA 520 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 14, "Analytical Procedures" issued by the Institute in 1997. The revised Standard deals with the auditor's use of analytical procedures as substantive procedures ("substantive analytical procedures"), and as procedures near the end of the audit that assist the auditor when forming an overall conclusion on the financial statements. Revised SA 520 also deals with the requirements and application of the aspects relating to substantive analytical procedures, analytical procedures that assist when forming an overall conclusion and investigating results of analytical procedures.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.22 SA 530 (Revised): Audit Sampling-SA 530 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 15, "Audit Sampling" issued by the Institute in 1998. The revised Standard applies when the auditor has decided to use audit sampling in performing audit procedures. It also deals with the auditor's use of statistical and non-statistical sampling when designing and selecting the audit sample, performing tests of controls and tests of details, and evaluating the results from the sample. This SA also deals with the requirements relating to sample design, size and selection of items for testing, performing audit procedures, nature and cause of deviations and misstatements, projecting misstatements and evaluating results of audit sampling. This SA contains four Appendices also.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.23 SA 540 (Revised): Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures- SA 540 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 18, "Audit of Accounting Estimates" issued by the Institute in 2000. The revised Standard deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how SA 315 and SA 330 and other SAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias. Considering the application of Ind AS/ IFRS in times to come and resulting estimates to made, this Standard assumes special significance for the auditors

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.24 SA 550 (Revised): Related Parties-SA 550 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 23, "Related Parties" issued by the Institute in 2001. The revised Standard deals with the auditor's responsibilities regarding related party relationship and transactions when performing an audit of financial statements. This standard also deals with the risk assessment procedures and related activities, identification and assessment of the risks of material misstatement associated with related party relationships and transactions, responses to the risks of material misstatement associated with related party relationships and transactions and evaluation of the accounting for and disclosure of identified related party relationships and transactions etc.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.25 SA 560 (Revised): Subsequent Events-SA 560 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 19, "Subsequent Events" issued by the Institute in 2000. The revised Standard deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. SA 560 also deals with the events occurring between the date of the financial statements and the date of the auditor's report, facts which become known to the auditor after the date of the auditor's report but before the date the financial statements are issued and facts which become known to the auditor after the financial statements have been issued.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.26 SA 570 (Revised) Going Concern-SA 570 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 16, "Going Concern" issued by the Institute in 1998. The revised Standard is quite detailed in terms of auditor's responsibility in the audit of financial statements with respect to management's use of the going concern assumption in the preparation and presentation of the financial statements. SA 570 requires the auditor to inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern. SA 570 also deals with the requirements of risk assessment procedures and related activities, evaluating management's assessment, additional procedures, audit conclusions and reporting, use of going concern assumption etc. The standard also discusses the principles when mitigating factors are present vis-à-vis Going Concern of the enterprise.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.27 SA 580 (Revised): Written Representations-SA 580 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 11, "Representations by Management" issued by the Institute in 1996. The revised Standard is quite detailed in terms of the duties and objectives of the auditors regarding the acknowledgement by the management that it is fulfilling its responsibility relating to preparation and presentation of financial statements and internal controls, the various forms of management representations, situations where management representations are unreliable or where the management refuses to provide requested representations.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2009.

1.1.28 SA 600 (Revised) : Using the Work of Another Auditor - This SA discusses the procedures to be applied in situations where an independent auditor reporting on the financial statements of an entity, uses the work of an independent auditor with respect to the financial statements of one or more divisions or branches included in the financial statement of the entity. The Statement also discusses the principal auditor's responsibility in relation to his use of the work of other auditor. This Standard becomes operative for all audits relating to accounting periods beginning on or after April 1, 1995.

When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit.

The auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor.

When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.

The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment.

The principal auditor should consider the significant findings of the other auditor.

There should be sufficient liaison between the principal auditor and the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor.

When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/ branches/subsidiaries or other components audited by other auditors.

1.1.29 SA 610: Using the work of Internal Auditors: SA 610 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 7, "Relying Upon the Work of an Internal Auditor" issued by the Institute in 1989. The revised Standard deals with the external auditor's responsibilities regarding the work of internal auditors. This SA also defines the terms "Internal audit function" and "Internal auditors". SA 610 also deals with the aspects like determining whether and to what extent to use the work of the internal auditors, using specific work of the internal auditors and documentation.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.30 SA 620 (Revised): Using the Work of an Auditor's Expert-SA 620 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 9 "Using the Work of An Expert" issued by the Institute in 1991. The revised Standard deals with the auditor's responsibilities regarding the use of an individual or organisation's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence. Revised SA 620 also deals with the requirements and application of the aspects relating to determining the need for an auditor's expert, nature, timing and extent of audit procedures, the competence, capabilities and objectivity of the auditor's expert, obtaining an understanding of the field of expertise of the auditor's expert, agreement with the auditor's expert, evaluating the adequacy of the auditor's expert's and reference to the auditor's expert in the auditor's report. This standard should be read in conjunction with SA 500 because Expert's opinion also serves as audit evidence in appropriate cases.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.31 SA 700 (Revised): Forming an Opinion and Reporting on Financial Statements-SA 700 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 28, "The Auditor's Report on Financial Statements" issued by the Institute in 2003. The revised Standard deals with the auditor's responsibilities to form an opinion on the financial statements and the form and content of the auditor's report issued as a result of an audit of financial statements. Revised SA 700 also deals with the requirements relating to forming an opinion on the financial statements, form of opinion, auditor's report, supplementary information presented with the financial statements and the application guidance of these aspects. Appendix to revised SA 700 also contains the Illustrative Formats of Auditors' Reports on Financial Statements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

1.1.32 SA 705: Modifications to the Opinion in the Independent Auditor's Report. This Standard on Auditing (SA) deals with the 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 objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that are necessary when:

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

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

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

1.1.33 SA 706: Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report -It deals with additional communication in the auditor's report when the auditor considers it necessary to: Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report. Other Standards on Auditing (SAs) may contain specific requirements for the auditor to include Emphasis of Matter paragraphs or Other Matter paragraphs in the auditor's report. In those circumstances, the requirements in this SA regarding the form and placement of such paragraphs apply. The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or

(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

1.1.34 SA 710 (Revised): Comparative Information—Corresponding Figures and Comparative Financial Statements-SA 710 is a revised version of the erstwhile Auditing and Assurance Standard (AAS) 25, "Comparatives" issued by the Institute in 2002. The revised Standard deals with the auditor's responsibilities regarding comparative information in an audit of financial statements. This SA defines the terms 'Corresponding figures', 'Comparative information' and 'Comparative financial statements'. Revised SA 710 also deals with the requirements and application of the aspects relating to audit procedures and audit reporting relating to Corresponding Figures and Comparative Financial Statements. Appendix to revised SA 710 contains the 'Example of Auditors' Reports'.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

1.1.35 SA 720: The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements-This Standard on Auditing (SA) deals with the auditor's responsibility regarding other information in documents containing audited financial statements and the auditor's report thereon. As per SA 720 the objective of the auditor is to respond appropriately when documents containing audited financial statements and the auditor's report thereon include other information that could undermine the credibility of those financial statements and the auditor's report. This SA also deals with the requirements related to reading other information, material inconsistencies and material misstatements of fact.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2010.

1.1.36 SA 800: Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks- This SA deals with special considerations in the application of those SAs to an audit of financial statements prepared in accordance with a special purpose framework. It does not override the requirements of the other SAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement. The objective of the auditor, when applying SAs in an audit of financial statements prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to:

(a) The acceptance of the engagement;

(b) The planning and performance of that engagement; and

(c) Forming an opinion and reporting on the financial statements.

This SA is effective for audits of financial statements for periods beginning on or after April 1, 2011.

