

AUDITING STANDARDS, STATEMENTS AND GUIDANCE NOTES AN OVERVIEW

Question 1

Comment on the following:

- (a) *You are the auditor of Easy Communications Ltd. for the year 2007–08. The inventory as at the end of the year i.e. 31.3.08 was ₹ 2.25 crores. Due to unavoidable circumstances, you could not be present at the time of annual physical verification. Under the above circumstances how would you ensure that the physical verification conducted by the management was in order?* (5 Marks)
- (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) (November 2008)

Answer

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

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

regard to adherence to laid down procedures for physical inventory count..

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

- (b) As per SA 510 (Revised), "Initial Audit Engagements—Opening Balances" in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:
- (i) Opening balances contain misstatements that materially affect the current period's financial statements; and
 - (ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

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

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

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

Question 2

Write short notes on the Frauds through supplier ledger.

(4 Marks) (November 2008 & May, 2011)

Answer

Frauds through suppliers ledger

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

- (1) Adjusting fictitious as duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the money when payments are made in respect of these invoices.
- (2) Suppressing credit notes issued by suppliers and withdrawing the corresponding amount not claimed by them.

- (3) Withdrawing amounts which remain unclaimed for more than the normal time limit for one reason or other by showing the same have been paid to the parties.
- (4) Accepting invoices at prices considerably highest than the market price and collecting the excess claim from the suppliers directly.

Question 3

- (a) *In the course of the audit of R Ltd., the audit manager of ABC & Co. observed that R Ltd. has outsourced certain activities to an outsourcing agency. As the engagement partner guide the audit manager in the assessment of services provided by the outsourcing agency in relation to the audit.* (4 Marks)
- (b) *In the course of audit of T Ltd., the audit team is not sure of the possible source of misstatements in the financial statements. As the audit manager identify the sources of misstatements.* (4 Marks)
- (c) *While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements?* (6 Marks)
- (d) *The management of S Ltd. requests you not to seek confirmation from its debtors. As the auditor of S Ltd., what can be an appropriate response?* (6 Marks) (May 2011)

Answer

- (a) As per SA 402 "Audit Considerations relating to an Entity Using a Service Organisation", for obtaining understanding of the user entity in accordance with SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", the user auditor shall obtain an understanding of how a user entity uses the services of a service organization in the user entity's operation including:
 - (i) The nature of services provided by the service organisation and the significance of such services to the user entity, including its effect on the internal control of user entity.
 - (ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation.
 - (iii) The degree of interaction between the activities of the service organization and those of user entity and
 - (iv) The nature of the relationship between the user entity and the service organization including the relevant contractual terms for the activities undertaken by the service organisation.
- (b) As per SA 450 "Evaluation of Misstatements Identified during the Audit", misstatements may result from

- (i) An inaccuracy in gathering or processing data from which the financial statements are prepared.
 - (ii) An omission of an amount of disclosure.
 - (iii) An incorrect accounting estimate arising from overlooking or clear misinterpretation of facts and
 - (iv) Judgements of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.
- (c)** As per SA 540 “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures”, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates.
- (i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.
 - (ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
 - (iii) The estimation making process adopted by the management including
 - (1) The method, including where applicable the model, used in making the accounting estimates
 - (2) Relevant controls
 - (3) Whether management has used an expert?
 - (4) The assumption underlying the accounting estimates
 - (5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
 - (6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.
- (d)** SA 505 “External Confirmations”, establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. If the management refuses to allow the auditor to 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 4

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)

Answer

Evaluating the work of an expert –

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

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

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

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

- (ii) The objectives and scope of the experts' work.
- (iii) A general outline as to specific items in the expert's report.
- (iv) Confidentiality of the client's information used by the expert.
- (v) The source data used.
- (vi) The assumptions and methods used and, if appropriate, their comparison with the prior period.
- (vii) The results of the expert's work in the light of auditor's overall knowledge of the business and of the results of his audit procedures.
- (viii) The auditor should also satisfy himself that the substance of the expert's findings is properly reflected in the financial statements.
- (ix) Consider whether the expert has used the appropriate source data, by making inquiries of the expert.
- (x) Conducting audit procedures on the data by the client to the expert to obtain reasonable assurance that the data are appropriate.

Question 5

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

(4 Marks) (November 2010)

Answer

Guidance note on Audit of Miscellaneous Expenditure (revised)

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

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

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

(c) research and development expenditure, etc.

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

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

Question 6

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 Expert

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

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

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

- Legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc.

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

Question 7

- (a) *In the course of audit of ABC Ltd. its management refuses to provide written representations. As an auditor what is your duty?* (4 marks)
- (b) *While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?* (4 marks)
- (c) *What are the auditor's responsibilities in respect of corresponding figures?* (4 marks)
- (d) *IT systems also pose specific risks to an entity's internal control? What are those risks?* (4 Marks) (May 2010)

Answer

(a) Duty of an Auditor if management refuses to provide written representations

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

- (i) Discuss the matter with management
- (ii) Re-evaluate the Integrity of the management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general and
- (iii) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

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

(b) Risk Factors while applying sampling techniques

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

- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of tests of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (ii) In the case of test of controls, the controls are less effective than they actually are, or in the case of tests of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

(c) Auditor's responsibilities in respect of corresponding figures

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

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

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

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

(d) Specific Risk to an Entity's internal Control

As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", IT system also poses specific risks to an entity's Internal Control. They are—

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

- (ii) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non existent transactions, or inaccurate recording of transactions. Particular risk may arise when multiple users access a common database.
- (iii) The possibility of IT personnel gaining access beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- (iv) Unauthorised changes to data in Master files
- (v) Unauthorised changes to systems or programs.
- (vi) Failure to make necessary changes to systems or programs.
- (vii) In appropriate manual intervention
- (viii) Potential loss of data or inability to access data as required.

