# 1

# Auditing Standards, Statements and Guidance Notes- An Overview

Question 1

(a) *The Auditor of PQR Pvt. Ltd. having turnover of ₹ 12 crore, was not able to get the confirmation about the existence and value of certain stock. However, a certificate from the Management has been obtained regarding the existence and value of the stock at the year end. The auditor relied on the same and without any further procedure, signed the Audit Report. Is he right in his approach?*

(b) *Discuss the impact of uncorrected misstatements identified during the audit and the auditor's response to the same.*

(c) *What are the roles and responsibilities of the statutory auditors in relation to compliance with the laws and regulations by the entity?* *(5 Marks each, November, 2014)*

Answer

(a) Validity of Written Representation: The physical verification of stock 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 and valuation of stock. In the case of PQR Pvt. Ltd., the auditor has not been able to verify the existence and value of certain stock 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 "Written Representations", 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 tenable.

(b) Uncorrected Misstatements Identified During the Audit: In accordance with SA 450 "Evaluation of Misstatements identified during the Audit", the auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider -

(i) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and

(ii) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

The auditor shall communicate this with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation.

The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected.

Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320, to confirm whether it remains appropriate in the context of the entity's actual financial results.

As per management, if effect of such uncorrected misstatement is immaterial then the auditor shall request for a written representation from management and, where appropriate, those charged with governance that whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

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 report accordingly.

(c) Roles and Responsibilities of the Auditor in Relation to Compliance with the Laws and Regulations: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements", as part of obtaining an understanding of the entity and its environment, the auditor shall obtain a general understanding of -

(i) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and

(ii) How the entity is complying with that framework.

The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements.

The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:

(i) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and

(ii) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

Thus, the auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework.

Question 2

*(a) What are the professional obligations of the auditor who has resigned from the audit before completion of his term due to non co-operation of the Management in completing certain audit procedures? (5 Marks, November, 2014)*

*(b) Discuss the Auditor's responsibility to provide access to his audit working papers to Regulators and third parties. (3 Marks, November, 2014)*

Answer

(a) Resignation Due to Management Imposing Limitation on the Scope of Audit: SA 705 "Modifications to the Opinion in the Independent Auditor's Report" provides the consequence of an inability to obtain sufficient appropriate audit evidence due to a management - imposed limitation after the auditor has accepted the engagement. The practicability of resigning from the audit may depend upon the stage of completion of the engagement at the time that management imposes the scope limitation.

When the auditor concludes that resignation from the audit is necessary because of a scope limitation, there may be a professional, regulatory or legal requirement for the auditor to communicate matters relating to the resignation from the engagement to regulators or the entity's owners.

In the case of resignation from the company, provisions of the Companies Act, 2013 applies. Section 140(2) of the Companies Act, 2013, requires the auditor, who has resigned from the company, to file within a period of 30 days from the date of resignation, a statement with the company and the registrar, and in case of government companies,

the auditor shall file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor will be liable for penal provisions.

Alternatively answer may be given as per SA 210 "Agreeing the Terms of Audit Engagements".

(b) Audit Working Paper: The auditor should not provide access to working papers to any third party without specific authority or unless there is a legal or professional duty to disclose. Clause (1) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by law for the time being in force. SA 200 on "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with Standards on Auditing" also reiterates that, "the auditor should respect the confidentiality of the information obtained and should not disclose any such information to any third party without specific authority or unless there is a legal or professional duty to disclose".

If there is a request to provide access by the regulator based on the legal requirement, the same has to be complied with after informing the client about the same.

Further, 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", provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

As per SA 230, Audit documentation serves a number of additional purposes, including the enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Therefore, it is auditor's responsibility to provide access to his audit working papers to Regulators whereas it's at auditor's discretion, to make portions of, or extract from his working paper to third parties.

Question 3

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

*(b) In the course of your audit you have come across a related party transaction which prima facie appears to be biased. How would you deal with this?*

*(4 Marks each, November, 2014)*

Answer

(a) Engagement to Compile Financial Information and Misstatements: 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 Z & Co., a partnership firm. It is our duty 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 Z & Co., that you are not conducting an audit, the said figures duly certified by the firm should be accepted is not correct.

(b) 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.

In this case, the auditor is finding a related party transaction which *prima facie* appears to be biased. So the auditor is required to confirm the same. For identified significant related party transactions outside the entity's normal course of business, the auditor shall inspect the underlying contracts or agreements, if any, and evaluate whether:

(i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;

(ii) The terms of the transactions are consistent with management's explanations; and

(iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

The auditor should also obtain audit evidence that the transactions have been appropriately authorised and approved.

After 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. Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that they have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and they have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

Finally, the auditor should report on the basis of this fact that the related party relationships and transactions prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks); or they are not cause for the financial statements to be misleading (for compliance frameworks).

Question 4

*Write a short note on Intangible Asset vs. Intangible Item.* *(4 Marks, November, 2014)*

Answer

Intangible Asset vs. Intangible Item: As per Accounting Standard 26 on "Intangible Assets", enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated.

If above discussed items fulfils the conditions given in the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise, will be considered as intangible asset. But if any of such discussed items does not satisfied these 3 conditions then it will not constitute intangible asset, like expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of purchase, it forms part of the goodwill recognised at the date of the amalgamation.

Further, Intangible assets are shown in Balance Sheet whereas intangible items which are not intangible assets are provided as expenditure in Statement of Profit and Loss.

