

QUESTION & ANSWER OF SA

(Based on Practice Manual Jan. 2017)

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Standards of Audit

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SA 210 - Agreeing the Terms of Audit Engagements

Question 1

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.

Answer

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:

1. Any indication that the entity misunderstands the objective and scope of the audit.
2. Any revised or special terms of the audit engagement.
3. A recent change of senior management.
4. A significant change in ownership.
5. A significant change in nature or size of the entity's business.
6. A change in legal or regulatory requirements.
7. A change in the financial reporting framework adopted in the preparation of the financial statements.
8. A change in other reporting requirements.

SA 220 - Quality Control for an Audit of Financial Statements

Question 1

M/s Sureshchandra & Co. has been appointed as an auditor of SC Ltd. for the financial year 2014-15. CA. Suresh, one of the partners of M/s Sureshchandra & Co., completed entire routine audit work by 29th May, 2015. Unfortunately, on the very next morning, while roving towards office of SC Ltd. to sign final audit report, he met with a road accident and died. CA. Chandra, another partner of M/s Sureshchandra & Co., therefore, signed the accounts of SC Ltd., without reviewing the work performed by CA. Suresh. State with reasons whether CA. Chandra is right in expressing an opinion on financial statements the audit of which is performed by another auditor.

Answer

Relying on Work Performed by Another Auditor: As per SA 220 “Quality Control for an Audit of Financial Statements”, an engagement partner taking over an audit during the engagement may apply the review procedures such as the work has been performed in accordance with professional standards and regulatory and legal requirements; significant matters have been raised for further consideration; appropriate consultations have taken place and the resulting conclusions have been documented and implemented; there is a need to revise the nature, timing and extent of work performed; the work performed supports the conclusions reached and is appropriately documented; the evidence obtained is sufficient and appropriate to support the auditor’s report; and the objectives of the engagement procedures have been achieved.

Further, one of the basic principles, which govern the auditor’s professional responsibilities and which should be complied with wherever an audit is carried, is that 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. This is the fundamental principle which is ethically required as per Code of Ethics.

However, the auditor should carefully direct, supervise and review work delegated. He should obtain reasonable assurance that work performed by other auditors/experts and assistants is adequate for his purpose.

In the given case, all the auditing procedures before the moment of signing of final report have been performed by CA. Suresh. However, the report could not be signed by him due to his unfortunate death. Later on, CA. Chandra signed the report relying on the work performed by CA. Suresh. Here, CA. Chandra is allowed to sign the audit report, though, will be responsible for expressing the opinion. He may rely on the work performed by CA. Suresh provided he further exercises adequate skill and due care and review the work performed by him.

SA 230 - Audit Documentation

Question 1

Discuss the Auditor's responsibility to provide access to his audit working papers to Regulators and third parties.

Answer

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 2

Mr. A, a practising Chartered Accountant, has been appointed as an auditor of True Pvt. Ltd. What factors would influence the amount of working papers required to be maintained for the purpose of his audit?

Answer

Factors Influencing the Amount of Working Papers: As per SA 230 "Audit Documentation", which refers to the record of audit procedures performed, relevant audit evidence obtained and conclusions the auditor reached, the amount of audit working papers depend on factors such as-

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.

3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
7. The audit methodology and tools used.
8. Timely preparation of Audit Documentation.

SA 240 - The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

Question 1

While auditing accounts of a public limited company for the year ended 31st March 2015, an auditor found out an error in the valuation of inventory, which affects the financial statement materially. Comment as per standards on auditing.

Answer

Errors in Valuation of Inventories and Auditor's Responsibilities: SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", requires that if circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. SA 240 also requires that when the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence.

Further, SA 320 Materiality in Planning and Performing an Audit, also requires that in such circumstances, the auditor should consider requesting the management to adjust the financial information or consider extending his audit procedures. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate. In the instant case, the auditor has detected the material errors affecting the financial statements; the auditor should communicate his findings to the management on a timely basis, consider the implications on true and fair view and also ensure that appropriate disclosures have been made.

Question 2

M/s Honest Limited has entered into a transaction on 5th March, 2015, 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, 2015.

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?

Answer

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:

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

- Central Government (in case amount of fraud is 1 crore or above) or
- Audit Committee or Board in other cases (in case the amount of fraud involved is less than 1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Question 3

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

Answer

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

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

1. Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
2. Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
3. Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
4. Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
5. Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
6. Altering records and terms related to significant and unusual transactions.
7. Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
8. Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
9. Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
10. Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Question 4

Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud.

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.

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

- Central Government (in case amount of fraud is 1 crore or above) or
- Audit Committee or Board in other cases (in case the amount of fraud involved is less than 1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Question 5

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?

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:

1. 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;
2. Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and
3. If the auditor withdraws:
 - a. 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

- b. 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

- Central Government (in case amount of fraud is 1 crore or above) or
- Audit Committee or Board in other cases (in case the amount of fraud involved is less than 1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Question 6

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?

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

- Central Government (in case amount of fraud is 1 crore or above) or
- Audit Committee or Board in other cases (in case the amount of fraud involved is less than 1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Question 7

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'.

Answer

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, 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

- Central Government (in case amount of fraud is 1 crore or above) or
- Audit Committee or Board in other cases (in case the amount of fraud involved is less than 1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is 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:

1. 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;
2. Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and
3. If the auditor withdraws:

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

Question 8

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.

Answer

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.

Question 9

You are appointed as an auditor of Global Ltd. Explain the risk factors relating to misstatements arising from misappropriation of assets.

Answer

Risk Factors Relating to Misstatements Arising from Misappropriation of Assets: As per SA 240, "The Auditor's Responsibilities Relating to Fraud in audit of Financial Statements", misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.

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

- ✓ **Incentives/Pressures:** Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:
 1. Known or anticipated future employee layoffs.

2. Recent or anticipated changes to employee compensation or benefit plans.
 3. Promotions, compensation or other rewards inconsistent with expectations.
- ✓ **Opportunities:** Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
1. Inventory items that are small in size, of high value, or in high demand.
 2. Fixed assets which are small in size, marketable, or lacking observable identification of ownership.
 3. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets.
 4. Inadequate segregation of duties or independent checks.
- ✓ **Attitudes/Rationalizations**
1. Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
 2. Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.
 3. Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
 4. Changes in behavior or lifestyle that may indicate assets have been misappropriated.

Question 10

Fraud can be committed by management overriding controls using such techniques as engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.

In view of the above-mentioned circumstances of management fraud, explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from such Management Fraud.

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. The auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements.

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 engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.

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.

Further, an auditor conducting an audit in accordance with SAs 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.

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

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.

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 (in case amount of fraud is `1 crore or above) or

Audit Committee or Board in other cases (in case the amount of fraud involved is less than `1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is 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:

1. 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;
2. Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and
3. If the auditor withdraws:
 - 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
 - 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.

SA 250 - Consideration of Laws and Regulations in an Audit of Financial Statements

Question 1

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.

Answer

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 2

State the reporting responsibility of an auditor in the context of non-compliance of Law and Regulation in an audit of Financial Statement.

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 3

What are the roles and responsibilities of the statutory auditors in relation to compliance with the laws and regulations by the entity?

Answer

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:

1. The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and
2. 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:

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

2. 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 4

R & M Co. wants to be alert on the possibility of non-compliance with Laws and Regulations during the course of audit of SRS Ltd. R & M Co. seeks your guidance for identifying the indications of non-compliance with Laws and Regulations.

Answer

As per SA 250, "Consideration of Laws and Regulations, the auditor shall perform the audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements by inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

However, when the auditor becomes aware of the existence of, or information about, the following matters, it may also be an indication of non-compliance with laws and regulations:

1. Investigations by regulatory organisations and government departments or payment of fines or penalties.
2. Payments for unspecified services or loans to consultants, related parties, employees or government employees.
3. Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
4. Purchasing at prices significantly above or below market price.
5. Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
6. Unusual payments towards legal and retainership fees.
7. Unusual transactions with companies registered in tax havens.
8. Payments for goods or services made other than to the country from which the goods or services originated.
9. Payments without proper exchange control documentation.
10. Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
11. Unauthorised transactions or improperly recorded transactions.
12. Adverse media comment.

Question 5

XYZ Pvt. Ltd. has submitted the financial statements for the year ended 31 -3-16 for audit. The audit assistant observes and brings to your notice that the company's records show following dues:

Income Tax relating to Assessment Year 2012-13 Rs. 125 lacs - Appeal is pending before Hon'ble ITAT since 30-9-14.

Customs duty Rs. 85 lakhs - Demand notice received on 15-9-15 but no action has been taken to pay or appeal.

As an auditor, how would you bring this fact to the members?