Question 8

Answer the following:

- (a) *You are appointed statutory auditor of X Ltd. X Ltd. has an internal audit system and reports for the same are given to you. Mention the factors you will consider to ensure that the said system of internal audit of X Ltd. is commensurate with the size of the company and nature of its business.* (8 Marks)
- (b) *The audit report of P Ltd. for the year 2007-08 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2008-09, how would you report, if:*
 - (i) *The company does not make provision for doubtful debts in 2008-09?*
 - (ii) *The company makes adequate provision for doubtful debts in 2008-09?*

(8 Marks) (June 2009)

Answer**(a) Internal Audit System end CARO 2003.**

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

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

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

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

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

- (i) What is the size of the internal audit department? In considering the adequacy of internal audit staff, it is necessary to consider the nature of the business, the number of operating points, the extent to which control is decentralised, the effectiveness of other forms of internal control, etc.
- (ii) What are the qualifications of the persons who undertake the internal audit work? Internal auditing, as its name implies, is an aspect of audit and, therefore, it is reasonable to expect that the internal audit department should normally be headed by a chartered accountant and that, depending upon the size of the department, it employs other qualified persons. In deciding the adequacy of the internal audit department, it is, therefore, necessary that there is adequate number of qualified personnel.
- (iii) To whom does the internal auditor report? In general, the higher the level to which the internal auditor reports, the greater will be his independence.
- (iv) What are the areas covered by the internal audit? Internal audit can cover a large number of areas including operational auditing, organisation and methods studies, special investigations and the like. For the purposes of the Order, however, the important areas which should be covered by internal audit are the examination of the operating systems to ensure that the systems are adequate and functioning in practice. The exact areas to be covered by the internal audit would depend upon the circumstances of each case but the statutory auditor should ask the internal auditor to provide the programme of his work and should determine whether, in his opinion, the coverage is adequate. If he feels it is not, he may suggest to the internal auditor to extend the programme in the required direction.
- (v) Has the internal auditor adequate technical assistance? In a number of companies, where the operations are highly technical in nature, an internal auditor cannot function effectively unless he has adequate technical assistance. This can be provided either by having full-time technically qualified persons in the internal audit department or by such persons being deputed to the internal audit department for specific assignments. Similar considerations would apply where a large part of the transactions are computerised. In such cases, the internal auditor should have the assistance of persons who are able to audit computer systems.
- (vi) What are the reports which are submitted by the internal auditor or what other evidence is there of his work? It is important that the auditor should satisfy himself

that not merely does an internal audit system exist but also that it is functioning effectively. He can do so by examining the reports submitted by the internal auditor.

- (vii) What is the follow-up? It is not sufficient that the internal audit system should point out errors in operation or deficiencies in the internal control system. It is equally necessary that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.
- (b) Auditor's responsibilities in cases where audit report for an earlier year is qualified is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements". As per SA 710, When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

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

- (i) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
- (ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

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

Question 9

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

(5 Marks)(November 2009)

Answer

This is a case of external confirmation, covered by SA 505 "External Confirmation". The

identities of creditors are not traceable to confirm the credit balance as appearing in the financial statement of the company. It is also not a case of pending litigation.

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

Question 10

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

As per SA 240 (Revised), "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" 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. The auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements.

Fraud involving one or more members of management or those charged with the governance is referred to as "management fraud". The primary responsibility for the prevention and detection of fraud rests with those charged with the governance and the management of the entity.

SA 200, "Objective and General Principles Governing an Audit of Financial Statements," indicates that an audit conducted in accordance with the standards on auditing generally accepted in India, is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement whether caused by error or fraud. The fact that an audit is carried out may act as deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of financial statements will not be detected, even though the audit is properly planned and performed in accordance with the standards on auditing generally accepted in India. An audit does not guarantee that all material misstatement will be detected because of such factors, as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees. Auditor's opinion on the financial statements is

based on the concept of obtaining reasonable assurance, hence in an audit; the auditor does not guarantee that material misstatements will be detected.

Question 11

Briefly explain the 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 12

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)

- (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)
- (c) Z Ltd. had appointed an outside expert to assess accrued gratuity liability of the company. Based on the said report, the company provides ₹ 80 lakhs as gratuity in the financial statements. (4 Marks)
- (d) A Company's net worth is eroded and creditors are unpaid due to liquidity constraints. The management represents to the statutory auditor that the promoter's wife is expected to give an unsecured loan to meet the liquidity constraints and that negotiations are underway to secure large export orders. (4 Marks) (June 2009)

Answer

- (a) According to SRS 4410, "Engagement to Compile Financial Information" if an accountant becomes aware of material misstatements, the accountant should persuade the management to carry out necessary amendments in the financial statements or other compiled financial information. If such amendments are not made and the financial statements are still considered to be misleading the accountant should withdraw from the engagement. Hence, in this case, there is a clear violation of SRS 4410.
- (b) According to SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" when the auditor comes across such circumstances indicating the possible misstatements resulting from the fraud then the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. In this case, the circumstances indicate that the possible misstatement in financial statements is due to fraud and error and the auditor must investigate further to consider effect on financial statements.

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

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

The auditor should ensure that the expert has used appropriate source data, has made consistent assumptions, has applied correct methods and that results of expert's work

are in line with auditor's overall knowledge of the business and match with results of his audit procedures. The auditor should also ensure that substance of expert's findings is properly reflected in the financial information.

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