Question 5

(a) *ABC Company files a law suit against Unlucky Company for ₹ 5 crores. The Attorney of Unlucky Company feels that the suit is without merit, so Unlucky Company merely discloses the existence of the law suit in the notes accompanying its financial statements. As an auditor of Unlucky Company, how will you deal with the situation?*

(b) *T & Co. wants to issue a prospectus, to provide potential investors with information about future expectations of the Company. You are hired by T & Co. to examine the projected financial statements and give report thereon. What things you will consider before accepting the audit engagement and what audit evidence will be obtained for reporting on projected financial statements?*

(c) *In the course of audit of K Ltd., its auditor Mr. 'N' observed that there was a special audit conducted at the instance of the management on a possible suspicion of a fraud and requested for a copy of the report to enable him to report on the fraud aspects. Despite many reminders it was not provided. In absence of the special audit report, Mr. 'N' insisted that he be provided with at least a written representation in respect of fraud on/by the company. For this request also, the management remained silent. Please guide Mr. 'N'.*

(d) *During the course of audit of Star Limited the auditor received some of the confirmation of the balances of creditors outstanding in the balance sheet through external confirmation by negative confirmation request. In the list of Sundry Creditors there are number of creditors of small balances except one, old outstanding of ₹ 15 Lacs, of whom, no confirmation on the credit balance received. Comment with respect to Standard of Auditing.* *(5 Marks each, May, 2014)*

Answer

(a) Existence of Contingent Liability: As per AS 29 "Provisions, Contingent liabilities and Contingent Assets", a contingent liability is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Further, future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the event will occur.

As per SA 570 “Going Concern”, there are certain examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. 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 is one of the example of such event.

When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements adequately describe the principal events or conditions

that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

In the instant case, ABC Company has filed a law suit against Unlucky Company for ₹ 5 crores. Though, the attorney of Unlucky Company feels that the suit is without merit so the company merely discloses the existence of law suit in the notes accompanying its financial statements. But the auditor may evaluate the source data on which basis the opinion is formed. If the auditor finds the uncertainty, he may request the management to adjust the sum of ₹ 5 crore by making provision for expenses as per AS 29. If the management does not accept the request the auditor should qualify the audit report.

(b) Projected Financial Statements: As per SAE 3400, "The Examination of Prospective Financial Information", the answer is divided into two parts i.e. (i) the things to be considered before accepting the engagement and (ii) audit evidence to be obtained for reporting on projected financial statements.

(i) Acceptance of Engagement: As per SAE 3400, "The Examination of Prospective Financial Information", before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:

(1) the intended use of the information;

(2) whether the information will be for general or limited distribution;

(3) the nature of the assumptions, that is, whether they are best-estimates or hypothetical assumptions;

(4) the elements to be included in the information; and

(5) the period covered by the information.

Further, 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.

In accordance with SA 210, "Terms of Audit Engagement", it is necessary that the auditor and the client should agree on the terms of the engagement.

(ii) Audit evidence to be obtained for Reporting on Projected Financial Statements: The auditor should document matters, which are important in providing evidence to support his report on examination of prospective financial information, and evidence that such examination was carried out.

The audit evidence in form of working papers will include:

(1) the sources of information,

(2) basis of forecasts,

(3) the assumptions made in arriving the forecasts,

(4) hypothetical assumptions, evidence supporting the assumptions,

(5) management representations regarding the intended use and distribution of the information, completeness of material assumptions,

(6) management's acceptance of its responsibility for the information,

(7) audit plan,

(8) the nature, timing and extent of examination procedures performed, and,

(9) in case the auditor expresses a modified opinion or withdraws from the engagement, the reasons forming the basis of such decision.

(c) Auditor's Responsibilities Relating to Fraud: As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.

As per SA 580 "Written Representations", if management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist.

In the instant case, the auditor observed that there was a special audit conducted at the instance of the management on a possible suspicion of fraud. Therefore, the auditor requested for special audit report which was not provided by the management despite of many reminders. The auditor also insisted for written representation in respect of fraud on/by the company. For this request also management remained silent.

It may be noted that, if management does not provide one or more of the requested written representations, the auditor shall discuss the matter with management; re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

In addition, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

The auditor is also required to report as per Clause (xii) of Paragraph 3 of CARO, 2015, if there is any fraud on or by the company has been noticed or reported during the year. The nature and the amount involved are to be indicated.

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:

(i) 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;

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

(iii) If the auditor withdraws:

(1) 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

(2) 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.

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

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favor, and less likely to respond otherwise.

In the instant case, the auditor sent the negative confirmation requesting the creditors having outstanding balances in the balance sheet while doing audit of Star Limited. One of the old outstanding of ₹ 15 lacs has not sent the confirmation on the credit balance. In case of non response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non response for negative confirmation request does not means that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request.

But, if the auditor identifies factors that give rise to doubts about the reliability of the response to the confirmation request, he shall obtain further audit evidence to resolve those doubts.

Question 6

*Write short notes on the following:*

*(a) Evaluation of inherent risk at the level of Financial Statements.*

*(b) Tolerable misstatement.* *(4 Marks each, May, 2014)*

Answer

(a) Evaluation of Inherent Risk at the Level of Financial Statements: To assess inherent risk, the auditor would use professional judgment to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment.

The following factors will be considered for determination of audit risk at financial statement level:

(i) Integrity of Management.

(ii) Management experience, knowledge and changes during the period.

(iii) Unusual pressures on the Management.

(iv) Nature of entity's business.

(v) Factors affecting the Industry in which the entity operates.