Answer

Non-Compliance of Laws and Regulations: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's 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. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

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 express a qualified or adverse opinion on the financial statements.

Further, the auditor is required to report on certain matters specified in Para 3 of CARO, 2016 under section 143 of the Companies Act, 2013.

One of such matter is non-payment of dues to Government, on account of any dispute. **As per clause (vii)(b) of Para 3 of CARO, 2016**, in case dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned.

In the present case, there is Income Tax demand of Rs. 125 Lacs and the company has gone for an appeal, it needs considerations as to whether the entire demand is disputed, because it is difficult to presume that the demand by Income Tax authority is without any basis. Therefore, as per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", partly to the extent the company considers that the demand is based on some logical basis, that amount may be provided for and the remaining may be disclosed as the contingent liability. Further, it should be brought to notice of the members by reporting.

Additionally, the demand notice has been received for Customs duty of Rs. 85 lakhs and is outstanding on the closure of financial year, for which no action has been taken by the management. Therefore, it should also be brought to notice of the members by reporting.

Question 6

Big and Small Ltd. received a show cause notice from central excise department intending to levy a demand of Rs. 25 lakhs in December 2015. The company replied to the above notice in January 2016 contending that it is not liable for the levy. No further action was initiated by the central excise department upto the finalization of the audit for the year ended on 31st March, 2016. As the auditor of the company, what is your role in this?

Answer

Compliance of Laws and Regulations & Reporting Requirements: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", 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.

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. Then the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice. In case, 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 express a qualified or adverse opinion on the financial statements.

Further, **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 event will occur.

Furthermore, the auditor's report under section 143 of the Companies Act, 2013 has to specifically include certain matters specified in Para 3 of CARO, 2016.

One of such matter is non-payment of dues to Government, on account of any dispute. **As per clause (vii)(b) of Para 3 of CARO, 2016**, in case dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned.

In the present case of Big and Small Ltd., issuance of show cause notice by Excise Department does not tantamount to demand payable by the Company. In so far as the Company has replied to the notice and no further correspondence was received from the Department. This show cause notice may be an alert or indication of non-compliance for the auditor. So auditor need to discuss with management and apply additional procedure. If the auditor concludes that there is non-compliance then provision for the same should be made as per AS 29. The auditor should also report the amount of dues not deposited on account of dispute and the forum where dispute is pending, in his audit report. If the management does not accept the request, the auditor should qualify the audit report accordingly or vice versa.

Question 7

PQR Ltd. has not deposited Provident Fund contribution of Rs. 10 lakhs with the authorities till the year-end.

Answer

Non-Compliance of Laws and Regulations & Reporting Requirements: As per SA 250 “Consideration of Laws and Regulations in an Audit of Financial Statement”, it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity’s operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity’s 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. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

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 express a qualified or adverse opinion on the financial statements.

Further, **as per Section 128 of the Companies Act, 2013**, a company has to maintain proper books of account on accrual basis and according to the double entry system of accounting.

Additionally, **as per Section 43B of the Income Tax Act, 1961**, there are certain expenses, which includes any sum payable by the assessee as an employer by way of contribution to any provident fund, which are allowed only on its actual payment.

The auditor is, therefore, required to **report under clause (vii)(a) of Para 3 of CARO, 2016** whether the company is regular in depositing undisputed statutory dues including provident fund with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

In the instant case, even though accrual principles have been followed, disclosure of non-payment is necessary. The auditor should disclose the fact of non-payment of Rs. 10 lakhs in his report.

Question 8

During the course of audit of CT Ltd. for the financial year 2015-16, it has noticed that Rs. 2.00 lakhs of employee contribution and Rs. 9.50 lakhs of employer contribution towards employee state insurance contribution have been accounted in the books of accounts in respective heads. Whereas, it was found that Rs. 4.00 lakhs only has been deposited with ESIC department during the year ended 31st March, 2016. The Finance Manager informed the auditor that due to financial crunch they have not deposited the amount due, but will deposit the amount overdue along with interest as and when financial position improves. Comment as a statutory auditor.

Answer

Non-Compliance of Laws and Regulations & Reporting Requirements: As per SA 250 “Consideration of Laws and Regulations in an Audit of Financial Statement”, it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity’s operations are conducted in accordance with the provisions of laws and regulations, including compliance

with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's 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. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. 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 express a qualified or adverse opinion on the financial statements.

Further, the auditor is required to report under **clause (vii)(a) of Para 3 of CARO, 2016** whether the company is regular in depositing undisputed statutory dues including employees' state insurance with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

In the instant case, even though accrual principles have been followed, disclosure of non-payment is necessary. The auditor should disclose the fact of non-payment of rupees 7.50 lakhs in his report.

SA 260 – Communication with Those Charged with Governance

Question 1

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.

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:

1. 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
2. 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:

1. 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;
2. Significant difficulties, if any, encountered during the audit;
3. Unless all of those charged with governance are involved in managing the entity:
 - a. Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and
 - b. Written representations the auditor is requesting; and
4. 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.

SA 299 - Responsibility of Joint Auditors

Question 1

Write a short note on Responsibility of Joint Auditors.

Answer

Responsibility of Joint Auditors: SA 299 on, "Responsibility of Joint Auditors" deals with the professional responsibilities, which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act, 2013. Main features of the said SA are discussed below:

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

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

1. in respect of the audit work which is not divided among the joint auditors and is carried out by all of them.
2. in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.
3. in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors.
4. for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute.
5. for ensuring that the audit report complies with the requirements of the relevant statute.
6. it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.
7. the responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.
8. each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

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

Question 2

KRP Ltd., at its annual general meeting, appointed Mr. X, Mr. Y and Mr. Z as joint auditors to conduct auditing for the financial year 2014-15. For the valuation of gratuity scheme of the company, Mr. X, Mr. Y and Mr. Z wanted to refer their own known Actuaries. Due to difference of opinion, all the joint auditors consulted their respective Actuaries. Subsequently, major difference was found in the actuary reports. However, Mr. X agreed to Mr. Y's actuary report, though, Mr. Z did not. Mr. X contends that Mr. Y's actuary report shall be considered in audit report due to majority of votes. Now, Mr. Z is in dilemma.

You are required to briefly explain the responsibilities of auditors when they are jointly and severally responsible in respect of audit conducted by them and also guide Mr. Z in such situation.

Answer

Difference of Opinion Among Joint Auditors: SA 299 on, "Responsibility of Joint Auditors" deals with the professional responsibilities, which the auditors undertake in accepting such appointments as joint auditors. In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

1. in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;
2. in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors;
3. in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
4. for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute;
5. for ensuring that the audit report complies with the requirements of the relevant statute;
6. it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit;
7. the responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors;
8. each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

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

in case of a disagreement.

In the instant case, there are three auditors, namely, Mr. X, Mr. Y and Mr. Z, jointly appointed as an auditor of KRP Ltd. For the valuation of gratuity scheme of the Company they referred their own known Actuaries. Mr. Z (one of the joint auditor) is not satisfied with the report submitted by Mr. Y's referred actuary. He is not agreed with the matters to be covered by the report whereas Mr. X agreed with the same.

Hence, as per SA 299, Mr. Z is suggested to express his own opinion through a separate report whereas Mr. X and Mr. Y may provide their joint report for the same.

Question 3

P Limited is a listed company and its business activities are divided into three regions. The company appointed PY & Co., KL & Co. and MK & Co., Chartered Accountants to conduct a Joint Audit and report on the financial statements for the Financial Year 2015-16.

Explain the relationship among the joint auditors for the audit of the financial statements for the year 2015-16.

Answer

Relationship Among Joint Auditors: SA 299 "Responsibility of Joint Auditors" deals with the professional responsibilities which the auditors undertake in accepting appointments as joint auditors. According to this SA, in respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him.

1. Separate Responsibility

On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

- a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;
- b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.
- c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
- d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and
- e) for ensuring that the audit report complies with the requirements of the relevant statute.

2. Joint Responsibility

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

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

Each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be

necessary for joint auditor to review the work performed by other joint auditors.

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

SA 300 - Planning an Audit of Financial Statement

Question 1

Briefly discuss the following statements in view of SA 300 "Planning an Audit of Financial Statements":

- a) For an initial audit, the auditor may need to expand the planning activities.
- b) Audit planning is not a discrete phase but a continuous phase.

Answer

(a) Additional Considerations in Initial Audit Engagements: As per SA 300, Planning an Audit of Financial Statements, the purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements.