1.1.37 SA 805: Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement-This SA deals with special considerations in the application of those SAs to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, SA 800 also applies to the audit. It does not apply to the report of a component auditor, issued as a result of work performed on the financial information of a component at the request of a group engagement team for purposes of an audit of group financial statements. Further it does not override the requirements of the other SAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement. The objective of the auditor, when applying SAs in an audit of a single financial statement or of a specific element, account or item of a financial statement, is to address appropriately the special considerations that are relevant to:

(a) The acceptance of the engagement;
(b) The planning and performance of that engagement; and
(c) Forming an opinion and reporting on the single financial statement or on the specific element, account or item of a financial statement.

This SA is effective for audits of single financial statements or of specific elements, accounts or items for periods beginning on or after April 1, 2011. In the case of audits of single financial statements or of specific elements, accounts or items of a financial statement prepared as at a specific date, this SA is effective for audits of such information prepared as at a date on or after April 1, 2011.

1.1.38 SA 810: Engagements to Report on Summary Financial Statements- This SA deals with the auditor's responsibilities when undertaking an engagement to report on summary financial statements derived from financial statements audited in accordance with SAs by that same auditor. The objectives of the auditor are to:

(a) Determine whether it is appropriate to accept the engagement to report on summary financial statements;
(b) Form an opinion on the summary financial statements based on an evaluation of the conclusions drawn from the evidence obtained; and
(c) Express clearly that opinion through a written report that also describes the basis for that opinion.

The auditor shall, ordinarily, accept an engagement to report on summary financial statements in accordance with this SA only when the auditor has been engaged to conduct an audit in accordance with SAs of the financial statements from which the summary financial statements are derived.

Before accepting an engagement to report on summary financial statements, the auditor shall

(a) Determine whether the applied criteria are acceptable;

(b) Obtain the agreement of management that it acknowledges and understands its responsibility:

i. For the preparation of the summary financial statements in accordance with the applied criteria;
ii. To make the audited financial statements available to the intended users of the summary financial statements without undue difficulty (or, if law or regulation provides that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements, to describe that law or regulation in the summary financial statements); and
iii. To include the auditor's report on the summary financial statements in any document that contains the summary financial statements and that indicates that the auditor has reported on them.

(c) Agree with management the form of opinion to be expressed on the summary financial statements.

If the auditor concludes that the applied criteria are unacceptable or is unable to obtain the agreement of management set out above, the auditor shall not accept the engagement to report on the summary financial statements, unless required by law or regulation to do so. An engagement conducted in accordance with such law or regulation does not comply with this SA. Accordingly, the auditor's report on the summary financial statements shall not indicate that the engagement was conducted in accordance with this SA. The auditor shall include appropriate reference to this fact in the terms of the engagement. The auditor shall also determine the effect that this may have on the engagement to audit the financial statements from which the summary financial statements are derived.

This SA is effective for engagements for periods beginning on or after April 1, 2011.

1.1.39 SRE 2400: Engagements to Review Financial Statements – The purpose of this Standard on Review Engagements (SRE) is to establish standards and provide guidance on the practitioner's professional responsibilities when a practitioner, who is not the auditor of an entity, undertakes an engagement to review financial statements and on the form and content of the report that the practitioner issues in connection with such a review. A practitioner, who is the auditor of the entity, engaged to perform a review of interim financial information performs such a review in accordance with SRE 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity". Consequent upon the requirements of Clause 41 of the Listing Agreement, this Standard also comes handy to the members of ICAI engaged as Reviewers of Financial Statements

This SRE is directed towards the review of financial statements. However, it is to be applied, adapted as necessary in the circumstances, to engagements to review other historical financial information. Guidance in the Standards on Auditing (SAs) may be useful to the practitioner in applying this SRE.

The objective of a review of financial statements is to enable a practitioner to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework (negative assurance).

This SRE is effective for reviews of financial statements for periods beginning on or after April 1, 2010.

1.1.40 SRE 2410: Review of Interim Financial Information Performed by the Independent Auditor of the Entity– The purpose of this Standard on Review Engagements (SRE) is to establish standards and provide guidance on the auditor's professional responsibilities when the auditor undertakes an engagement to review interim financial information of an audit client, and on the form and content of the report. The term "auditor" is used throughout this SRE, not because the auditor is performing an audit function but because the scope of this SRE is limited to a review of interim financial information performed by the independent auditor of the financial statements of the entity.

For purposes of this SRE, interim financial information is financial information that is prepared and presented in accordance with an applicable financial reporting framework2 and comprises either a complete or a condensed set of financial statements for a period that is shorter than the entity's financial year.

This SRE is effective for reviews of interim financial information for periods beginning on or after April 1, 2010.

1.1.41 SAE 3400: The Examination of Prospective Financial Information-The purpose of this Standard on Assurance Engagement (SAE) is to establish standards and provide guidance on engagements to examine and report on prospective financial information including examination procedures for best-estimate and hypothetical assumptions. This SAE does not apply to the examination of prospective financial information expressed in general or narrative terms, such as that found in management's discussion and analysis in an entity's annual report, though many of the procedures outlined herein may be suitable for such an examination. Here it would be worthwhile to mention that Clause 3 of Part I of Second Schedule to the Chartered Accountants Act, 1949 as amended states that a member of ICAI into practice shall be deemed guilty of professional misconduct if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in manner which may lead to the belief that he vouches for the accuracy of the forecast.

In an engagement to examine prospective financial information, the auditor1 should obtain sufficient appropriate evidence as to whether:

(a) management's best-estimate assumptions on which the prospective financial information is based are not unreasonable and, in the case of hypothetical assumptions, such assumptions are consistent with the purpose of the information;
(b) the prospective financial information is properly prepared on the basis of the assumptions;
(c) the prospective financial information is properly presented and all material assumptions are adequately disclosed, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions; and
(d) the prospective financial information is prepared on a consistent basis with historical financial statements, using appropriate accounting principles.

The auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

This SAE is effective in relation to reports on projections/forecasts, issued on or after April 1, 2007.

1.1.42 SAE 3402- Assurance Reports on Controls at a Service Organisation : This Standard on Assurance Engagements (SAE) deals with assurance engagements undertaken by a professional accountant in public practice to provide a report for use by user entities and their auditors on the controls at a service organization that provides a service to user entities that is likely to be relevant to user entities' internal control as it relates to financial reporting. It complements SA 402, in that reports prepared in accordance with this SAE are capable of providing appropriate evidence under SA 402.

[1] The term "auditor" is used throughout this SAE when describing services involving examination of prospective financial information. Such reference is not intended to imply that a member performing such services need necessarily be the statutory auditor of the entity's financial statements.

This SAE only deals with assertion-based engagements that convey reasonable assurance, with the assurance conclusion worded directly in terms of the subject matter and the criteria.

This SAE applies only when the service organization is responsible for, or otherwise able to make an assertion about, the suitable design of controls.

This SAE is effective for service auditors' assurance reports covering periods ending on or after April 1, 2011.

1.1.43 SRS 4400: Engagements to Perform Agreed-upon Procedures regarding Financial Information - The purpose of this Standard on Related Services is to establish standards and provide guidance on the auditor's professional responsibilities when an engagement to perform agreed-upon procedures regarding financial information is undertaken and on the form and content of the report that the auditor issues in connection with such an engagement.

The objective of an agreed-upon procedures engagement is for the auditor to carry-out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.

The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.

The auditor should carry out the procedures agreed-upon and use the evidence obtained as the basis for the report of factual findings.

The procedures applied in an engagement to perform agreed-upon procedures may include:

- *Inquiry and analysis*
- *Recomputation, Comparison and other clerical accuracy checks*
- *Observation*
- *Inspection*
- *Obtaining confirmations*

The report on an agreed-upon procedures engagement needs to describe the purpose and the agreed-upon procedure of the engagement in sufficient detail to enable the reader to understand the nature and the extent of the work performed. The report should also clearly mention that no audit or review has been performed.

This Standard on Related Services is applicable to all agreed-upon procedures engagements beginning on or after April 1, 2004.

1.1.44 SRS4410: Engagements to Compile Financial Information - The purpose of this Standard on Related Services (SRS) is to establish Standards on professional responsibilities of an accountant when an engagement to compile financial statements or other financial information is undertaken and the form and content of the report to be issued in connection with such a compilation so that the association of the name of the accountant with such financial statements or financial information is not misconstrued by a user of those statements or information as having been audited by him.