(b) Tolerable Misstatement: As per SA 530, "Audit Sampling", a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Further, while designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality, to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

Question 7

*(a) G Ltd. is a mobile phone operating company. Barring the marketing function it had outsourced the entire operations like maintenance of mobile infrastructure, customer billing, payroll, accounting functions, etc. Assist the auditor of G Ltd. as to how he can obtain an understanding of how G Ltd. uses the services of the outsourced agency in its operations.* *(5 Marks, November, 2013)*

*Or*

*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.* *(4 Marks, May, 2011)*

*(b) M/s Honest Limited has entered into a transaction on 5th March, 2013, near year-end, whereby it has agreed to pay ₹5 lakhs per month to Mr. Y as annual retainer-ship fee for*

*"engineering consultation". No amount was actually paid, but ₹ 60 lakhs is provided in books of account as on March 31, 2013.*

*Your inquiry elicits a response that need-based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service. As the auditor of M/s Honest Limited, what would be your approach? (5 Marks, November, 2013)*

Answer

(a) As per SA 402 on "Audit Considerations Relating to an Entity Using a Service Organisation", when obtaining an 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 organisation in the user entity's operations, including:

(i) 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;

(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 organisation and those of the user entity; and

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

(b) As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", fraud can be committed by management overriding controls using such techniques as Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

Keeping in view the above, it is clear that Company has passed fictitious journal entries near year end to manipulate the operating results. Also Auditor's enquiry elicited a response that need-based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service, is not acceptable.

Accordingly, the auditor would adopt the following approach-

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:

(i) 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;

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

(iii) If the auditor withdraws:

(1) 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

(2) 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.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

The auditor is also required to report as per Clause (xii) of Paragraph 3 of CARO, 2015, if there is any fraud on or by the company has been noticed or reported during the year. The nature and the amount involved are to be indicated.

Question 8

*(a) C & Co., hired Mr. A, Chartered Accountant, to compile its financial statements for the interim period ending on 31st December 2012. Kindly assist Mr. A in drafting scope of engagement letter with specific focus on C & Co's responsibility.*

*(b) Mr. X was appointed as the auditor of M/s Easygo Ltd. and intends to apply the concept of materiality for the financial statements as a whole. Please guide him as to the factors that may affect the identification of an appropriate benchmark for this purpose.*

*(4 Marks each, November, 2013)*

Answer

(a) As per SRS 4410 "Engagements to Compile Financial Information", the engagement letter to be issued by Mr. A should state the following as management's responsibility:

(i) the accuracy and completeness of the information supplied to us, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.

(ii) preparation and presentation of the financial statements of the entity, in accordance with the applicable laws and regulations, if any.

(iii) safeguarding the assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.

(iii) ensuring that the activities of the entity are carried in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.

(iv) Ensuring complete disclosure of all material and relevant information to the accountant.

(b) SA 320 "Materiality in Planning and Performing an Audit" prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole.

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

(i) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);

(ii) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);

(iii) The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;

(iv) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and

(v) The relative volatility of the benchmark.

Question 9

*(a) In the course of audit of Z Ltd, its auditor wants to rely on audit evidence obtained in previous audit in respect of effectiveness of internal controls instead of retesting the same during the current audit. As an advisor to the auditor kindly caution him about the factors that may warrant a re-test of controls. (4 Marks, May, 2013)*

*(b) In audit plan for T Ltd, as the audit partner you want to highlight the sources of misstatements, arising from other than fraud, to your audit team and caution them. Identify the sources of misstatements. (4 Marks, May, 2013)*

*Or*

*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. (4 Marks, May 2011)*

*(c) The auditor of H Ltd. Wanted to obtain confirmation from its creditors. But the management made a request to the auditor not to seek confirmation from certain creditors citing disputes. Can the auditor of H Ltd. accede to this request?*

*(4 Marks, May, 2013)*

*(d) R & Co, a firm of Chartered Accountants have not revised the terms of engagements and obtained confirmation from the clients, for last 5 years despite changes in business and professional environment. Please elucidate the circumstances that may warrant the revision in terms of engagement. (4 Marks, May, 2013)*

Answer

(a) As per SA 330 on "The Auditor's Responses to Assessed Risks", changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance.

The auditor's decision on whether to rely on audit evidence obtained in previous audits for control is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment.

Factors that may warrant a re-test of controls are-

(i) A deficient control environment.

(ii) Deficient monitoring of controls.

(iii) A significant manual element to the relevant controls.

(iv) Personnel changes that significantly affect the application of the control.

(v) Changing circumstances that indicate the need for changes in the control.

(vi) Deficient general IT-controls.

(b) According to SA 450 "Evaluation of Misstatements identified during the Audit", the following are the sources of misstatements arising from other than fraud -

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

(ii) An omission of an amount or disclosure;

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

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

(c) SA 505, "External Confirmations", establishes standards on the auditor'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. The auditor may come across certain situations in which the management may request him not to seek external confirmation from certain parties because of dispute with the trade payables, etc. The management, for example, might make such a request on the grounds that due to a dispute with the particular trade payable, the request for confirmation might aggravate the sensitive negotiations between the entity and the trade payables.

In such cases, when an auditor agrees to management's request not to seek external confirmation regarding certain trade payables, the auditor should consider validity of grounds for such a request and assess management's integrity and obtain evidence to support the same. The auditor should also ask the management to submit its request in a written form, detailing therein the reasons for such a request.

If the auditor of H Ltd. agrees to management's request not to seek external confirmation regarding a particular matter, the auditor should document the reasons for acceding to the management's request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter. While considering the validity of request, in case the auditor of H Ltd. reaches at a conclusion that the same was not valid, he may appropriately modify the report.