For initial audits, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

1. Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.
2. Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
3. The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (as per SA 510 "Initial Audit Engagements– Opening Balances").
4. Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

(b) Audit Planning – a Continuous Process: As per SA 300, Planning an Audit of Financial Statements, planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as-

1. The analytical procedures to be applied as risk assessment procedures.
2. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
3. The determination of materiality.
4. The involvement of experts.
5. The performance of other risk assessment procedures.

The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit

procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

SA 315 - Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment

Question 1

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

Answer

Assessment of Risk and Acceptable Level: SA 315 and SA 330 “Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment” and “The Auditor’s Responses to Assessed Risks” establishes standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk. SA 315 and SA 330 require that the auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. “Detection risk” is the risk that an auditor’s substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material. The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. The auditor should use his professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. If it cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.

Question 2

While commencing the statutory audit of ABC Company Limited, what should be the considerations of the auditor to assess Risk of Material Misstatement and his response to such risks?

Answer

Considerations of Auditor for Assessing the Risk of Material Misstatement: As per SA 315 “Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment”, the auditor shall identify and assess the risks of material misstatement at the financial statement level; and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures. For this purpose, the auditor shall -

1. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
2. Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
3. Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and

4. Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Auditor's Responses to the Assessed Risk of Material Misstatement: According to **SA 330 "The Auditor's Responses to Assessed Risks"**, the auditor shall design and implement overall responses to address the assessed risks of material misstatement. In designing the audit procedures to be performed, the auditor shall-

1. Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:
 - a. The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure; and
 - b. Whether the risk assessment takes into account the relevant controls, thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively; and
2. Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

Question 3

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

Answer

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—

1. Reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both.
2. 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.
3. The possibility of IT personnel gaining access beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
4. Unauthorised changes to data in Master files.
5. Unauthorised changes to systems or programs.
6. Failure to make necessary changes to systems or programs.
7. In appropriate manual intervention.
8. Potential loss of data or inability to access data as required.

Question 4

What are the points to be considered while evaluating the "Knowledge of the Business" in the conduct of an audit?

Answer

The broad matters to be considered while obtaining knowledge of business for a new audit assignment are set out in SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment. These are:

1. Relevant industry, regulatory, economic and other external factors including the applicable financial reporting framework.
2. The nature of the entity, including:
 - a. its operations;
 - b. its ownership and governance structures;
 - c. the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - d. the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.
3. The entity's selection and application of accounting policies.
4. The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
5. The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

Question 5

While commencing the statutory audit of ABC Company Limited, what should be the considerations of the auditor to assess Risk of Material Misstatement and his response to such risks?

Answer

Considerations of Auditor for Assessing the Risk of Material Misstatement: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", the auditor shall identify and assess the risks of material misstatement at the financial statement level; and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures. For this purpose, the auditor shall:

1. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;
2. Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
3. Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and
4. Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Auditor's Responses to the Assessed Risk of Material Misstatement: According to SA 330 "The Auditor's Responses to Assessed Risks", the auditor shall design and implement overall responses to

address the assessed risks of material misstatement. In designing the audit procedures to be performed, the auditor shall:

1. Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:
 - a. The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure; and
 - b. Whether the risk assessment takes into account the relevant controls, thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively; and
2. Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

SA 320 - Materiality in Planning and Performing an Audit

Question 1

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.

Answer

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:

1. The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
2. 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);
3. 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;
4. 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
5. The relative volatility of the benchmark.

Question 2

As an auditor of RST Ltd. Mr. P applied the concept of materiality for the financial statements as a whole. On the basis of obtaining additional information of significant contractual arrangements that draw attention to a particular aspect of a company's business, he wants to re-evaluate the materiality concept. Please, guide him.

Answer

Re-evaluation of the Materiality Concept: In the instant case, Mr. P, as an auditor of RST Ltd. has applied the concept of materiality for the financial statements as a whole. But he wants to re-evaluate the materiality concept on the basis of additional information of significant contractual arrangements which draws attention to a particular aspect of the company’s business.

As per SA 320 “Materiality in Planning and Performing an Audit”, while establishing the overall audit strategy, the auditor shall determine materiality for the financial statement as a whole. He should set the benchmark on the basis of which he performs his audit procedure. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality

level or levels to be applied to those particular classes of transactions, account balances or disclosures.

The auditor shall revise materiality for the financial statements in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

If the auditor concludes a lower materiality for the same, then he should consider the fact that whether it is necessary to revise performance materiality and whether the nature, timing and extent of the further audit procedures remain appropriate.

Thus, Mr. P can re-evaluate the materiality concepts after considering the necessity of such revision.

SA 330 - The Auditor's Responses to Assessed Risks

Question 1

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.

Answer

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-

1. A deficient control environment.
2. Deficient monitoring of controls.
3. A significant manual element to the relevant controls.
4. Personnel changes that significantly affect the application of the control.
5. Changing circumstances that indicate the need for changes in the control.
6. Deficient general IT-controls.

Question 2

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?

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:

1. The auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and;
2. There are inherent limitations to internal control, including management override. Depending on the circumstances, the auditor may determine that:
3. Performing only substantive analytical procedures will be sufficient to reduce the audit risk to an acceptably low level;
4. Only tests of detail are appropriate;
5. 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:

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

SA 402 - Audit Considerations Relating to an Entity Using Service Organization

Question 1

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

Answer

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:

1. 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;
2. The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
3. The degree of interaction between the activities of the service organisation and those of the user entity; and
4. 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.

Question 2

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

Answer

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

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 3

When a sub-service organization performs services for a service organization, there are two alternative methods of presenting the description of controls. The service organization determines which method will be used. As a user auditor what information would you obtain about controls at a sub-service organization?

Answer

Controls at a Sub-Service Organisation: In accordance with SA 402 “Audit Considerations relating to an Entity Using a Service Organisation”, a user entity may use a service organisation that in turn uses a sub-service organisation to provide some of the services provided to a user entity that are part of the user entity’s information system relevant to financial reporting. The sub-service organisation may be a separate entity from the service organisation or may be related to the service organisation.

A user auditor may need to consider controls at the sub-service organisation. In situations where one or more sub-service organisations are used, the interaction between the activities of the user entity and those of the service organisation is expanded to include the interaction between the user entity, the service organisation and the sub-service organisations. The degree of this interaction, as well as the nature and materiality of the transactions processed by the service organisation and the sub-service organisations are the most important factors for the user auditor to consider in determining the significance of the service organisation’s and sub-service organisation’s controls to the user entity’s controls.

Further, the user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity’s internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement.

If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding by application of the following two methods of presenting description of internal controls i.e. (i) Type 1 report; or (ii) Type 2 report.

If a service organisation uses a subservice organisation, the service auditor's report may either include or exclude the subservice organisation's relevant control objectives and related controls in the service organisation's description of its system and in the scope of the service auditor's engagement. These two methods of reporting are known as the inclusive method and the carve-out method respectively.

In either method, the service organisation includes in its description of controls a description of the functions and nature of the processing performed by the sub- service organisation.

If the Type 1 or Type 2 report excludes the control at a subservice organization and the services provided by the subservice organization are relevant to the audit of the user entity's financial statements, the user auditor is required to apply the requirements of the SA 402 in respect of the subservice organization.

The nature and extent of work to be performed by the user auditor regarding the services provided by a subservice organization depend on the nature and significance of those services to the user entity and relevance of those services to the audit.

Question 4

In the course of audit of Raja and Rank Ltd., the audit manager of Sharma & Co. observed that Raja and Rank Ltd. has outsourced certain activities to an outsourcing agency.

- a) As the engagement partner, guide the audit manager in the assessment of services provided by the outsourcing agency in relation to the audit.
- b) Discuss the procedure to be applied in case the user auditor is unable to obtain a sufficient understanding from the user entity?

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, 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:

1. 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.
2. The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation.
3. The degree of interaction between the activities of the service organization and those of user entity and
4. 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.

When obtaining an understanding of internal control relevant to the audit in **accordance with SA 315 "Identifying and Assessing the Risks of Material Mis- statement through Understanding the Entity and its Environment"**, the user auditor shall evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation.

(b) The user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement.

If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the following procedures:

1. Obtaining a Type 1 or Type 2 report, if available;
2. Contacting the service organisation, through the user entity, to obtain specific information;
3. Visiting the service organisation and performing procedures that will provide the necessary information about the relevant controls at the service organisation; or
4. Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organisation.

SA 450 - Evaluation of Misstatements Identified during the Audits

Question 1

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.

Answer

According to **SA 450 “Evaluation of Misstatements identified during the Audit”**, the following are the sources of misstatements arising from other than fraud -

1. An inaccuracy in gathering or processing data from which the financial statements are prepared;
2. An omission of an amount or disclosure;
3. An incorrect accounting estimate arising from overlooking, or clear misinterpretation of facts; and
4. Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

Question 2

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

Answer

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-

1. 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
2. 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.