In all circumstances when an accountant's name is associated with financial information compiled by him, the accountant should issue a report.

The accountant should obtain an acknowledgement from management of it responsibility for the accuracy and completeness of the underlying accounting data and the complete disclosure of all material and relevant information.

It is in the interest of both the accountant and the entity that the accountant sends an engagement letter documenting the key terms of appointment. An engagement letter confirms the accountant's acceptance of the engagement and helps avoid misunderstanding regarding matters such as the objective and scope of the engagement and the extent of auditors responsibilities.

The accountant should read the complied information and consider whether it appears to be appropriate in form and free from obvious material misstatements.

If the accountant becomes aware of material non-compliance with any applicable Accounting Standard (s), the same should be brought to the attention of management and, if the same is not rectified by the management, it should be included in the Notes to Accounts and the compilation report of the accountant.

The financial statements on other financial information compiled should be approved by the client before the compilation report is signed by the accountant.

This Standard on Related Services (SRS) is applicable to all compilation engagements beginning on or after April 1, 2004.

(Students may note that the Framework of Standards, Engagement and Quality Control Standards and Guidance Notes on Related Services are reproduced in Volume II to the book)

Question 1

"The auditors need not review accounting policies unless there is a change in the basis of accounting". Comment.

Answer

The auditor while conducting an audit should critically examine the accounting policies adopted by the client and test them for conformity with the accounting standards and recommendations of the Institute. The Companies Act, 1956 as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes a 'true and fair' view has not been defined either in the Companies Act, 1956 or in any other statute. The pronouncements of the Institute seek to describe the accounting principles and the methods of applying these principles in the preparation and presentation of financial statements so that they give a true and fair view. The 'Preface to the Statements of Accounting Standards' issued

by the Institute in 1979 states as under:

"While discharging their attest function, it will be the duty of the members of the Institute to ensure that the Accounting Standards are implemented in the presentation of financial statements covered by their audit reports. In the event of any deviation from the Standards, it will be also their duty to make adequate disclosures in their reports so that the users of such statements may be aware of such deviations."

In cases where no pronouncement of the Institute exists, the auditor should examine the acceptability of the said accounting policy. The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated. It is also quite clear that there is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgement by the management of the enterprise. The auditor is further required to determine whether the relevant information is properly disclosed in the financial statements by considering the judgements that management has made in preparing the financial statements; accordingly, the auditor assesses the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

Thus, the auditor should determine himself as to whether or not the said treatment is consistent with the basic principles of accounting. Therefore, it would not be correct to state that the auditor need not review the accounting policies unless there is a change in the basis of accounting.

Question 2

Briefly describe the auditor's responsibility regarding subsequent events.

Answer

Subsequent Events and Auditor's Responsibility: When the auditor draws up his audit plan, checking of subsequent events is an important audit procedure irrespective of the level of test checks employed for checking of the transactions during the year. In fact more detailed check is normally required for subsequent events to confirm certain assertions contained in the financial statements, e.g., the payment made by debtors after the close of accounting period would confirm that outstanding debtors on the date of the balance sheet date have been realised. SA 560 on "Subsequent Events" establishes standards on the auditor's responsibility regarding subsequent events. SA 560 on "Subsequent Events" states that the term "subsequent events" refers to events occurring between the date of the financial statements and the date of the auditor’s report, and facts that become known to the auditor after the date of the auditor’s report.. AS 4 on " Contingencies and Events Occurring after the

Balance Sheet Date" deals with all those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and by the corresponding approving authority in the case of any other entity. As per AS 4, two types of events can be identified:(a) those which provide further evidence of conditions that existed at the balance sheet date; and (b) those which are indicative of conditions that arose subsequent to the balance sheet date. SA 560 lays down that the auditor should consider the effect of subsequent events on the financial statements and on the auditor's report. When the time between the close of the year-end and the adoption of accounts is about to take place, examination of subsequent events gains more importance.

SA 560 further requires that the auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity's latest subsequent interim financial statements, if any.

When, as a result of the procedures performed above, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

Question 3

Briefly describe how an auditor can use the work of an auditor's expert.

Answer

Using the Work of an Auditor's Expert: As per "SA 620 Using the Work of an Auditor's Expert", the auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's

purposes, including: The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence; If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and

If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

Specific procedures to evaluate the adequacy of the auditor's expert's work for the auditor's purposes may include:

- Inquiries of the auditor's expert.
- Reviewing the auditor's expert's working papers and reports.
- Corroborative procedures, such as:
    - Observing the auditor's expert's work;
    - Examining published data, such as statistical reports from reputable, authoritative sources;
    - Confirming relevant matters with third parties;
    - Performing detailed analytical procedures; and
    - Re-performing calculations.
- Discussion with another expert with relevant expertise when, for example, the findings or conclusions of the auditor's expert are not consistent with other audit evidence.
- Discussing the auditor's expert's report with management.

Relevant factors when evaluating the relevance and reasonableness of the findings or conclusions of the auditor's expert, whether in a report or other form, may include whether they are:

- Presented in a manner that is consistent with any standards of the auditor's expert's profession or industry;
- Clearly expressed, including reference to the objectives agreed with the auditor, the scope of the work performed and standards applied;
- Based on an appropriate period and take into account subsequent events, where relevant;
- Subject to any reservation, limitation or restriction on use, and if so, whether this has implications for the auditor; and
- Based on appropriate consideration of errors or deviations encountered by the auditor's expert.

If after performing all these procedures the auditor concludes that the work of the expert is not consistent with the information in the financial statements or that it does not constitute sufficient appropriate audit evidence, the auditor should express a qualified, disclaimer or an adverse opinion. In other cases, the opinion has to be unqualified. If while giving his report the auditor considers it appropriate to disclose the identity of the expert, he should obtain his prior consent.

Question 4

Write short notes on the following:

(a) Financial indications to be considered for evaluating the assumption of going concern

(b) Auditor's responsibilities regarding comparatives.

(c) Sampling Risk

(d) Reporting on a compilation engagements

Answer

(a) Financial Indications and Going Concern: SA 570 on "Going Concern", aims to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements. The following are the financial indications be considered:

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

(b) Auditor's responsibilities regarding comparatives: SA 710, "Comparative Information – Corresponding Figures and Comparative Financial Statements", establishes standards on the auditor's responsibilities regarding comparatives.

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

(a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and

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

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560 (Revised).

As required by SA 580 (Revised), the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

(c) Sampling Risk: As per SA 530 "Audit Sampling", the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

(d) Reporting on a compilation engagements: SA 4410 "Engagements to Compile Financial Information", the report on compilation engagements should, ordinarily, be in the following lay out:

(a) *Title*: The title of the report should be "Accountant's Report on Compilation of Unaudited Financial Statements" (and not "Auditor's Report");

(b) *Addressee*: The report should ordinarily be addressed to the appointing authority;

(c) Identification of the financial information also noting that it is based on the information provided by the management;

(d) When relevant, a statement that the accountant is not independent of the entity;

(e) A statement that the management is responsible for:

- completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant;
- maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;
- preparation and presentation of financial statements or other financial information in accordance with the applicable laws and regulations, if any;
- establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities;
- establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non-compliance;

(f) A statement that the engagement was performed in accordance with this Standard on Related Services;

(g) A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information;

(h) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework;

(i) Date of the report;

(j) Place of signature; and

(k) Accountant's signature

The financial statements or other financial information compiled by the accountant should contain a reference such as "Unaudited," "Compiled without Audit or Review" and also "Refer to Compilation Report" on each page of the financial information or on the front of the complete set of financial statements.

Question 5

Explain what is meant by "Written Representations" and indicate to what extent an auditor can place reliance on such representations.

Answer

Written Representation: A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Thus written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement. Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report. The written representations shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations, the relevant matters covered by such statements need not be included in the representation letter.

Extent of Reliance: SA 580, "Written Representations", states that If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general.