(d) As per SA 210 on "Agreeing the Terms of Audit Engagements", the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

(i) Any indication that the entity misunderstands the objective and scope of the audit.

(ii) Any revised or special terms of the audit engagement.

(iii) A recent change of senior management.

(iv) A significant change in ownership.

(v) A significant change in nature or size of the entity's business.

(vi) A change in legal or regulatory requirements.

(vii) A change in the financial reporting framework adopted in the preparation of the financial statements.

(viii) A change in other reporting requirements.

Question 10

*Write a short note on Corresponding figures.* *(4 Marks, May, 2013)*

Answer

Corresponding Figures: As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements", "corresponding figures" is a comparative information where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period. These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures.

Question 11

*As a statutory auditor of a company, comment on the following:*

*(a) A fire broke out on 15th May, 2012, in which material worth ₹ 50 lakhs which was lying in stock since 1st March, 2012 was totally destroyed. The financial statements of the company have not been adopted till the date of fire. The management of the company argues that since the loss occurred in the year, 2012-13, no provision for the loss needs to be made in the financial statements for 2011-12.*

*(b) While verifying the employee records in a company, it was found that a major portion of the labour employed was child labour. On questioning the management, the auditor was told that it was outside his scope of the financial audit to look into the compliance with other laws. (5 Marks each, November, 2012)*

Answer

(a) Event Occurring After the Balance Sheet Date: This case requires attention to SA 560 "Subsequent Events" and AS 4 "Contingencies and Events occurring after the Balance Sheet Date".

As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

AS 4 also requires disclosure of the non-adjusting event, in the report of the approving authority.

Further, as per SA 560 "Subsequent Events", the auditor should assure that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

The event took place after the close of the accounting year and does not relate to conditions existing at the balance sheet date. Thus, it will have no effect on items appearing at the balance sheet date because as per AS 4 "Contingencies and Events Occurring after Balance Sheet Date" have to be adjusted that provide evidence of conditions existing as at the balance sheet date. However, the auditor has to ensure that this loss will not materially affect the substratum of the enterprises as per its size, nature and complexity of operations.

Thus, subject to satisfaction in respect of non-violation of going concern concept, the company has correctly accounted by not providing provision. However, the auditor is required to ensure the proper disclosure of abovementioned event.

(b) Compliance with Other Laws: As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", the auditor shall obtain sufficient appropriate audit

evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements including tax and labour laws.

Further, non-compliance with other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements.

In the instant case, major portion of the labour employed in the company was child labour. While questioning by auditor, reply of the management that it was outside his scope of financial audit to look into the compliance with other laws is not acceptable as it may have a material effect on financial statements.

Thus, auditor should ensure the disclosure of above fact and provision for the cost of fines, litigation or other consequences for the entity. In case if the auditor concludes that non-compliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statement.

Question 12

*While carrying out the statutory audit of a large entity, what are the substantive procedures to be performed to assess the risk of material misstatement? (8 Marks, November, 2012)*

Answer

Substantive Procedures to be Performed to Assess the Risk of Material Misstatement: As per SA 330, "The Auditor's Response to Assessed Risk", substantive procedure is an audit procedure designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures.

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

In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size.

Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.

Alternative Solution:

SA 330 'The Auditor's Responses to Assessed Risks' requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement.

This requirement reflects the facts that:

- The auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and;
- There are inherent limitations to internal control, including management override.

Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce the audit risk to an acceptably low level;
- Only tests of detail are appropriate;
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

Based on the above, the auditor's substantive procedures would include the following audit procedures related to the financial statement closing process:

- Agreeing or reconciling the financial statements with the underlying accounting records and
- Examining material journal entries and other adjustments made during the course of preparing the financial statements.

Question 13

*As an auditor how will you verify the existence of Related Parties? (8 Marks, November, 2012)*

*Or*

*Elaborate how the Statutory Auditor can verify the existence of related parties for the purpose of reporting under Accounting Standard 18. (8 Marks, May, 2006)*

Answer

Verification of Existence of Related Parties: As per 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. Example-

(i) Entity Income Tax Returns.

(ii) Information supplied by the entity to regulatory authorities.

(iii) Shareholder registers to identify the entity's principal shareholders.

(iv) Statements of conflicts of interest from management and those charged with governance.

(v) Records of the entity's investments and those of its pension plans.

(vi) Contracts and agreements with key management or those charged with governance.

(vii) Significant contracts and agreements not in the entity's ordinary course of business.

(viii) Specific invoices and correspondence from the entity's professional advisors.

(ix) Life insurance policies acquired by the entity.

(x) Significant contracts re-negotiated by the entity during the period.

(xi) Internal auditors' reports.

(xii) 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:

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

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

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

Question 14

*(a) R & Co. is the statutory auditor of S Ltd. For the financial year ended on 31st March 2012, S Ltd had disclosed in the notes (Note No. X) "The state pollution control board had ordered the closure of the company's only manufacturing plant on the ground that it is environmentally damaging, which the company had challenged in a law suit. Pending the outcome of the law suit the financial statements are prepared on a going concern basis". Further the financial statements prepared by the management of S Ltd include*

*financial statements of certain branches which are audited by other auditors. What are the reporting responsibilities of R & Co.? (10 Marks, May, 2012)*

(b) *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?*

*(5 Marks, May, 2012)*

Answer

(a) Reporting Responsibilities of Statutory Auditor: This question involves two broad aspect with respect to reporting requirements i.e. (i) one which deals with Going Concern aspect where the company has gone for legal suit and (ii) other is work done by other auditors.