SA 500 - Audit Evidence

Question 1

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.

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,-

1. Evaluate the competence, capabilities and objectivity of that expert;
2. Obtain an understanding of the work of that expert; and
3. 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:

1. 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;
2. If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
3. If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

Question 2

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

Answer

Evaluating the Work of 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,-

1. Evaluate the competence, capabilities and objectivity of that expert;

2. Obtain an understanding of the work of that expert; and
3. 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:

1. 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;
2. If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
3. If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

Question 3

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

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-

1. **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.

2. **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.

3. **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.
4. **Recalculation:** Recalculation consists of checking the arithmetical accuracy of documents or records. Recalculation may be performed manually or electronically.
5. **Reperformance:** It involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.
6. **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.
7. **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 4

M/s LNK's group gratuity scheme's valuation by actuary shows wide variation compared to the previous year's figures. As a Statutory Auditor, how would you deal in this situation?

Answer

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:

1. 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;
2. If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
3. 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.

Question 5

Director of T Ltd. draws an advance of US\$ 200 per day in connection with the foreign trip undertaken on behalf of the company. On his return he files a declaration stating that entire advance was expended without any supporting evidence. T Ltd. books the entire expenses on the basis of such declaration. As the auditor of T Ltd. how do you deal with this?

Answer

Audit Evidence: SA 500 "Audit Evidence" states that an auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base his option.

Section 143(1)(e) the Companies Act, 2013 requires an auditor to enquire whether personal expenses have been charged to revenue account.

In the context of the facts of case, ascertain whether the payment made by the company for the foreign trip form an "allowance" or "reimbursement". An allowance is a fixed sum of money allowed on the basis of specified criteria. No evidence supporting the expenditure is required for payment of allowance to the director. On the other hand, if the payment is reimbursement should be against actual expenditure.

The director concerned should provide proof of expenditure. Since the director has given only a declaration, the auditor should ascertain other relevant facts as to whether the advance paid is pursuant to the policy of the company which is based on approximate estimation of the expenditure normally incurred by a person of the status of a director and the same is applicable to persons of a similar status within the company. If the auditor considers the advance taken is reasonable then the declaration can be considered adequate, otherwise he may have to call for additional documentary evidences.

SA 501 - Audit Evidence - Specific Considerations for Selected Items

Question 1

You are the auditor of Easy Communications Ltd. for the year 2014–15. The inventory as at the end of the year i.e. 31.3.15 was ₹ 2.25 crores. Due to unavoidsable 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?

Answer

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.

Question 2

LMN Ltd. supplies navy uniforms across the country. The company has 4 warehouses at different locations throughout the India and 5 warehouses at the borders. The major stocks are generally supplied from the borders. LMN Ltd. appointed M/s OPQ & Co. to conduct its audit for the financial year 2014-15. Mr. O, partner of M/s OPQ & Co., attended all the physical inventory counting conducted throughout the India but could not attend the same at borders due to some unavoidable reason.

You are required to advise M/s OPQ & Co.,

1. How sufficient appropriate audit evidence regarding the existence and condition of inventory may be obtained?
2. How an auditor is supposed to deal when attendance at physical inventory counting is impracticable?

Answer

1. **Special Consideration with Regard to Inventory:** As per SA 501 “Audit Evidence- Specific Considerations for Selected Items”, when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

- ✓ Attendance at physical inventory counting, unless impracticable, to:
 - a) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;
 - b) Observe the performance of management's count procedures;
 - c) Inspect the inventory; and
 - d) Perform test counts; and
- ✓ Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results

2. Attendance at Physical Inventory Counting Not Practicable: In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

Further, where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

In some cases, though, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 on Modifications to the Opinion in the Independent Auditor's Report, requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

Question 3

"If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence of inventory by attending the physical inventory counting unless impracticable". Discuss.

Answer

Attendance at Physical Inventory Counting When Inventory is Material: According to SA 501 "Audit Evidence - Specific Considerations for Selected Items", when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by attending the physical inventory counting, unless impracticable, to –

- a) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting.
- b) Observe the performance of management's count procedures.
- c) Inspect the inventory.
- d) Perform test counts.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory.

SA 505 - External Confirmations

Question 1

The auditor of H Ltd. wanted to obtain confirmation from its trade payables. But the management made a request to the auditor not to seek confirmation from certain trade payables citing disputes. Can the auditor of H Ltd. accede to this request?

Answer

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.

Question 2

During the course of audit of Star Limited the auditor received some of the confirmation of the balances of trade payables outstanding in the balance sheet through external confirmation by negative confirmation request. In the list of trade payables, there are number of trade payables 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.

Answer

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 trade payables 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 mean 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 3

The accountant of C Ltd. has requested you, not to send balance confirmations to a particular group of trade receivables since the said balances are under dispute and the matter is pending in the Court. As a Statutory Auditor, how would you deal?

Answer

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 :

1. Inquire as to Management’s reasons for the refusal, and seek audit evidence as to their validity and reasonableness,
2. 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
3. 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

Moon Limited replaced its statutory auditor for the Financial year 2014-15. 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 trade payable had neither approached for the payment nor he is traceable. Under the circumstances no confirmation of the credit balance is available.

Answer

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.

Question 5

Mr. Z who is appointed as auditor of Elite Co. Ltd. wants to use confirmation request as audit evidence during the course of audit. What are the factors to be considered by Mr. Z when designing a confirmation request? Also state the effects of using positive external confirmation request by Mr. Z.

Answer

As per SA 505, "External Confirmation", factors to be considered when designing confirmation requests include:

1. The assertions being addressed.
2. Specific identified risks of material misstatement, including fraud risks.
3. The layout and presentation of the confirmation request.
4. Prior experience on the audit or similar engagements.
5. The method of communication (for example, in paper form, or by electronic or other medium).
6. Management's authorization or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorization.
7. The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information. A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence. There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the confirming parties.

SA 510 - Initial Audit Engagements - Opening Balances

Question 1

CA. Ashutosh has been appointed as an auditor of Awesome Health Ltd. for the financial year 2014-15 which was audited by CA. Amrawati in 2013-14. As the Auditor of Awesome Health Ltd., state the steps that CA. Ashutosh would take to ensure that the Closing Balances of the financial year 2013-14 have been brought to account in 2014-15 as Opening Balances and the Opening Balances do not contain any misstatements.

Answer

Obtaining sufficient appropriate audit evidence while conducting Initial Audit Engagement : According to SA 510 on "Initial Audit Engagements- Opening Balances", the objective of the Auditor while conducting an initial audit engagement with respect to opening balances is to obtain sufficient appropriate audit evidence so that the-

1. opening balances of the preceding period have been correctly brought forward to the current period;
2. opening balances do not contain any misstatement that materially affect the current period's financial statements; and
3. 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 a 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 about opening balances may be obtained as part of the current period's audit procedures. For example, the collection/ payment of opening accounts receivable/ accounts payable during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In respect of other assets and liabilities such as property plant and equipment, investments, long term debts, the auditor will examine the records relating to opening balances. The auditor may also be able to get the confirmation from third parties (e.g., balances of long term loan obtained from banks can be confirmed from the Bank Loan statement).

Question 2

You have been appointed as the auditor of Good Health Ltd. for 2014-15 which was audited by CA Trustworthy in 2013-14. As the Auditor of the company state the steps you would take to ensure that the Closing Balances of 2013-14 have been brought to account in 2014-15 as Opening Balances and the Opening Balances do not contain misstatements.

Answer

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:

1. Opening balances contain misstatements that materially affect the current period's financial statements; and
2. 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 3

What are 'Initial Audit Engagements'?

Answer

Initial Audit Engagement: As per SA 510 “Initial Audit Engagements - Opening Balances”, initial audit engagement is an engagement in which either:

1. The financial statements for the prior period were not audited; or
2. The financial statements for the prior period were audited by a predecessor auditor.

Question 4

In an initial audit engagement the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow, when financial statements are audited for the first time. 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?

Answer

Audit Procedure for ensuring correctness of Opening Balances: As per SA 510 “Initial Audit Engagements-Opening Balances”, the auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by -

1. Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;

2. Determining whether the opening balances reflect the application of appropriate accounting policies; and
3. By evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or performing specific audit procedures to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance.

Approach for drafting Audit Report: 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, as appropriate, in accordance with SA 705 and in case where 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, in accordance with SA 705.