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and

audit evidence in general. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

Question 6

How can an Auditor identify Related Parties?

Answer

Identification of Related Parties: The duties of an auditor with regard to reporting of transactions with related parties as required by Accounting Standard 18 are given in SA 550 on Related Parties. As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. Since it is the management, which is primarily responsible for identification of related parties, SA 550 requires that to identify names of all known related parties, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example:

- Entity income tax returns.
- Information supplied by the entity to regulatory authorities.
- Shareholder registers to identify the entity's principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity's investments and those of its pension plans.
- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity's ordinary course of business.
- Specific invoices and correspondence from the entity's professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Internal auditors' reports.
- Documents associated with the entity's filings with a securities regulator (e.g, prospectuses).

  Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions

  An arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as:

- The establishment of a business relationship through appropriate vehicles or structures.
- The conduct of certain types of transactions under specific terms and conditions.

- The provision of designated services or financial support.

  Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include:

- Participation in unincorporated partnerships with other parties.
- Agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business.
- Guarantees and guarantor relationships.

  Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement. In addition, the auditor needs to be alert for transactions which appear unusual in the circumstances and which may indicate the existence of previously unidentified related parties. Examples of transactions outside the entity's normal course of business may include:

  - Complex equity transactions, such as corporate restructurings or acquisitions.
  - Transactions with offshore entities in jurisdictions with weak corporate laws.
  - The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
  - Sales transactions with unusually large discounts or returns.
  - Transactions with circular arrangements, for example, sales with a commitment to repurchase.
  - Transactions under contracts whose terms are changed before expiry.

  Finally, the auditor should also obtain a written representation from the management concerning the completeness of information provided regarding the identifications of related parties.

Question 7

"There should be sufficient liaison between a principal auditor and other auditors". Discuss the above statement and state in this context the reporting considerations, when the auditor uses the work performed by other auditor.

Answer

SA 600 on "Using the Work of Another Auditor" lays down the procedure to be applied in situations where a principal auditor reporting on the financial statement of the entity uses the work of another independent auditor. SA 600 contemplates coordination between auditors and requires that there should be sufficient liaison between the principal auditor and the other

auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor. For example, by bringing to the principal auditor's immediate attention any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, the principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties. The other auditor should respond to such questionnaire on a timely basis.

When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

In all circumstances, if the other auditor issues, or intends to issue, a modified auditor's report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting that it requires a modification of the principal auditor's report

Question 8

As a Statutory Auditor, how would you deal with the following?

(a) While commencing the statutory audit of B Company Limited, the auditor undertook the risk assessment and found that the detection risk relating to certain class of transactions cannot be reduced to acceptance level.

(b) While auditing accounts of a public limited company for the year ended 31st March 2010, an auditor found out an error in the valuation of inventory, which affects the financial statement materially – Comment as per standards on auditing.

Answer

(a) Assessment of Risk and Acceptable Level: SA 315 and SA 330 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" and "The Auditor's Responses to Assessed Risks" establishes standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk. SA 315 and SA 330 require that the auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is

reduced to an acceptably low level. "Detection risk" is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material. The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. The auditor should use his professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. If it cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.

(b) Errors in Valuation of Inventories and Auditor's Responsibilities: SA 240, "The Auditor's Responsibilities Relating Fraud in an Audit of Financial Statements", requires that if circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. SA 240 also requires that when the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence .Further, SA 320 Materiality in Planning and Performing an Audit, also requires that in such circumstances, the auditor should consider requesting the management to adjust the financial information or consider extending his audit procedures. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate. In the instant case, the auditor has detected the material errors affecting the financial statements; the auditor should communicate his findings to the management on a timely basis, consider the implications on true and fair view and also ensure that appropriate disclosures have been made.

Question 9

An auditor of Sagar Ltd. was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Is he right in his approach?

Answer

Validity of Written Representation: The physical verification of fixed assets is the primary responsibility of the management. The auditor, however, is required to examine the verification

programme adopted by the management. He must satisfy himself about the existence, ownership and valuation of fixed assets. In the case of Sagar Ltd., the auditor has not been able to verify the existence and value of some machinery despite the verification procedure followed in routine audit. He accepted the certificate given to him by the management without making any further enquiry. As per SA 580, when representation relate to matters which are material to the financial information, then the auditor should seek corroborative audit evidence for other sources inside or outside the entity. He should evaluate whether such representations are reasonable and consistent with other evidences and should consider whether individuals making such representations can be expected to be well informed on the matter. "Written Representations" cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter, which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter. Therefore, the approach adopted by the auditor is not right.

Question 10

(a) What are 'Initial Audit Engagements'?

(b) In an initial audit engagement the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow in when the financial statements are audited for the preceding period by another auditor

(c) If, after performing the procedure, you are not satisfied about the correctness of 'Opening Balances'; what approach you will adopt in drafting your audit report in situation mentioned in (b) above?

Answer

(a) Initial Audit Engagement – Opening Balances: As per SA 510 'Initial Audit Engagements - Opening Balances' initial audit engagement is an engagement in which either:

(i) The financial statements for the prior period were not audited; or

(ii) The financial statements for the prior period were audited by a predecessor auditor

(b) Financial Statements Audited by another Auditor – Audit Procedure: If the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated

(c) Drafting Audit Report: If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate. Further, If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion

Question 11

Enumerate the 'Basic Elements of Audit Report' as enshrined in SA 700.

Answer

Basic Elements of Auditor's Report: As per SA 700, "Forming an Opinion and Reporting on Financial Statements", the auditor's report includes the following basic elements:

(a) A title;

(b) An addressee, as required by the circumstances of the engagement;

(c) An introductory paragraph that identifies the financial statements audited;

(d) A description of the responsibility of management (or other appropriate term) for the preparation of the financial statements;

(e) A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:

- A reference to Standards on Auditing and the law or regulation; and
- A description of an audit in accordance with those Standards;

(f) An opinion paragraph containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements (including identifying the jurisdiction of origin of the financial reporting framework);

(g) The auditor's signature;

(h) The date of the auditor's report; and

(i) The place of signature.

Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards issued by the Institute of Chartered Accountants of India and International Standards on Auditing.

Question 12

Write a short note on Responsibility of Joint Auditors .

Answer

Responsibility of Joint Auditors: SA 299 on, "Responsibility of Joint Auditors" deals with the professional responsibilities, which the auditors undertake in accepting such appointments as

joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act, 1956. Main features of the said SA are discussed below:

- *Division of Work:* Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.
- *Coordination:* Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.

(c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

(f) it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.

(g) the responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.

(h) each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

Question 13

As a Statutory Auditor, how would you deal with the following?

(a) The Managing Director of the Company has committed a "Teeming and Lading" Fraud. The amount involved has been however subsequently after the year end deposited in the company.

(b) The accountant of C Ltd. has requested you, not to send balance confirmations to a particular group of debtors since the said balances are under dispute and the matter is pending in the court.

Answer

(a) Fraud Committed by Managing Director: The Managing Director of the company has committed a "Teeming and Lading" fraud. The fact that the amount involved has been subsequently deposited after the year end is not important because the auditor is required to perform his responsibilities as laid down in SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements". First of all, as per SA 240, the auditor needs to perform procedures whether the financial statements are materially misstated. Because an instance of fraud cannot be considered as an isolated occurrence and it becomes important for the auditor to perform audit procedures and revise the audit risk assessment. Secondly, the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. Thirdly, the auditor should communicate the matter to the Chairman and Board of Directors. Finally, in view of the fact that the fraud has been committed at the highest level of management, it affects the reliability of audit evidence previously obtained since there is a genuine doubt about representations of management. Finally, the auditor shall have to report under CARO, 2003 indicating the nature and amount involved in respect of fraud noticed during the year.

(b) External confirmation Requests: SA 505, "External Confirmations", establishes standards on the debtor's use of external confirmation as a means of obtaining audit evidence. It requires that the auditor should employ external confirmation procedures in consultation with the management.