As per facts of the case, the State Pollution Control Board has issued the closure order for S Ltd., on account of environmental damaging by its only manufacturing plant. However, S Ltd had challenged the same by way of a law suit. Due to pendency of the outcome of the legal suit, the company has prepared its financial statements on going concern basis.

As per SA 570 "Going Concern", under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Management's assessment of the entity's ability to continue as a going concern involves making a judgment, at a particular point in time, about inherently uncertain future outcomes of events or conditions.

The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. For this the auditor may take the help of expert.

As per SA 620, "Using the Work of an Auditor's Expert", if expertise in a field is necessary to obtain sufficient appropriate audit evidence, he may determine to use the work of an auditor's expert. On the basis of expert's opinion he may decide to rely or not on assessment of management.

As per SA 570 "Going Concern", pending legal proceedings is a condition that, individually, may cast significant doubt about the going concern assumption. Existence of above condition signifies that a material uncertainty exists.

Further, when the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(i) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(ii) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph as per SA 706 "Emphasis of matter paragraphs and other matter paragraphs in the Independent Auditor's Report", in the auditor's report to:

(i) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and

(ii) Draw attention to the note in the financial statements that discloses the matters

In the present situation, management of S Ltd. had disclosed the above fact in the financial statement. Further, use of the going concern assumption is appropriate but a material uncertainty exists so assuming the assessment and disclosure of S Ltd. in order, R & Co. should include an Emphasis of Matter paragraph in the auditor's report.

Further, as per SA 600 "Using the work of Another Auditor", 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.

Note: Alternative answer is possible assuming that company is not going concern, hence auditor should issue adverse report.

(b) 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:

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

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

(iii) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;

(iv) 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

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

Question 15

*In the course of audit of Q Ltd, its statutory auditor wants to be sure of the adequacy of related party disclosures? Kindly guide the auditor in identifying the possible source of related party information.* *(8 Marks, May, 2012)*

Answer

Identification of Possible Sources for Related Parties' Information: 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. However, it is the management, which is primarily responsible for identification of related parties. The duties of an auditor with regard to reporting of related party transaction as required by Accounting Standard 18 "Related Party Disclosures" is given in SA 550.

(i) 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).

(ii) Some arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions as 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 or 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 etc.

(iii) 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 etc.

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

Question 16

*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.*

*(6 Marks, May, 2012)*

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:

(i) Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

(ii) Inappropriately adjusting assumptions and changing judgments used to estimate account balances.

(iii) Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.

(iv) Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.

(v) Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.

(vi) Altering records and terms related to significant and unusual transactions.

(vii) Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).

(viii) 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).

(ix) 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).

(x) 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).

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

The auditor is also required to report as per Clause (xii) of Paragraph 3 of CARO, 2015, if there is any fraud on or by the company has been noticed or reported during the year. The nature and the amount involved are to be indicated.

Question 17

*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. Comment. (5 Marks, November, 2011)*

Answer

Evaluating the Work of Management's Expert: As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes,-

(a) Evaluate the competence, capabilities and objectivity of that expert;

(b) Obtain an understanding of the work of that expert; and

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

The auditor may obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as personal experience with previous work of that expert; discussions with that expert; discussions with others who are familiar with that expert's work; knowledge of that expert's qualifications; published papers or books written by that expert.

Aspects of the management's expert's field relevant to the auditor's understanding may include what assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.

The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:

(i) The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;

(ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and

(iii) If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

Question 18

*State briefly the basic elements of Management Representation Letter.(2 Marks, November, 2011)*

Answer

Basic Elements of a Management Representation Letter: As per SA 580 "Written Representations", some of the basic elements of a Management Representation letter are-

(i) It is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

(ii) It does not include financial statements, the assertions therein, or supporting books and records.

(iii) 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.

(iv) The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Question 19

*(a) 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? (6 Marks, May 2011)*

*(b) 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? (6 Marks, May 2011)*

*Or*

*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. As a Statutory Auditor, how would you deal? (4 Marks, May, 2005)*

Answer

(a) 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.

(b) 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 20

*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? (8 Marks, May, 2011)*

*Or*

*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. Comment. (4 Marks, June 2009)*

Answer

Evaluating the Work of Management's Expert: As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes,-

(a) Evaluate the competence, capabilities and objectivity of that expert;

(b) Obtain an understanding of the work of that expert; and

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

The auditor may obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as personal experience with previous work of that expert; discussions with that expert; discussions with others who are familiar with that expert's work; knowledge of that expert's qualifications; published papers or books written by that expert.

Aspects of the management's expert's field relevant to the auditor's understanding may include what assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.

The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:

(i) The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;

(ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and

(iii) If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

Question 21

*Write a short note on Frauds committed through supplier's ledger.* *(4 Marks, May, 2011)*

*Or*

*Write a short note on Frauds through supplier ledger.* *(4 Marks, November 2008)*

Answer

Frauds Committed Through Suppliers Ledger: Fraud through supplies ledger could be made in any of the following ways, which the auditor has to take care of -

(i) Inflating suppliers account with fictitious or duplicate invoices and subsequent misappropriations as if payments are made to the supplier.

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

(iii) 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.

(iv) Inflating values of items purchased and collecting the excess from suppliers i.e. accepting invoices at prices considerably higher than the market price and collecting the excess claim from the suppliers directly.