Question 5

CA. Jack, a recently qualified practicing Chartered Accountant got his first audit assignment of Futura (P) Ltd. for the financial year 2014 -15. He obtained all the relevant appropriate audit evidence for the items related to Statement of Profit and Loss. However, while auditing the Balance Sheet items, CA. Jack left out obtaining appropriate audit evidence, say, confirmations, from the outstanding Accounts Receivable amounting ` 150 lakhs, continued as it is from the last year, on the affirmation of the management that there is no receipts and further credits during the year. CA. Jack, therefore, excluded from the audit programme, the audit of accounts receivable on the understanding that it pertains to the preceding year which was already audited by predecessor auditor. Comment.

Answer

Verification of Accounts Receivable: As per SA 510 "Initial Audit Engagements – Opening Balances", while conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether-

1. Opening balances contain misstatements that materially affect the current period's financial statements; and
2. 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.

When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of 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.

For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures, say, the collection of opening accounts receivable during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In addition, according to SA 580 "Written Representations", the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements; in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent in relation to, or the completeness of, a specific assertion. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

In the given case, the management of Futura (P) Ltd. has restrained CA. Jack, its auditor, from obtaining appropriate audit evidence for balances of Accounts Receivable outstanding as it is from the preceding year. CA. Jack, on believing that the preceding year balances have already been audited and on the statement of the management that there are no receipts and credits during the current year, therefore excluded the verification of Accounts Receivable from his audit programme.

Thus, CA. Jack should have requested the management to provide written representation for their views and expressions; and he should also not exclude the audit procedure of closing balances of Accounts Receivable from his audit programme. Consequently, CA. Jack shall also be held guilty for professional misconduct for not exercising due diligence, or grossly negligence in the conduct of his professional duties as per the Code of Ethics.

SA 520 - Analytical Procedure

Question 1

What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client?

Answer

As per “SA 520 (Revised) Analytical Procedure”, when the auditor intends to perform analytical procedures on data prepared by the client, he should consider the following:

1. Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;
2. Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;
3. Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
4. Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation and if analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:
 - a. Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
 - b. Performing other audit procedures as necessary in the circumstances.

SA 530 - Audit Sampling

Question 1

Sampling Risk

Answer

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

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

Question 2

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

Answer

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-

1. 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.
2. 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.

SA 540 - Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

Question 1

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?

Answer

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:

1. The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.
2. 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.
3. The estimation making process adopted by the management including-
 - a. The method, including where applicable the model, used in making the accounting estimates.
 - b. Relevant controls.
 - c. Whether management has used an expert ?
 - d. The assumption underlying the accounting estimates.
 - e. 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
 - f. Whether and, if so, how the management has assessed the effect of estimation uncertainty.

SA 550 - Related Parties

Question 1

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

Answer

Verification of Existence of Related Parties: 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-

1. Entity Income Tax Returns.
2. Information supplied by the entity to regulatory authorities.
3. Shareholder registers to identify the entity's principal shareholders.
4. Statements of conflicts of interest from management and those charged with governance.
5. Records of the entity's investments and those of its pension plans.
6. Contracts and agreements with key management or those charged with governance.
7. Significant contracts and agreements not in the entity's ordinary course of business.
8. Specific invoices and correspondence from the entity's professional advisors.
9. Life insurance policies acquired by the entity.
10. Significant contracts re-negotiated by the entity during the period.
11. Internal auditors' reports.
12. 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:

1. Bank, legal and third party confirmations obtained as part of the auditor's procedures;
2. Minutes of meetings of shareholders and of those charged with governance; and
3. Such other records or documents as the auditor considers necessary in the circumstances of the entity.

Question 2

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.

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.

1. 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 renegotiated by the entity during the period, internal auditors' reports, documents associated with the entity's filings with a securities regulator (e.g., prospectuses).
2. 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.

3. 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.
4. 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 3

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?

Answer

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:

1. 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,
2. The terms of the transactions are consistent with management's explanations; and
3. 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

JY & Co. is appointed as auditor of Breeze Ltd. JY & Co. seeks your guidance for reviewing the records and documentation of the company regarding 'related party transactions in the normal course of businesses. Describe the steps to be followed.

Answer

Review of Records and Documentation Regarding Related Party Transaction: According to 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.

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

- a) Bank, legal and third party confirmations obtained as part of the auditor’s procedures;
- b) Minutes of meetings of shareholders and of those charged with governance; and
- c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

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 etc.

SA 560 - Subsequent Events

Question 1

Briefly describe the auditor's responsibility regarding subsequent events.

Answer

Subsequent Events and Auditor's Responsibility: When the auditor draws up his audit plan, checking of subsequent events is an important audit procedure irrespective of the level of test checks employed for checking of the transactions during the year. In fact more detailed check is normally required for subsequent events to confirm certain assertions contained in the financial statements, e.g., the payment made by debtors after the close of accounting period would confirm that outstanding debtors on the date of the balance sheet date have been realised. SA 560 on "Subsequent Events" establishes standards on the auditor's responsibility regarding subsequent events. SA 560 on "Subsequent Events" states that the term "subsequent events" refers to events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. AS 4 on "Contingencies and Events Occurring after the Balance Sheet Date" deals with all those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and by the corresponding approving authority in the case of any other entity. As per AS 4, two types of events can be identified: (a) those which provide further evidence of conditions that existed at the balance sheet date; and (b) those which are indicative of conditions that arose subsequent to the balance sheet date. SA 560 lays down that the auditor should consider the effect of subsequent events on the financial statements and on the auditor's report. When the time between the close of the year-end and the adoption of accounts is about to take place, examination of subsequent events gains more importance.

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

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

1. Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
2. Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
3. 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.
4. Reading the entity's latest subsequent interim financial statements, if any.

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

Question 2

A Co. Ltd. has not included in the Balance Sheet as on 31-03-2015 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 30-04-2015. The auditor wants to sign the said Balance Sheet and give the audit report on 31-05-2015. The auditor came to know the result of the negotiations on 15-05-2015. Comment.

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. 31-3-2015 to the date of Auditors Report ie. 31-05-2015. 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 2013-14 and 2014-15 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 3

A fire broke out on 15th May, 2014, in which material worth ₹ 50 lakhs which was lying in inventory since 1st March, 2014 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, 2014-15, no provision for the loss needs to be made in the financial statements for 2013-14.

Answer

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.

SA 570 - Going Concern

Question 1

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

Answer

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

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

Question 2

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?

Answer

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.

Question 3

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

Answer

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

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

Operating Indications

1. Management intentions to liquidate the entity or to cease operations.
2. Loss of key management without replacement.

3. Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
4. Labour difficulties.
5. Shortages of important supplies.
6. Emergence of a highly successful competitor.

Other Indications

1. Non-compliance with capital or other statutory requirements.
2. 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.
3. Changes in law or regulation or government policy expected to adversely affect the entity.
4. 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 4

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

Answer

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 5

Yummy Ltd., dealing in manufacturing and trading of milk butter, has a benchmark in its product for so many years. Tasty Ltd., a rival company to Yummy Ltd., has introduced its new product, peanut butter. Due to being health conscious, the consumers have shifted from milk butter to peanut butter within few months. This has result into massive loss during the year to Yummy Ltd. due to non-selling of perishable milk products. The company has also started having negative net worth. It's production head, finance head and marketing head have also left the company. The company has no sound action plan to mitigate these situations. Kindly guide the auditor of Yummy Ltd., how he should deal with the situation.

Answer

Inability to Continue as a Going Concern: As per SA 570 on "Going Concern", it is the responsibility of the Auditor 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. The auditor shall evaluate management's assessment of the entity's ability to continue as a going

concern. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

In the instant case, Yummy Ltd. has suffered massive loss due to introduction of a substitute of its product by its rival company, Tasty Ltd., and having negative net worth also. Besides this, its production head, finance head and marketing head have also left the company. The company, in addition, has no action plan to mitigate these situations. Thus there are clear indications that there is danger to entity's ability to continue in future. Considering the fact that there is no sound plan of action from the management to mitigate these factors and to put the company back on the recovery, the going concern assumption does not hold appropriate.

Therefore, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified or adverse opinion.

If the result of the inappropriate assumption used in the preparation of financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

Question 6

X Ltd closed its manufacturing operations and sold all its manufacturing fixed assets during the financial year ended 31st March, 2016. However, it intends continue its operations as a trading company. In respect of other fixed assets, the company carried out a physical verification as at the end of 31st March, 2016 and found a material discrepancy to the tune of ₹ 1 lac, which was written off and is disclosed separately in the Statement of Profit and Loss. Kindly incorporate the above in your audit report.

Answer

Disclosure in Audit Report: As per SA 570 "Going Concern", 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-

1. 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
2. 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.

The auditor is further required to specifically include certain matters as per CARO, 2016 under section 143 of the Companies Act, 2013. According to clause (i)(b) of Para 3 of CARO, the auditor has to comment whether the fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account.