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

(a) Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;

(b) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and

(c) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those charged with governance in accordance with "SA 260 (Revised) Communication with Those Charged with Governance". The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with "SA 705 Modifications to the Opinion in the Independent Auditor's Report".

Question 14

Answer the following:

(a) Enumerate, in brief, the important aspects to be evaluated by the external auditor in determining the efficiency and extent of reliance to be placed on the work and function of an Internal Auditor.

(b) While compiling the financial statements of a concern, you observed that the input information supplied by the concern is incomplete, incorrect and few of the Accounting Standards have not been followed. Describe, in brief, the procedure you will follow in the above.

Answer

(a) Evaluation of Internal Audit Function: The external auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor. As per SA 610 "Using the Work of Internal Auditors ", factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

Objectivity

- The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.
- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.
- Whether the internal auditors are free of any conflicting responsibilities.
- Whether those charged with governance oversee employment decisions related to the internal audit function.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.
- Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

Technical competence

- Whether the internal auditors are members of relevant professional bodies.
- Whether the internal auditors have adequate technical training and proficiency as internal auditors.
- Compliance with the mandatory/ recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).
- Whether there are established policies for hiring and training internal auditors.

Due professional care

- Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

Communication: Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

- Meetings are held at appropriate intervals throughout the period;
- The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor; and
- The external auditor informs the internal auditors of any significant matters that may affect the internal audit function

(b) Compilation of Financial Information: According to SRS 4410 "Engagements to Compile Financial Information", an accountant would normally have to rely upon the management for information to compile the financial statements in a compilation engagement. If in the course of compilation of financial statements, it is observed that the information supplied by the entity is incorrect, incomplete or otherwise unsatisfactory, the accountant should perform following procedures:

(i) Make any enquiries of management to assess the reliability and completeness of the information provided;

(ii) Assess internal controls prevailing in the entity; and

(iii) Verify any matters or explanations.

The accountant may also request the management to provide additional information. This may be asked in the form of management representation letter. If the management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for such withdrawal.

If one or more accounting standards are not complied with, the same should be brought to the notice of the management and if the same is not rectified by the management, the accountant should include the same in notes to the accounts and the compilation report to the management.

Question 15

Answer the following

(a) Enumerate (in brief) the basic principles governing an audit.

(b) While examining the going concern assumption of an entity, what important indications should be evaluated and examined?

Answer

(a) SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", describes the basic principles which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out. Basic principles are:

(i) Integrity, Objectivity and Independence: The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being compatible with integrity and objectivity.

(ii) Confidentiality: The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

(iii) Skills and Competence: The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing.

(iv) Work performed by others: When the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose.

(v) Documentation: The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

(vi) Planning: The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on a knowledge of the client's business.

(vii) Audit evidence: The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

(viii) Accounting System and Internal Control: The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal controls normally contribute to such assurance.

(ix) Audit conclusions and reporting: The auditor should review and assess the conclusions drawn from the audit evidence obtain and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

(b) Evaluating Going Concern Assumption: SA 570, "Going Concern", requires that while planning a performing audit procedure and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements. In assessing such a risk, the auditor should examine the following indications.

Financial Indications

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating Indications

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labour difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other Indications

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Question 16

Enumerate the risks and internal control characteristics in an audit conducted in Computer Information Systems (CIS) environment.

Answer

The risks and internal control characteristics in CIS environment as per SA 315, "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" and SA 330 "The Auditor's Responses to Assessed Risks" include the following:

- *Lack of transaction trails*: Some computer information systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, there may not be a complete trail. Accordingly, errors embedded in an application's program logic may be difficult to detect on a timely basis by manual (user) procedures.
- *Uniform processing of transactions:* Computer processing uniformly processes like transactions with the same processing instructions. Thus, the clerical errors ordinarily associated with manual processing are virtually eliminated. Conversely, programming errors (or other systemic errors in hardware or software) will ordinarily result in all transactions being processed incorrectly.

- *Lack of segregation of functions:* Many control procedures that would ordinarily be performed by separate individuals in manual systems may become concentrated in a CIS environment. Thus, an individual who has access to computer programs, processing or data may be in a position to perform incompatible functions.
- *Potential for errors and irregularities*: The potential for human error in the development, maintenance and execution of computer information systems may be greater than in manual systems, partially because of the level of detail inherent in these activities. Also, the potential for individuals to gain unauthorised access to data or to alter data without visible evidence may be greater in CIS than in manual systems.

  In addition, decreased human involvement in handling transactions processed by computer information systems can reduce the potential for observing errors and irregularities. Errors or irregularities occurring during the design or modification of application programs or systems software can remain undetected for long periods of time.
- *Initiation or execution of transactions*: Computer information systems may include the capability to initiate or cause the execution of certain types of transactions, automatically. The authorisation of these transactions or procedures may not be documented in the same way as that in a manual system, and management's authorisation of these transactions may be implicit in its acceptance of the design of the computer information systems and subsequent modification.
- Dependence of other controls over computer processing: Computer processing may produce reports and other output that are used in performing manual control procedures. The effectiveness of these manual control procedures can be dependent on the effectiveness of controls over the completeness and accuracy of computer processing. In turn, the effectiveness and consistent operation of transaction processing controls in computer applications is often dependent on the effectiveness of general computer information systems controls.
- Potential for increased management supervision: Computer information systems can offer management a variety of analytical tools that may be used to review and supervise the operations of the entity. The availability of these analytical tools, if used, may serve to enhance the entire internal control structure.
- Potential for the use of computer-assisted audit techniques: The case of processing and analysing large quantities of data using computers may require the auditor to apply general or specialised computer audit techniques and tools in the execution of audit tests.

Question 17

A Company gets its accounting data processed by a third party to achieve cost reduction. As a Statutory Auditor of such a company, what are the additional precautions/checks that you would consider for conduct of the audit?

Answer

Precaution to be taken by auditor in case accounting data processed by third party: Processing of accounting data may be given to a third party on account of various considerations such as economy, own computer working to full capacity, an interim measures restricting accessibility to sensitive information, etc. A client may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data (e.g., a computer systems service organisation). If a client uses a service organisation, certain policies, procedures and records maintained by the service organisation might be relevant to the audit of the financial statements of the client. Consequently, the auditor would consider the nature and extent of activities undertaken by service organisations so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk. 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,[2] the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity's operations, including :

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

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

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

(d) 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 organisation.

Sources of Information

Information on the nature of the services provided by a service organisation may be available from a wide variety of sources, such as:

- User manuals.
- System overviews.
- Technical manuals.
- The contract or service level agreement between the user entity and the service organisation.
- Reports by service organisations, internal auditors or regulatory authorities on controls at the service organisation.
- Reports by the service auditor, including management letters, if available.

[2] SA 315, paragraph 11.

Knowledge obtained through the user auditor's experience with the service organisation, for example through experience with other audit engagements, may also be helpful in obtaining an understanding of the nature of the services provided by the service organisation. This may be particularly helpful if the services and controls at the service organisation over those services are highly standardized.

Question 18

Elaborate how the Statutory Auditor can verify the existence of related parties for the purpose of reporting under Accounting Standard 18.

Answer

Verification of Existence of Related Parties: SA 550 "Related Parties", During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

- Entity income tax returns.
- Information supplied by the entity to regulatory authorities.
- Shareholder registers to identify the entity's principal shareholders.
- Statements of conflicts of interest from management and those charged with governance.
- Records of the entity's investments and those of its pension plans.
- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity's ordinary course of business.
- Specific invoices and correspondence from the entity's professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Internal auditors' reports.
- Documents associated with the entity's filings with a securities regulator (e.g, prospectuses).

Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

(a) Bank, legal and third party confirmations obtained as part of the auditor's procedures;

(b) Minutes of meetings of shareholders and of those charged with governance; and

(c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

Question 19

As a Statutory Auditor, how would you deal with a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit.

Answer

Impossibility to continue the performance of audit: SA 240 "The Auditor's Responsibilities Relating Fraud in an Audit of Financial Statements ",if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

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

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(c) If the auditor withdraws:

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

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

Question 20

What are the financial indications to be considered by an auditor for evolution of the going Concern assumption?