Question 22

*A Co. Ltd. has not included in the Balance Sheet as on 31-03-2010 a sum of ₹ 1.50 crores being amount in the arrears of salaries and wages payable to the staff for the last 2 years as a result of successful negotiations which were going on during the last 18 months and concluded on 30-04-2010. The auditor wants to sign the said Balance Sheet and give the audit report on 31-05-2010. The auditor came to know the result of the negotiations on 15-05-2010. Comment.* *(5 Marks, November, 2010)*

Answer

Subsequent Events: This case requires attention to SA 560 "Subsequent Events", AS 4 "Contingencies and Events occurring after the Balance Sheet Date" and AS 29 "Provisions, Contingent liabilities and Contingent Assets".

As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. Similarly as per AS 29 "Provisions, Contingent liabilities and Contingent Assets", future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the will occur.

In the instant case, the amount of ₹ 1.50 crores is a material amount and it is the result of an event, which has occurred after the Balance Sheet date. The facts have become known to the auditor before the date of issue of the Audit Report and Financial Statements.

The auditor has to perform the procedure to obtain sufficient, appropriate evidence covering the period from the date of the financial statements i.e. 31-3-2010 to the date of Auditors Report ie.31-05-2010. It will be observed that as a result of long pending negotiations a sum of ₹ 1.50 cores representing arrears of salaries of the year 2008-09 and 2009-10 have not been included in the financial statements. It is quite clear that the obligation requires provision for outstanding expenses as per AS 4 and AS 29.

As per SA 560 "Subsequent Events", the auditor should assure that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

So the auditor should request the management to adjust the sum of ₹ 1.50 crores by making provision for expenses. If the management does not accept the request the auditor should qualify the audit report.

Question 23

*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?* *(4 Marks, November, 2010)*

Answer

Using the Work of an Auditor's Expert: As per SA 620, "Using the Work of an Auditor's 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 options or statements of an expert for the purpose of audit evidence:

(i) The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.

(ii) The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.

(iii) The estimation of oil and gas reserves.

(iii) The valuation of environmental liabilities, and site clean-up costs.

(iv) The interpretation of contracts, laws and regulations.

(v) The analysis of complex or unusual tax compliance issues.

When the auditor intends to use the work of an expert, he shall evaluate the adequacy of the auditor's expert's work, 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 his work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, he shall agree with that expert on the nature and extent of further work to be performed by that expert; or perform further audit procedures appropriate to the circumstances.

Question 24

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

*(5 Marks, November, 2010)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.

Question 25

*S Ltd. issued Bonds to the tune of ₹100 lacs and provided security to the tune of ₹80 lacs for the same. It insists that it will disclose the Bonds as "Secured" in the Balance Sheet of the Company. Comment.* *(5 Marks, May, 2010)*

Answer

Disclosure in Balance Sheet: Prima facie, the Bonds issued to the tune of ₹ 100 lacs are provided with security to the tune of ₹ 80 lacs i.e. neither fully secured nor unsecured. Guidance Note on the "Terms used in Financial Statements" issued by ICAI, states "Secured Loans" as loan secured wholly or partly against an asset. Hence the Bonds should be classified under 'Secured Loans' for the purpose of disclosure in the Balance Sheet. However the nature of security should be clearly specified.

Question 26

*(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?*

*(4 Marks each, May, 2010)*

Answer

(a) Duty of an Auditor if Management Refuses to Provide Written Representations: As per SA 580 "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 in accordance with SA 705 "Modifications to the Opinion in the Independent Auditor's Report".

(b) Risk Factors While Applying Sampling Techniques: As per SA 530 "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:

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

(ii) 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 "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 27

*Comment on the following:*

*(a) 'A' Limited has paid minimum alternate tax under Section 115 JB of the Income Tax Act, 1961, for the year ended 31st March, 2009. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same.*

*(5 Marks, November, 2009)*

*Or*

*For the year ended 31st March, 2007, a company has paid Minimum Alternative tax under section 115 JB of the Income Tax Act, 1961. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same.*

*(5 Marks, November 2007)*

*(b) 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 he is traceable. Under the circumstances no confirmation of the credit balance is available. (5 Marks, November, 2009)*

*(c) The statutory audit of Fortune Limited for the year ended on 31.03.2009 was completed and auditor also submitted his report with the audited Financial Statements to the management of the company. Thereafter, the management of the company approached the auditor to revise certain items in the Financial Statements.*

*(5 Marks, November, 2009)*

Answer

(a) Disclosure of MAT: As per Para 6 of the Guidance Note issued by ICAI on "Accounting for credit available in respect of MAT under the IT Act, 1961", although MAT credit is not a deferred tax asset under AS 22, yet it gives rise to expected future economic benefit in the form of adjustment of future income tax liability arising within the specific period.

The Framework for the preparation and presentation of financial statements, issued by the ICAI, defines the term 'asset' is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

MAT paid in a year in respect of which the credit is allowed during the specified period under the Income Tax Act is a resource controlled by the company as a result of past event, namely the payment of MAT. The MAT credit has expected future economic benefits in the form of its adjustment against the discharge of the normal tax liability if the same arises during the specified period. Accordingly, such credit is an asset.

According to the Framework, once an item meets the definition of the term 'Asset', it has to meet the criteria for recognition of an asset, so that it may be recognised as such in the financial statements.

Para 88 of the Framework provides the following criteria for recognition of an asset:

An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

Thus, if the auditor is satisfied that the probability of the company to claim the said credit is high, it could recognise the same as an asset. In balance sheet it could be shown under the head "Loans and Advances" as MAT credit entitlement.