In the given case, X Ltd. has sold out its manufacturing fixed assets during the year. However, it intends to continue its operations as a trading company. Therefore, selling of manufacturing fixed assets does not affect the going concern assumption of the company. Additionally, while carrying out physical verification of fixed assets, a material discrepancy to the tune of ₹ 1 lac was found, which was written off and disclosed separately in the Statement of Profit and Loss. Hence, this fact needs to be disclosed in the Audit Report as follows:

Para in the Audit Report-

We have made our viewpoint from the facts of the case and on the basis of guidance drawn from AS 1. We report as under-

As per Accounting Standard (AS) 1, "Disclosure of Accounting Policies", "the enterprise is normally viewed as a going concern that is as continuing its operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations." Although the company has disposed off its manufacturing fixed assets during the financial year ending on 31-03-2016, it is still a going concern in the form of a trading company. We also report that on physical verification of other fixed assets, a material discrepancy to the tune of Rs. 1 Lac was noticed and that the same has been properly dealt with in the books of account.

Question 7

M/s T K Projects Limited, a manufacturing company in the Steel industry was allegedly involved in some irregularity relating to allotment of coal blocks for which a complaint was lodged against the company by the government. The financial institutions stopped additional working capital finance which caused a financial crisis resulting in stoppage of production. The company incurred a massive loss during the year 2015-16. There were delays in salary and other payments. Certain key managerial personnel including GM Finance and certain other employees left the company. The company has no sound action plan to mitigate these situations. Guide the statutory auditor on how he should deal with this situation.

Answer

Inability to Continue as a Going Concern: As per SA 570 on "Going Concern", it is the responsibility of the auditor 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. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern. In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

In the instant case, M/s T K Projects Limited has incurred massive loss during the year 2015-16 as the financial institutions have stopped financing additional working capital to the company because of a complaint which was lodged against the company by government for involvement in some irregularity relating to allotment of coal blocks. There were delays in salary and other payments. Besides this, certain key managerial personnel, GM Finance and certain other employees have also left the company. The company, in addition, has no sound action plan to mitigate these situations.

Thus, there are clear indications that there is danger to entity's ability to continue in future. Considering the fact that there is no sound plan of action to mitigate these factors, the going concern assumption does not seem appropriate.

Therefore, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised). But, if the result of the appropriate assumption used in the preparation of financial statements is material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion and in the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

SA 580 - Written Representations

Question 1

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

Answer

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

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

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement. Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations.

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

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor’s report.

Question 2

State briefly the basic elements of Management Representation Letter.

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-

1. It is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.
2. It does not include financial statements, the assertions therein, or supporting books and records.
3. 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.
4. The written representations shall be for all financial statements and period(s) referred to in the auditor's report.

Question 3

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

Answer

Validity of Written Representation: The physical verification of fixed assets is the primary responsibility of the management. The auditor, however, is required to examine the verification programme adopted by the management. He must satisfy himself about the existence, ownership and valuation of fixed assets. In the case of Sagar Ltd., the auditor has not been able to verify the existence and value of some machinery despite the verification procedure followed in routine audit. He accepted the certificate given to him by the management without making any further enquiry.

As per SA 580 "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 right.

Question 4

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

Answer

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:

1. Discuss the matter with management,
2. 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
3. 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".

SA 600 - Using the Work of Another Auditor

Question 1

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

Answer

SA 600 on “Using the Work of Another Auditor” lays down the procedure to be applied in situations where a principal auditor reporting on the financial statement of the entity uses the work of another independent auditor. SA 600 contemplates coordination between auditors and requires that there should be sufficient liaison between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

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

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

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

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

SA 610 - Using the Work of Internal Auditors

Question 1

CA. Amboj, a practicing chartered accountant has been appointed as an internal auditor of Textile Ltd. He conducted the physical verification of the inventory at the year-end and handed over the report of such verification to CA. Kishor, the statutory auditor of the Company, for his view and reporting. Can CA. Kishor rely on such report?

Answer

Using the Work of Internal Auditor: As per SA 610 "Using the Work of Internal Auditors", while determining whether the work of the internal auditors can be used for the purpose of the audit, the external auditor shall evaluate-

1. The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors;
2. The level of competence of the internal audit function; and
3. Whether the internal audit function applies a systematic and disciplined approach, including quality control.

Further, the external auditor shall not use the work of the internal audit function if the external auditor determines that:

1. The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
2. The function lacks sufficient competence; or
3. The function does not apply a systematic and disciplined approach, including quality control.

In the instant case, CA. Kishor should ascertain the internal auditor's scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible he should also test check few items and he can also observe the procedures performed by the internal auditors.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise. The final responsibility to express opinion on the financial statement remains with the statutory auditor.

Question 2

Mr. A is appointed as statutory auditor of XYZ Ltd. XYZ Ltd is required to appoint internal auditor as per statutory provisions given in the Companies Act, 2013 and appointed Mr. B as its internal auditor. The external auditor Mr. A asked internal auditor to provide direct assistance to him regarding evaluating significant accounting estimates by the management and assessing the risk of material misstatements.

1. Discuss whether Mr. A, statutory auditor, can ask direct assistance from Mr. B, internal auditor as stated above in view of auditing standards.

2. Will your answer be different, if Mr. A ask direct assistance from Mr. B, internal auditor with respect to external confirmation requests and evaluation of the results of external confirmation procedures?

Answer

1. **Direct Assistance from Internal Auditor:** As per SA 610 "Using the Work of Internal Auditor", the external auditor shall not use internal auditors to provide direct assistance to perform procedures that involve making significant judgments in the audit.

Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement.

Significant judgments include the following:

- Assessing the risks of material misstatement;
- Evaluating the sufficiency of tests performed;
- Evaluating the appropriateness of management's use of the going concern assumption;
- Evaluating significant accounting estimates; and
- Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.

In view of above, Mr. A cannot ask direct assistance from internal auditors regarding evaluating significant accounting estimates and assessing the risk of material misstatements.

2. **Direct Assistance from Internal Auditor in case of External Confirmation Procedures:** SA 610 "Using the Work of Internal Auditor", provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors. In determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned.

Further, in accordance with SA 505, "External Confirmation" the external auditor is required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, it would not be appropriate to assign these responsibilities to internal auditors. However, internal auditors may assist in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.

SA 620 - Using the Work of an Auditor's Expert

Question 1

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

Answer

Using the Work of an 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:

1. 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.
2. The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
3. The estimation of oil and gas reserves.
4. The valuation of environmental liabilities, and site clean-up costs.
5. The interpretation of contracts, laws and regulations.
6. 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 2

KRP Ltd., at its annual general meeting, appointed Mr. X, Mr. Y and Mr. Z as joint auditors to conduct auditing for the financial year 2014-15. For the valuation of gratuity scheme of the company, Mr. X, Mr. Y and Mr. Z wanted to refer their own known Actuaries. Due to difference of opinion, all the joint auditors consulted their respective Actuaries. Subsequently, major difference was found in the actuary reports. However, Mr. X agreed to Mr. Y's actuary report, though, Mr. Z did not. Mr. X contends that Mr. Y's actuary report shall be considered in audit report due to majority of votes. Now, Mr. Z is in dilemma.

Explain the responsibility of auditors, in case, report made by Mr. Y's actuary, later on, found faulty.

Answer

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

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

Further, in view of SA 620, if the expert's work involves use of significant assumptions and methods, then the relevance and reasonableness of those assumptions and methods must be ensured by the auditor and if the expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data in the circumstances must be verified by the auditor.

In the instant case, Mr. X, Mr. Y and Mr. Z, jointly appointed as an auditor of KRP Ltd., referred their own known Actuaries for valuation of gratuity scheme. Actuaries are an auditor's expert as per SA 620. Mr. Y's referred actuary has provided the gratuity valuation report, which later on found faulty. Further, Mr. Z is not agreed with this report therefore he submitted a separate audit report specifically for such gratuity valuation.

In such situation, it was duty of Mr. X, Mr. Y and Mr. Z, before using the gratuity valuation report of Actuary, to ensure the relevance and reasonableness of assumptions and methods used. They were also required to examine the relevance, completeness and accuracy of source data used for such report before expressing their opinion.

Mr. X and Mr. Y will be held responsible for grossly negligence and using such faulty report without examining the adequacy of expert actuary's work whereas Mr. Z will not be held liable for the same due to separate opinion expressed by him.