Answer

As per SA 570 on Going Concern, the following are the financial indications to be considered:-

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.

- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Question 21

You are appointed to compile financial statements of Y & Co. for tax purposes. During the course of work, you learn that the inventory is grossly understated. On pointing the same, the partners of Y & Co. tell you that since you are not conducting an audit, the said figures duly certified by the firm should be accepted. Comment.

Answer

As per "SRS 4410 Engagements to Compile Financial Information", If the accountant becomes aware of material misstatements, the accountant should persuade the management to carry out necessary amendments in the financial statements or other complied financial information. If such amendments are not made and the financial statements are still considered to be misleading, the accountant should withdraw from the engagement.

As per guidance note on Tax Audit under section 44AB of the Income Tax Act, 1961, the stock auditor should study the procedure followed by the assessee in taking the inventory of closing stock at the end of the year and the valuation thereof. The tax auditor should also examine the basis adopted for ascertaining the cost and this basis should be consistently followed. It is very necessary for an auditor to ensure that the method followed for valuation of stock results in disclosure of correct profit and gains.

In the instant case, appointment was made to compile financial statements for tax audit purpose of Y & Co., a firm. It is our duty of to ensure that method followed for valuation of stock results in disclosure of correct profit and gains.

In this case the stock valuation was grossly understated. Consequently, disclosure of profit is also not correct. Hence, contention of the Y & Co., that you are not the conducting an audit, , the said figures duly certified by the firm should be accepted is not correct.

Question 22

Comment on the following:

(a) *You are the auditor of Easy Communications Ltd. for the year 2007–08. The inventory as at the end of the year i.e. 31.3.08 was ₹ 2.25 crores. Due to unavoidable circumstances, you could not be present at the time of annual physical verification. Under the above*

circumstances how would you ensure that the physical verification conducted by the management was in order?

(b) You have been appointed as the auditor of Good Health Ltd. for 2007-08 which was audited by CA Trustworthy in 2006-07. As the Auditor of the company state the steps you would take to ensure that the Closing Balances of 2006-07 have been brought to account in 2007-08 as Opening Balances and the Opening Balances do not contain misstatements.

Answer

(a) As per SA 501, "Audit Evidence – Additional Considerations For Specific Items" the auditor should perform audit procedures, designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting.SA 501 is additional guidance to that contained in SA 500, "Audit Evidence", with respect to certain specific financial statement amounts and other disclosures. .

If the auditor is unable to be present at the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded. The auditor would also verify the procedure adopted, treatment given for the discrepancies noticed during the physical count. The auditor would also ensure that appropriate cut off procedures were followed by the management. He should also get management's written representation on (a) the completeness of information provided regarding the inventory and (b) assurance with regard to adherence to laid down procedures for physical inventory count..

By following the above procedure it will be ensured that the physical verification conducted by the management was in order.

(b) As per SA 510 (Revised), "Initial Audit Engagements—Opening Balances" in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

(i) Opening balances contain misstatements that materially affect the current period's financial statements; and

(ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Being new assignment audit evidence regarding opening balances can be obtained by perusing the copies of the audited financial statements.

For current assets and liabilities some audit evidence can ordinarily be obtained as part of

audit procedures during the current period. For example, the collection/payment of opening balances of receivables and payables will provide audit evidence as to their existence, rights and obligations, completeness and valuation at the beginning of the period.

In respect of other assets and liabilities such as fixed assets, investments long term debt, the auditor will examine the records relating to opening balances. The auditor may also be able to get confirmation from third parties (e.g., balances of long term loan obtained from banks).

Question 23

Write short notes on the Frauds through supplier ledger.

Answer

Frauds though suppliers ledger

Fraud through supplies ledger could be made in any of the following ways, which the auditor has to take case of:

(1) Adjusting fictitious as duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the money when payments are made in respect of these invoices.

(2) Suppressing credit notes issued by suppliers and withdrawing the corresponding amount not claimed by them.

(3) Withdrawing amounts which remain unclaimed for more than the normal time limit for one reason or other by showing the same have been paid to the parties.

(4) Accepting invoices at prices considerably highest than the market price and collecting the excess claim from the suppliers directly.

Question 24

(a) In the course of the audit of R Ltd., the audit manager of ABC & Co. observed that R Ltd. has outsourced certain activities to an outsourcing agency. As the engagement partner guide the audit manager in the assessment of services provided by the outsourcing agency in relation to the audit.

(b) In the course of audit of T Ltd., the audit team is not sure of the possible source of misstatements in the financial statements. As the audit manager identify the sources of misstatements.

(c) While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements?

(d) The management of S Ltd. requests you not to seek confirmation from its debtors. As the auditor of S Ltd., what can be an appropriate response?

Answer

(a) As per SA 402 "Audit Considerations relating to an Entity Using a Service Organisation", for obtaining understanding of the user entity in accordance with SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", the user auditor shall obtain an understanding of how a user entity uses the services of a service organization in the user entity's operation including:

(i) The nature of services provided by the service organisation and the significance of such services to the user entity, including its effect on the internal control of user entity.

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

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

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

(b) As per SA 450 "Evaluation of Misstatements Identified during the Audit", misstatements may result from

(i) An inaccuracy in gathering or processing data from which the financial statements are prepared.

(ii) An omission of an amount of disclosure.

(iii) An incorrect accounting estimate arising from overlooking or clear misinterpretation of facts and

(iv) Judgements of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

(c) As per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor 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.

(i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.

(ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

(iii) 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.

(d) SA 505 "External Confirmations", establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. If the management refuses to allow the auditor to a send a confirmation request, the auditor shall

(i) Inquire as to Management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness.

(ii) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures and

(iii) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those in charge of governance and also determine its implication for the audit and his opinion.

Question 25

Y Ltd. engaged an actuary to ascertain its employee cost, gratuity and leave encashment liabilities. As the auditor of Y Ltd., you would like to use the report of the actuary as an audit evidence. How do you evaluate the work of the actuary?

Answer

Evaluating the work of an expert –

As per SA 620 "Using the Work of an Auditor's Expert", when management has used a management's expert in preparing the financial statements, the auditor's decision on whether to use an auditor's expert may also be influenced by such factors as:

- The nature, scope and objectives of the management's expert's work.

- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- The management's expert's competence and capabilities.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- Any controls within the entity over the management's expert's work.

However, an evaluation of the work of an expert can be done considering the following facts:

(i) When the auditor plans to use the expert's work as audit evidence, he should satisfy himself as to the expert's skills and competence by considering the expert's:
   - professional qualifications, licence or membership in an appropriate professional body, and
   - experience and reputation in the field in which the evidence is sought.

(ii) The objectives and scope of the experts' work.

(iii) A general outline as to specific items in the expert's report.

(iv) Confidentiality of the client's information used by the expert.

(v) The source data used.

(vi) The assumptions and methods used and, if appropriate, their comparison with the prior period.

(vii) The results of the expert's work in the light of auditor's overall knowledge of the business and of the results of his audit procedures.

(viii) The auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial statements.

(ix) Consider whether the expert has used the appropriate source data, by making inquiries of the expert.

(x) Conducting audit procedures on the data by the client to the expert to obtain reasonable assurance that the data are appropriate.

Question 26

Write short notes on Guidance note on Audit of Miscellaneous Expenditure (revised).

Answer

Guidance note on Audit of Miscellaneous Expenditure (revised): This Guidance Note provides guidance on audit procedures to be applied while auditing miscellaneous

expenditure. 'Miscellaneous expenditure' shown in the balance sheet of companies (or shown under this or some other appropriate heading in the balance sheet of other enterprises) embraces within its fold a variety of items of expenditure which are not entirely charged to income in the year in which they are incurred, but are carried forward in the balance sheet to be written-off in subsequent periods. Unless some benefit from the expenditure can reasonably be expected to be received in future and unless the amount of such benefit is reasonably determinable, there is no justification for carrying forward the expenditure for being written-off in subsequent periods. Also, the amount of expenditure to be carried forward should not exceed the expected future revenue/other benefits related to the expenditure.