(b) External Confirmation: This is a case of external confirmation, covered by SA 505 "External Confirmations". The identities of trade payables 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.

(c) Revision of Financial Statements: As per the Guidance Note on Revised Accounts of Companies Before Circulation to Shareholders, management can revise its accounts after adoption on which report has been issued by the Auditors, but before circulation to the shareholders.

In the instant case, the statutory auditor should ascertain whether the original audit report along with audited accounts has been circulated to the share-holders. If not, he can issue

a revised report on the amended financial statements as laid down by the said Guidance Note:

(i) For the same, the revised accounts must be re-approved by the Board of Directors of the company.

(ii) He should ask the company to return all the original copies of the earlier audit report along with the audited accounts.

(iii) The fact of revision of financial statements with reasons should be incorporated in the Directors' Report. If it is neither included nor found adequately disclosed in the Director's Report, he should include the fact with figures and reasons in his revised audit report to the shareholders. He should specifically mention that it is a revised audit report.

Note: Section 131 of the Companies Act, 2013 prescribes the voluntary revisions of the financial statements or Board's report which is yet to be notified.

Question 28

*Briefly explain Audit procedures on subsequent events.* *(4 Marks, November, 2009)*

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 29

*Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud.* *(6 Marks, November, 2009)*

Answer

Duties & Responsibilities of an auditor in case of Material Misstatement Resulting from Management Fraud: Misstatement in the financial statements can arise from fraud or error. The term fraud refers to an 'Intentional Act' by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

As per SA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. The auditor, conducting an audit, is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

As described in SA 200, the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

Additionally, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

The auditor is also required to report as per Clause (xii) of Paragraph 3 of CARO, 2015, if there is any fraud on or by the company has been noticed or reported during the year. The nature and the amount involved are to be indicated.

Question 30

*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. (5 Marks, June 2009)*

*(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. (5 Marks, June 2009)*

*(c) 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. (4 Marks, June 2009)*

Answer

(a) Compilation of Financial Statements: According to SRS 4410 "Engagements 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.

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.

(b) Material Misstatements: 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) Going Concern Assumption: 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 31

*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?*

*(8 Marks, June 2009)*

Answer

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 32

*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 unavoideable 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. (5 Marks each, November 2009)*

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 "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 33

*Write a short note on Situations where external confirmations can be used.*

*(4 Marks, November, 2007)*

*Or*

*Write a short note on Eight situations of external confirmations.* *(4 Marks, May, 2007)*

Answer

Situations where External Confirmations can be Used:

(i) Bank balance from bankers

(ii) Account receivable balances

(iii) Stocks held by third parties

(iv) Property title deeds held by third parties

(v) Investments purchased but delivery not taken

(vi) Loan from lenders

(vii) Account payable balances

(viii) Long outstanding share application money.

Question 34

*You notice a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit. As a Statutory Auditor, how would you deal? (5 Marks, November, 2007)*

Answer

Impossibility to Continue the Performance of Audit: According to SA 240 "The Auditor's Responsibilities Relating to 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.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

The auditor is also required to report as per Clause (xii) of Paragraph 3 of CARO, 2015, if there is any fraud on or by the company has been noticed or reported during the year. The nature and the amount involved are to be indicated.

Question 35

*"The auditors should communicate audit matters of governance interest arising from the audit of financial statements with those charged with the governance of an entity". Briefly state the matters to be included in such Communication. (8 Marks, November, 2006)*

Answer

Communications of Audit Matters with Those Charged With Governance: As per SA 260 "Communication with those Charged with Governance", the auditor shall communicate with those

charged with governance, the responsibilities of the auditor in relation to the financial statement audit, including that -

(a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and

(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

The auditor shall communicate with those charged with governance the following:

(a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

(b) Significant difficulties, if any, encountered during the audit;

(c) Unless all of those charged with governance are involved in managing the entity:

  (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and

  (ii) Written representations the auditor is requesting; and

(d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

Question 36

*State the reporting responsibility of an auditor in the context of non-compliance of Law and Regulation in an audit of Financial Statement.* *(8 Marks, November, 2006)*

Answer

Reporting Responsibility of an Auditor in the Context of Non-Compliance of Law and Regulation: According to SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements", the reporting responsibilities of an Auditor may be divided into the following categories-

*Reporting Non-Compliance to Those Charged with Governance:* Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor, the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

If, in the auditor's judgment, the non-compliance referred above is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

*Reporting Non-Compliance in the Auditor's Report on the Financial Statements:* If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with SA 705 express a qualified or adverse opinion on the financial statements.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705.

If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with SA 705.

*Reporting Non-Compliance to Regulatory and Enforcement Authorities:* If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.

Question 37

*Write a short note on Reporting on a compilation engagements. (4 Marks, November, 2006)*

Answer

Reporting on a Compilation Engagements: As per SRS 4410 "Engagements to Compile Financial Information", the report on compilation engagements should, ordinarily, be in the following layout -

(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 38

*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? (8 Marks, May, 2006)*

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.

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

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.

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 39

*Answer the following:*

*(a) Enumerate (in brief) the basic principles governing an audit. (5 Marks, November, 2005)*

*(b) While examining the going concern assumption of an entity, what important indications should be evaluated and examined? (6 Marks, November, 2005)*

Answer

(a) Basic Principles Governing an Audit: The basic principles which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried are described below -

(i) Integrity, Objectivity and Independence: The auditor should be straightforward, honest and sincere in his approach to his professional work. 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. The auditor requires specialised skills and competence along with a continuing awareness of developments including pronouncements of the ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.