SA 700 - Forming an Opinion and Reporting on Financial Statements

Question 1

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

Answer

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

1. **Title:** The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor.
2. **Addressee:** The auditor's report shall be addressed as required by the circumstances of the engagement.
3. **Auditor's Opinion:** The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

The Opinion section of the auditor's report shall also:

- a) Identify the entity whose financial statements have been audited;
 - b) State that the financial statements have been audited;
 - c) Identify the title of each statement comprising the financial statements;
 - d) Refer to the notes, including the summary of significant accounting policies; and
 - e) Specify the date of, or period covered by, each financial statement comprising the financial statements.
4. **Basis for Opinion:** The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:
 - a) States that the audit was conducted in accordance with Standards on Auditing;
 - b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
 - c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI;
 - d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.
 5. **Going Concern:** Where applicable, the auditor shall report in accordance with SA 570 (Revised)
 6. **Key Audit Matters:** For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with SA 701. When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with SA 701.

7. Responsibilities for the Financial Statements: The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." The auditor's report shall use the term that is appropriate in the context of the legal framework applicable to the entity and need not refer specifically to "management". In some entities, the appropriate reference may be to those charged with governance.
8. Auditor's Responsibilities for the Audit of the Financial Statements.
9. Location of the description of the auditor's responsibilities for the audit of the financial statements.
10. Other Reporting Responsibilities.
11. Signature of the Auditor.

SA 705 - Modifications to the Opinion in the Independent Auditor's Report

Question 1

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?

Answer

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".

Question 2

Discuss the various aspects to be considered by the Statutory Auditor before qualifying his report.

Answer

Aspects to be considered before Qualifying the Audit Report: SA 705 "Modifications to the Opinion in the Independent Auditor's Report" specifies that auditor's report may need modification on account of certain matters which may or may not affect the auditor's opinion. There may be certain circumstances when an auditor may not be able to express an unqualified opinion because the effort of such circumstances in the auditor's judgment is, or may be material to the financial statements, for example, there is a limitation on the scope of the auditor's work or there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The auditor shall express a qualified opinion when-

1. The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
2. The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Further, while qualifying a report, it is important to appreciate as to which of the various items of statement of fact or statement of opinion require a qualification in respect of audit under the Companies Act, 2013. The auditor may also see whether the matters constituting the qualification involve a material contravention of any requirements of the Companies Act, 2013 which have a bearing on the accounts.

Finally, whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report. A quantified opinion should be expressed as "except for" for the effects of the matter to which qualification related.

Question 3

Under the applicable Standards on Auditing, in what circumstances does the report of the statutory auditor require modifications? What are the types of modifications possible to the said report?

Answer

Modifications in Audit Report: As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", the auditor shall modify the opinion in the auditor's report when:

- a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
- b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

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

Types of Modification to the Auditor's Opinion: As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", modified opinion may be defined as a qualified opinion, an adverse opinion or a disclaimer of opinion.

Types of modifications possible to the said report are below-mentioned:

1. **Qualified Opinion:** The auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.
2. **Adverse Opinion:** The auditor shall express an adverse opinion adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
3. **Disclaimer of Opinion:** The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

SA 706 – Emphasis of Matter Paragraphs & Other Matter Paragraphs in the Independent Auditor's Report

Question 1

Write a short note on Emphasis of matter paragraph in Audit Reports. Answer

Answer

Emphasis of Matter Paragraph in Audit Reports: An auditor's report can be modified for matters that do not affect the auditor's opinion. An "emphasis of matter" paragraph is such a type of modification in an audit report. In certain circumstances, such a paragraph is added to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such a paragraph does not affect the auditor's opinion.

SA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", deals with additional communication in the auditor's report when the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements.

Specific requirements for the auditor to include Emphasis of Matter paragraphs in the auditor's report in certain circumstances. These circumstances include:

- a) When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
- b) To alert users that the financial statements are prepared in accordance with a special purpose framework.
- c) When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).

Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- a) An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- b) A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
- c) Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- d) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

However, a widespread use of Emphasis of Matter paragraphs may diminish the effectiveness of the auditor's communication about such matters.

SA 710 – Comparative Information – Corresponding Figures and Comparative Financial Statements

Question 1

Auditor's responsibilities regarding comparatives.

Answer

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

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

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

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

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

Question 2

Write a short note on Corresponding figures.

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 3

The audit report of P Ltd. for the year 2013-14 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2014-15, how would you report, if:

1. The company does not make provision for doubtful debts in 2014-15?
2. The company makes adequate provision for doubtful debts in 2014-15?

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:

1. 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
2. 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 4

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

Answer

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:

1. The comparative information agrees with the amounts and other disclosures presented in the prior period; and
2. 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.

SA 800 - Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework

Question 1

The financial statements of TC & Co. have been prepared by management of an entity in accordance with the financial reporting provisions of a contract (that is, a special purpose framework) to comply with provisions of the contract. Based on the contract, management does not have a choice of financial reporting frameworks. As an auditor what considerations would be undertaken while planning and performing audit?

Answer

Considerations for Planning and Performing Audit in case of Special Purpose Framework: As per SA 800 "Special Considerations-Audits of Financial Statements Prepared in accordance with Special Purpose Frameworks", financial statements prepared in accordance with a special purpose framework may be the only financial statements an entity prepares. In such circumstances, those financial statements may be used by users other than those for whom the financial reporting framework is designed.

While planning and performing audit of such special purpose framework based company, the auditor should consider below mentioned factors:

1. To obtain an understanding of the entity's selection and application of accounting policies. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements.
2. Compliance of all SAs relevant to audit, the auditor may judge it necessary to depart from a relevant requirement in an SA by performing alternative audit procedures to achieve the aim of that requirement.
3. Application of some of the requirements of the SAs in an audit of special purpose financial statements may require special consideration by the auditor. For example, in SA 320, judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. In the case of an audit of special purpose financial statements, however, those judgments are based on a consideration of the financial information needs of the intended users.
4. In the case of special purpose financial statements, such as those prepared in accordance with the requirements of a contract, management may agree with the intended users on a threshold below which misstatements identified during the audit will not be corrected or otherwise adjusted. The existence of such a threshold does not relieve the auditor from the requirement to determine materiality in accordance with SA 320 for purposes of planning and performing the audit of the special purpose financial statements.
5. Communication with those charged with governance in accordance with SAs is based on the relationship between those charged with governance and the financial statements subject to audit, in particular, whether those charged with governance are responsible for overseeing the

preparation of those financial statements. In the case of special purpose financial statements, those charged with governance may not have such a responsibility.

SA 810 – Engagements to Report on Summary Financial Statements

Question 1

The management of CSITA Ltd. has prepared its summary financial statements for the year 2015-16 to be provided to its investors. Consequently the company wants to appoint you for conducting audit of summary financial statements. What are the procedures that you will perform and consider necessary as the basis for forming an opinion on the summary financial statements?

Answer

As per SA 810, “Engagement to Report on Summary Financial Statements”, the auditor shall perform the following procedures, and any other procedures that the auditor may consider necessary, as the basis for the auditor’s opinion on the summary financial statements:

1. Evaluate whether the summary financial statements adequately disclose their summarised nature and identify the audited financial statements.
2. When summary financial statements are not accompanied by the audited financial statements, evaluate whether they describe clearly:
 - a) From whom or where the audited financial statements are available; or
 - b) The law or regulation that specifies that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements.
3. Evaluate whether the summary financial statements adequately disclose the applied criteria.
4. Compare the summary financial statements with the related information in the audited financial statements to determine whether the summary financial statements agree with or can be re-calculated from the related information in the audited financial statements.
5. Evaluate whether the summary financial statements are prepared in accordance with the applied criteria.
6. Evaluate, in view of the purpose of the summary financial statements, whether the summary financial statements contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.
7. Evaluate whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty, unless law or regulation provides that they need not be made available and establishes the criteria for the preparation of the summary financial statements.

SRE 2400 - Engagements to Review Financial Statements

Question 1

You are offered to engage as a practitioner to perform a review of historical financial statements of Santa Limited, where you have not audited the financial statements.

Briefly discuss the preconditions you will be considering prior to accepting such review engagement.

Answer

As per SRE 2400, “Engagement to Review Historical Financial Statements”, prior to accepting a review engagement, the practitioner shall:

1. Determine whether the financial reporting framework applied in the preparation of the financial statements is acceptable including, in the case of special purpose financial statements, obtaining an understanding of the purpose for which the financial statements are prepared and of the intended users; and
2. Obtain the agreement of management that it acknowledges and understands its responsibilities:
 - a) For preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation;
 - b) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
 - c) To provide the practitioner with:
 - ✓ Access to all information of which management is aware that is relevant to the preparation of the financial statements, such as records, documentation and other matters;
 - ✓ Additional information that the practitioner may request from management for the purpose of the review; and
 - ✓ Unrestricted access to persons within the entity from whom the practitioner determines it necessary to obtain evidence.