The Guidance Note deals with the audit considerations related to the following items that normally constitute 'miscellaneous expenditure':

(a) preliminary expenses;

(b) expenses including commission or brokerage on underwriting or subscription of shares or debentures including discount allowed on the issue of shares or debentures;

(c) research and development expenditure, etc.

Since AS 26, applies to different entity from different dates, it may happen that certain enterprises, till the date the standard becomes mandatory for them may continue to defer the expenditure incurred on items that normally constitute "miscellaneous expenditure". Once an entity applies AS 26 to account for intangible assets, the expenditure incurred on items that normally constitute miscellaneous expenditure shall be governed by the Standard, except in the case of already appearing miscellaneous expenditure in the balance sheet which is to be accounted for using AS 26.

As per Guidance note on Audit of Miscellaneous Expenditure (Revised), the auditor should examine whether the financial statements contain adequate disclosures as required by AS 26. The auditor should also examine that the financial statements disclose the accounting policy with regard to miscellaneous expenditure. On the first occasion when AS 26 is applied by an enterprise for accounting for items of miscellaneous expenditure, the financial statements should also disclose the change in accounting policy with regard to miscellaneous expenditure in accordance with the requirements of Accounting Standard (AS) 5, "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies".

Question 27

While doing audit, Ram, the Auditor requires reports from experts for the purpose of Audit evidence. What types of reports/opinions he can obtain and to what extent he can rely upon the same?

Answer

Using the Work of an Expert: As per SA 620, "Using the Work of an Expert", during the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert.

While doing audit, Ram, the auditor can obtain the following types of reports, or opinions or statements of an expert for the purpose of audit evidence:

- Valuations of certain types of assets, for example, land and buildings, plant and machinery, works of art, and precious stones.
- Determination of quantities or physical condition of assets, for example, minerals stored in stockpiles, mineral and petroleum reserves, and the remaining useful life of plant and machinery.
- Determination of amounts using specialised techniques or methods, for example, an actuarial valuation.
- The measurement of work completed and to be completed on contracts in progress for the purpose of revenue recognition.
- Legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc.

When the auditor intends to use the work of an expert, he should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information, by considering the sufficiency, relevance and reliability of source data used, the assumptions and methods used and, if appropriate, their consistency with the prior period, and the results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of his audit procedures.

Question 28

(a) In the course of audit of ABC Ltd. its management refuses to provide written representations. As an auditor what is your duty?

(b) While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

(c) What are the auditor's responsibilities in respect of corresponding figures?

(d) IT systems also pose specific risks to an entity's internal control? What are those risks?

Answer

(a) Duty of an Auditor if management refuses to provide written representations: As per SA 580 (Revised) "Written Representations", if the management does not provide one or more of the requested written representations, the auditor shall:

(i) Discuss the matter with management

(ii) Re-evaluate the Integrity of the management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general and

(iii) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor should disclaim an opinion on the financial statements if management does not provide written representations.

(b) Risk Factors while applying sampling techniques: As per SA 530(Revised) "Audit Sampling", 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. Sampling risk can lead to two types of erroneous conclusions.

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of tests of details, that a material misstatement does not exists when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatements exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

(c) Auditor's responsibilities in respect of corresponding figures: As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements", in respect of corresponding figures, the auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

(a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and

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

If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SA 560 (Revised) "Subsequent Events",.

As required by SA 580, "Written Representations", the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any prior period item that is separately disclosed in the current year's statement of profit and loss.

(d) Specific Risk to an Entity's internal Control: As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", IT system also poses specific risks to an entity's Internal Control. They are–

(i) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both

(ii) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non existent transactions, or inaccurate recording of transactions. Particular risk may arise when multiple users access a common database.

(iii) The possibility of IT personnel gaining access beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.

(iv) Unauthorised changes to data in Master files

(v) Unauthorised changes to systems or programs.

(vi) Failure to make necessary changes to systems or programs.

(vii) In appropriate manual intervention

(viii) Potential loss of data or inability to access data as required.

Question 29

Answer the following:

(a) You are appointed statutory auditor of X Ltd. X Ltd. has an internal audit system and reports for the same are given to you. Mention the factors you will consider to ensure that the said system of internal audit of X Ltd. is commensurate with the size of the company and nature of its business.

(b) The audit report of P Ltd. for the year 2007-08 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2008-09, how would you report, if:

(i) The company does not make provision for doubtful debts in 2008-09?

(ii) The company makes adequate provision for doubtful debts in 2008-09?

Answer

(a) Internal Audit System end CARO 2003: The Companies Act, 1956 does not require a company to necessarily have an internal audit system. As per Para 4(vii) of CARO, 2003, statutory auditor is required to comment on whether the auditee company has an internal audit system commensurate with its size and nature of its business.

The clause has a mandatory application in respect of listed companies irrespective of the size of paid-up capital and reserves or turnover. For other companies, it is applicable if

either of the following conditions is satisfied:

(a) The company has a paid-up capital and reserves exceeding ₹ 50 lakhs at the commencement of the financial year, or

(b) The company has an average annual turnover of ₹ 5 crores or more for a period of 3 consecutive financial years immediately preceding the financial year concerned.

The auditor has to examine whether the internal audit system is commensurate with the size of the company and the nature of its business. The following are some of the factors to be considered in this regard:

(i) What is the size of the internal audit department? In considering the adequacy of internal audit staff, it is necessary to consider the nature of the business, the number of operating points, the extent to which control is decentralised, the effectiveness of other forms of internal control, etc.

(ii) What are the qualifications of the persons who undertake the internal audit work? Internal auditing, as its name implies, is an aspect of audit and, therefore, it is reasonable to expect that the internal audit department should normally be headed by a chartered accountant and that, depending upon the size of the department, it employs other qualified persons. In deciding the adequacy of the internal audit department, it is, therefore, necessary that there is adequate number of qualified personnel.

(iii) To whom does the internal auditor report? In general, the higher the level to which the internal auditor reports, the greater will be his independence.

(iv) What are the areas covered by the internal audit? Internal audit can cover a large number of areas including operational auditing, organisation and methods studies, special investigations and the like. For the purposes of the Order, however, the important areas which should be covered by internal audit are the examination of the operating systems to ensure that the systems are adequate and functioning in practice. The exact areas to be covered by the internal audit would depend upon the circumstances of each case but the statutory auditor should ask the internal auditor to provide the programme of his work and should determine whether, in his opinion, the coverage is adequate. If he feels it is not, he may suggest to the internal auditor to extend the programme in the required direction.

(v) Has the internal auditor adequate technical assistance? In a number of companies, where the operations are highly technical in nature, an internal auditor cannot function effectively unless he has adequate technical assistance. This can be provided either by having full-time technically qualified persons in the internal audit department or by such persons being deputed to the internal audit department for

specific assignments. Similar considerations would apply where a large part of the transactions are computerised. In such cases, the internal auditor should have the assistance of persons who are able to audit computer systems.

(vi) What are the reports which are submitted by the internal auditor or what other evidence is there of his work? It is important that the auditor should satisfy himself that not merely does an internal audit system exist but also that it is functioning effectively. He can do so by examining the reports submitted by the internal auditor.

(vii) What is the follow-up? It is not sufficient that the internal audit system should point out errors in operation or deficiencies in the internal control system. It is equally necessary that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.

(b) Auditor's responsibilities in cases where audit report for an earlier year is qualified is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements". As per SA 710, When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

SA 710 further states that if the auditor's report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

(i) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

(ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

In the instant Case, if P Ltd. does not make provision for doubtful debts the auditor will have to modify his report for both current and previous year's figures as mentioned above. If however, the provision is made, the auditor need not refer to the earlier year's modification.

Question 30

Moon Limited replaced its statutory auditor for the Financial year 2008-09. During the course of audit, the new auditor found a credit item of ₹ 5 lakhs. On enquiry, the company explained him that it is, a very old credit balance. The creditor had neither approached for the payment nor is he traceable. Under the circumstances, no confirmation of the credit balance is available. Comment.