(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. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied.

(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 gain an understanding of the accounting system and related controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

(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.

The audit report should contain a clear written opinion on the financial information and should comply the legal requirements. When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons therefore.

(Note: Student may note that at present, there is no specific standard namely basic principles governing an audit. However, there are certain fundamental principles which are ethically required as per Code of Ethics read with SA 200 and SA 220. But in general abovementioned principles are basic principles only).

(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 trade payables.
- 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 trade payables 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 40

*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. As a Statutory Auditor, how would you deal? (4 Marks, May, 2005)*

Answer

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.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within 60 days of his knowledge and after following the prescribed procedure.

The auditor is also required to report as per Clause (xii) of Paragraph 3 of CARO, 2015, if there is any fraud on or by the company has been noticed or reported during the year. The nature and the amount involved are to be indicated.

Question 41

*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.*

*(5 Marks, May, 2005)*

Answer

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 42

*Obtaining audit evidence in performing compliance and substantive procedures. Comment.*

*(10 Marks, May, 2005)*

Answer

Obtaining Audit Evidence: As per SA 500 "Audit Evidence", in performing compliance and substantive procedures, the auditor may obtain audit evidence by following methods-

(i) Inspection: Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of

the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

(ii) Observation: Observation consists of looking at a process or procedure being performed by the others. For example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

(iii) External Confirmation: An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition.

(iv) Recalculation: Recalculation consists of checking the arithmetical accuracy of documents or records. Recalculation may be performed manually or electronically.

(v) Reperformance: It involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

(vi) Analytical Procedure: Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

(vii) Inquiry: Inquiry consists of seeking information of knowledgeable persons, both financial and non- financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Question 43

*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?*

*(5 Marks, November, 2004)*

Answer

Validity of Management 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 44

*(a) What are 'Initial Audit Engagements'? (2 Marks, November, 2004)*

*(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 cases (i) when the financial statements are audited for the preceding period by another auditor; and (ii) when financial statements are audited for the first time. (7 Marks, November, 2004)*

*(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 two situations mentioned in (b) above? (7 Marks, November, 2004)*

Answer

(a) Initial Audit Engagement: 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) (i) 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.

(ii) Audit of Financial Statements for the First Time – Audit Procedure: When the audit of financial statements is being conducted for the first time, the auditor has to perform auditing procedures to obtain sufficient appropriate audit evidence. Since opening balances represent effect of transaction and events of the preceding period and accounting policies applied in the preceding period, the auditor need to obtain evidence having regard to nature of opening balances, materiality of the opening balances and accounting policies. Since it will not be possible for auditor to perform certain procedures, e.g., observing physical verification of inventories, etc. the auditor may obtain confirmation, etc. and perform suitable procedures in respect of fixed assets, investments, etc. The auditor can also obtain management representation with regards to the opening balances.

(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 45

*As a Statutory Auditor, how would you deal with the following cases:*

*(a) National Tourism Ltd., a wholly owned Government Company approaches you to give a revised report on the revised accounts, as the original accounts has undergone changes consequent to the audit of Comptroller and Auditor General of India.*

*(b) M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to the previous year's figures.* *(4 Marks each, May, 2004)*

Answer

(a) Auditor's Report on Revised Accounts: The Guidance Note on Auditor's Report on Revised Accounts of Companies Before Circulation to Shareholders deals with those situations wherein the statutory auditor is required to give report on the revised accounts. The auditors of National Tourism Ltd. have been asked to give revised report on the revised accounts as the original accounts have undergone changes consequent to audit of the C&AG. The Guidance Note requires that the statutory auditor must observe the following steps while issuing the revised report -

(i) All copies of the original accounts and reports thereon are returned to the auditor.

(ii) The adequate disclosure has to be made that the accounts which were earlier approved by the Board of Directors and reported by the auditors have been revised

and re-approved by the Board of Directors as a specific note on the amended accounts.

(iii) In case the notes to accounts do not contain any note on revision or such a note is not considered adequate or comprehensive, the statutory auditor shall have to indicate that accounts have been revised based on the audit report of C&AG. The auditor at the time of issue of revised report has to bring these facts in his report if not included as a note in the revised accounts.

(iv) Finally, the auditor's report (revised) should clearly draw the attention to their earlier audit report.

Note: Section 131 of the Companies Act, 2013 prescribes the voluntary revisions of the financial statements or Board's report which is yet to be notified.

(b) Using the Work of Management's Expert: As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes,-

(a) Evaluate the competence, capabilities and objectivity of that expert;

(b) Obtain an understanding of the work of that expert; and

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

The auditor may obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as personal experience with previous work of that expert; discussions with that expert; discussions with others who are familiar with that expert's work; knowledge of that expert's qualifications; published papers or books written by that expert.

Aspects of the management's expert's field relevant to the auditor's understanding may include what assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.

The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:

(i) The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;

(ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and

(iii) If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

The auditor has to evaluate the work of an expert, say, actuary, before adopting the same. This becomes more crucial since M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to previous year figures. There is no doubt that

relevance and reasonableness of assumptions and methods used are the responsibility of the expert, but the auditor has to determine whether they are appropriate based on the auditor's knowledge of the client's business and result of his audit procedures.

In the present case, the auditor must verify the reasonableness of assumptions made and methods adopted by the actuary in the evaluation particularly with reference to factors such as rate of return on investments, retirement age, number and salary of employees, etc. Accordingly, the auditor has to satisfy himself whether valuation done by the actuary can be adopted, otherwise, he may report on his findings for wide variation.