Answer

This is a case of external confirmation, covered by SA 505 "External Confirmation". The identities of creditors are not traceable to confirm the credit balance as appearing in the financial statement of the company. It is also not a case of pending litigation.

It might be a case that an income of ₹ 5 lakhs had been hidden in previous year/s. The statutory auditor should examine the validity of the credit balance as appeared in the company's financial statements. He should obtain sufficient evidence in support of the balance. He should apply alternative audit procedures to get documentary proof for the transaction/s and should not rely entirely on the management representation. Finally, he should include the matter by way of a qualification in his audit report to the members.

Question 31

Briefly explain the audit procedures on subsequent events

Answer

Audit Procedures on Subsequent Events: As per SA 560 "Subsequent Events", events occurring between the dates of balance sheet and audit report and the facts that become known to the auditor after the date of the auditor's report.

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

The auditor shall perform the procedures required above so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:

(a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

(b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity's latest subsequent interim financial statements, if any.

When, as a result of the procedures performed as required the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

Question 32

Comment on the following:

(a) You are appointed to compile financial statements of Y & Co. for tax purposes. During the course of work, you learn that the inventory is grossly understated. On pointing the same, the partners of Y & Co. tell you that since you are not conducting an audit, the said figures duly certified by the firm should be accepted.

(b) While conducting statutory Audit of ABC Ltd., you come across IOUs amounting to ₹ 2 crores as against a cash balance shown in books of ₹ 2.10 crores. You also observe that despite similar high balances throughout the year, small amounts of ₹ 50,000 are withdrawn from the bank to meet day-to-day expenses.

(c) Z Ltd. had appointed an outside expert to assess accrued gratuity liability of the company. Based on the said report, the company provides ₹ 80 lakhs as gratuity in the financial statements.

(d) A Company's net worth is eroded and creditors are unpaid due to liquidity constraints. The management represents to the statutory auditor that the promoter's wife is expected to give an unsecured loan to meet the liquidity constraints and that negotiations are underway to secure large export orders.

Answer

(a) According to SRS 4410, "Engagement to Compile Financial Information" if an accountant becomes aware of material misstatements, the accountant should persuade the management to carry out necessary amendments in the financial statements or other compiled financial information. If such amendments are not made and the financial statements are still considered to be misleading the accountant should withdraw from the engagement. Hence, in this case, there is a clear violation of SRS 4410.

(b) According to SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" when the auditor comes across such circumstances indicating the possible misstatements resulting from the fraud then the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. In this case, the circumstances indicate that the possible misstatement in financial statements is due to fraud and error and the auditor must investigate further to consider effect on financial statements.

The Guidance Note on Audit of Cash and Bank balances also mentions that if the entity is maintaining an unduly large balance of cash, he should carry out surprise verification of cash more frequently to ascertain whether it agrees. If cash in hand is not in agreement with the book balance, he should seek explanations and if the same are not satisfactory should state the said fact appropriately in his Audit Report.

(c) SA 620 states that while using the work of an expert, auditor should consider the materiality of the item, nature and complexity of the item, the other audit evidence available and professional qualifications, experience and reputation in the field of the concerned expert.

The auditor should ensure that the expert has used appropriate source data, has made consistent assumptions, has applied correct methods and that results of expert's work are in line with auditor's overall knowledge of the business and match with results of his audit procedures. The auditor should also ensure that substance of expert's findings is properly reflected in the financial information.

(d) In this case, it is subjective, but prima-facie a mere expectation of future cash flows from the promoter's wife without any firm commitment and the possibility of an export order being negotiated, may not that be sufficient appropriate audit evidence of mitigating factors for resolving the going concerns question under SA 570 "Going Concern".

Question 33

Comment on the following:

(a) The auditor of SS Ltd. accepted the gratuity liability valuation based on the certificate issued by a qualified actuary. However, the auditor noticed that the retirement age adopted is 65 years as against the existing retirement age of 60 years. The company is considering a proposal to increase the retirement age.

(b) ABC & Co. and DEF & Co, Chartered Accountant firms were appointed as joint auditors of Good Health Care Ltd. for 2009-10. A special audit was conducted U/s 233A of the Companies Act 1956 during March 2011 and observed gross understatement of Revenue. The revenue aspects were looked after by DEF & Co, but there was no documentation for the division of work between the joint auditors.

Answer

(a) *Using the work of an Expert: As per SA 620 "Using the Work of an Auditor's Expert", the expertise of an expert may be required in the actuarial calculation of liabilities associated with insurance contracts or employee benefit plans, however, the auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert.*

Hence, the auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence as per SA 500.

If the expert's work involves use of significant assumptions and methods, then the relevance and reasonableness of those assumptions and methods and if the expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data in the circumstances must be ensured by the auditor.

In the instant case, a qualified actuary has issued a certificate for gratuity liability valuation, for which retirement age adopted is 65 years against the existing retirement age of 60 years; however, the company is considering a proposal to increase the retirement age. In view of SA 500 alongwith SA 620, the assumption made by actuary has no relevance and reasonableness as presently retiring age is of 60 years. Hence the auditor is required to bring out the facts to the notice of management and advice the modification accordingly. In case of failure of compliance of the same the auditor may qualify the report.

(b) *Documentation for Division of Work between the Joint Auditors: As per SA 299 "Responsibility of Joint Auditors", where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas.*

In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would not be divided and would be covered by all the joint auditors.

The division of work among joint auditors as well as the areas of work to be covered by all of them should be adequately documented and preferably communicated to the entity.

Further, each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work in accordance with the generally accepted audit procedures. It is not necessary for a joint auditor to review the work

performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice any departure from generally accepted accounting principles or any material error noticed in the course of the audit.

In the present case, there was no documentation for the division of work and the responsibility of revenue aspect was delegated to DEF & Co., in which gross understatement of revenue has been observed. ABC & Co. has not reviewed the work as they have put their reliance on the work performed by DEF & Co.

Hence, there is a violation of SA 299 as the division of work has not been documented. In the normal course DEF & Co. will be held liable for negligence. If DEF & Co. refuses to accept sole responsibility for the fault, ABC & Co. have to prove by other ways and means of evidences that the particular area of audit was exclusively done by DEF & Co. only.

Question 34

In the course of the statutory audit of Z Ltd, its statutory auditors, having determined that the work of internal auditor is likely to be adequate for the purpose of statutory audit, wanted to use the work of internal auditor in respect of physical verification of fixed assets. How an evaluation of this specific work done by the internal auditor can be done?

Answer

Evaluation of Specific Work Done by Internal Auditor: The statutory auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor.

As per SA 610 "Using the Work of Internal Auditors ", the nature, timing and extent of the audit procedures performed on specific work of the internal auditors will depend on the external auditor's assessment of the risk of material misstatement, the evaluation of the internal audit function, and the evaluation of the specific work of the internal auditors. Such audit procedures may include examination of items already examined by the internal auditors, examination of other similar items; and observation of procedures performed by the internal auditors.

Further, to determine the adequacy of specific work performed by the internal auditors for the external auditor's purposes, the external auditor shall evaluate whether:

(1) The work was performed by internal auditors having adequate technical training and proficiency;

(2) The work was properly supervised, reviewed and documented;

(3) Adequate audit evidence has been obtained to enable the internal auditors to draw

reasonable conclusions;

(4) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and

(5) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

Question 35

In the course of audit of A Ltd you suspect the management has indulged in fraudulent financial reporting? State the possible source of such fraudulent financial reporting.

Answer

Possible Sources of Fraudulent Financial Reporting: As per SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements", fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. It may be accomplished by manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared or Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information or intentional misstatements involve intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure etc.

It often involves management override of controls, misappropriation of assets etc that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

1. *Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.*
2. *Inappropriately adjusting assumptions and changing judgments used to estimate account balances.*
3. *Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.*
4. *Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.*
5. *Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.*
6. *Altering records and terms related to significant and unusual transactions.*

7. *Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).*
8. *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).*
9. *Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).*
10. *Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).*