If the practitioner is not satisfied as to any of the matters set out above as preconditions for accepting a review engagement, the practitioner shall discuss the matter with management or those charged with governance. If changes cannot be made to satisfy the practitioner as to those matters, the practitioner shall not accept the proposed engagement unless required by law or regulation to do so. However, an engagement conducted under such circumstances does not comply with this SRE. Accordingly, the practitioner shall not include any reference within the practitioner’s report to the review having been conducted in accordance with this SRE.

If it is discovered after the engagement has been accepted that the practitioner is not satisfied as to any of the above preconditions, the practitioner shall discuss the matter with management or those charged with governance, and shall determine:

- a) Whether the matter can be resolved;
- b) Whether it is appropriate to continue with the engagement; and
- c) Whether and, if so, how to communicate the matter in the practitioner’s report.

Question 2

You are engaged to review the system and the information generated from the financial statements. Discuss the elements of the practitioner's report for the Historical Financial Statements review engagement.

Answer

Elements of the Practitioner's Report for Review Engagement: As per SRE 2400 "Engagements to Review Historical Financial Statements", The practitioner's report for the review engagement shall be in writing, and shall contain the following elements:

1. A title, which shall clearly indicate that it is the report of an independent practitioner for a review engagement;
2. The addressee(s), as required by the circumstances of the engagement;
3. An introductory paragraph that:
 - a) Identifies the financial statements reviewed, including identification of the title of each of the statements contained in the set of financial statements and the date and period covered by each financial statement;
 - b) Refers to the summary of significant accounting policies and other explanatory information; and
 - c) States that the financial statements have been reviewed;
4. A description of the responsibility of management for the preparation of the financial statements, including an explanation that management is responsible for:
 - a) Their preparation in accordance with the applicable financial reporting framework including, where relevant, their fair presentation;
 - b) Such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;
5. If the financial statements are special purpose financial statements:
 - a) A description of the purpose for which the financial statements are prepared and, if necessary, the intended users, or reference to a note in the special purpose financial statements that contains that information; and
 - b) If management has a choice of financial reporting frameworks in the preparation of such financial statements, a reference within the explanation of management's responsibility for the financial statements to management's responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances;
6. A description of the practitioner's responsibility to express a conclusion on the financial statements including reference to this SRE and, where relevant, applicable law or regulation;
7. A description of a review of financial statements and its limitations, and the following statements:
 - a) A review engagement under this SRE is a limited assurance engagement;
 - b) The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained; and

- c) The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with Standards on Auditing (SAs), and, accordingly, the practitioner does not express an audit opinion on the financial statements;
- 8. A paragraph under the heading "Conclusion" that contains:
 - a) The practitioner's conclusion on the financial statements as a whole in accordance with this SRS, as appropriate; and
 - b) A reference to the applicable financial reporting framework used to prepare the financial statements.
- 9. When the practitioner's conclusion on the financial statements is modified:
 - a) A paragraph under the appropriate heading that contains the practitioner's modified conclusion in accordance with this SRS, as appropriate; and
 - b) A paragraph, under an appropriate heading, that provides a description of the matter(s) giving rise to the modification;
- 10. A reference to the practitioner's obligation under this SRE to comply with relevant ethical requirements;
- 11. The date of the practitioner's report;
- 12. The practitioner's signature; and
- 13. The place of signature.

SAE 3400 – The Examination of Prospective Financial Information

Question 1

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?

Answer

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.

1. **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:
 - a. the intended use of the information;
 - b. whether the information will be for general or limited distribution;
 - c. the nature of the assumptions, that is, whether they are best-estimates or hypothetical assumptions;
 - d. the elements to be included in the information; and
 - e. 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.

2. **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:

- a) the sources of information,
- b) basis of forecasts,
- c) the assumptions made in arriving the forecasts,
- d) hypothetical assumptions, evidence supporting the assumptions,
- e) management representations regarding the intended use and distribution of the information, completeness of material assumptions,
- f) management’s acceptance of its responsibility for the information,
- g) audit plan,
- h) the nature, timing and extent of examination procedures performed, and,

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

Question 2

KG Ltd. wants to provide prospective Financial Information to its investors with information about future expectations of the company. You are engaged by KG Ltd. to examine the Projected Financial Information and give report thereon. What will you consider in assessing the presentation and disclosure of the prospective Financial Information and the underlying assumptions?

Answer

Consideration for Assessing Presentation and Disclosure of Prospective Financial Information and Underlying Assumptions: As per SAE 3400 “The Examination of Prospective Financial Information”, when assessing the presentation and disclosure of the prospective financial information and the underlying assumptions, in addition to the specific requirements of any relevant statutes, regulations as well as the relevant professional pronouncements, the auditor will need to consider whether-

1. the presentation of prospective financial information is informative and not misleading;
2. the accounting policies are clearly disclosed in the notes to the prospective financial information;
3. the assumptions are adequately disclosed in the notes to the prospective financial information. It needs to be clear whether assumptions represent management's best- estimates or are hypothetical and, when assumptions are made in areas that are material and are subject to a high degree of uncertainty, this uncertainty and the resulting sensitivity of results needs to be adequately disclosed;
4. the date as of which the prospective financial information was prepared is disclosed. Management needs to confirm that the assumptions are appropriate as of this date, even though the underlying information may have been accumulated over a period of time;
5. the basis of establishing points in a range is clearly indicated and the range is not selected in a biased or misleading manner when results shown in the prospective financial information are expressed in terms of a range; and
6. there is any change in the accounting policy of the entity from that disclosed in the most recent historical financial statements and whether reason for the change and the effect of such change on the prospective financial information has been adequately disclosed.

SAE 3420 - Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

Question 1

The management of S Ltd. requests you to accept an engagement to report on compilation of pro forma financial information to be included in a prospectus. In light of SAE 3420, what are the factors to be considered by you as a practitioner before agreeing to accept such engagement to report on pro forma financial information.

Answer

Engagements to Report on the Compilation of Pro Forma Financial Information: As per SAE 3420," Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus", before agreeing to accept an engagement to report on whether pro forma financial information included in a prospectus has been compiled, in all material respects, on the basis of the applicable criteria, the practitioner shall-

1. Determine that the practitioner has the capabilities and competence to perform the engagement;
2. On the basis of a preliminary knowledge of the engagement circumstances and discussion with the responsible party, determine that the applicable criteria are suitable and that it is unlikely that the pro forma financial information will be misleading for the purpose for which it is intended;
3. Evaluate the wording of the opinion prescribed by the relevant law or regulation, if any, to determine that the practitioner will likely be able to express the opinion so prescribed based on performing the procedures specified in this SAE;
4. Where the sources from which the unadjusted financial information and any acquiree or divestee financial information have been extracted have been audited or reviewed and a modified audit opinion or review conclusion has been expressed, or the report contains an Emphasis of Matter paragraph, consider whether or not the relevant law or regulation permits the use of, or reference in the practitioner's report to, the modified audit opinion or review conclusion or the report containing the Emphasis of Matter paragraph with respect to such sources;
5. If the entity's historical financial information has never been audited or reviewed, consider whether the practitioner can obtain a sufficient understanding of the entity and its accounting and financial reporting practices to perform the engagement;
6. If the event or transaction includes an acquisition and the acquiree's historical financial information has never been audited or reviewed, consider whether the practitioner can obtain a sufficient understanding of the acquiree and its accounting and financial reporting practices to perform the engagement; and
7. Obtain the agreement of the responsible party that it acknowledges and understands its responsibility for:
 - a) Adequately disclosing and describing the applicable criteria to the intended users if these are not publicly available;
 - b) Compiling the pro forma financial information on the basis of the applicable criteria; and
 - c) Providing the practitioner with:
 - I. Access to all information (including, when needed for purposes of the engagement, information of the acquiree(s) in a business combination), such as records, documentation and other material, relevant to evaluating whether the pro forma

financial information has been compiled, in all material respects, on the basis of the applicable criteria;

- II. Additional information that the practitioner may request from the responsible party for the purpose of the engagement;
- III. Access to those within the entity and the entity's advisors from whom the practitioner determines it necessary to obtain evidence relating to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria; and
- IV. When needed for purposes of the engagement, access to appropriate individuals within the acquiree(s) in a business combination.

SRS 4410 - Compilations Engagements

Question 1

While compiling the accounts of Hope Ltd., you observed that a few accounting standards have not been followed and there have been omission of some information which was required to be followed in the current situation. How would you deal with this?

Answer

Non-Compliance with the Accounting Standards: As per SRS 4410, "Compilation Engagements", The financial information may be prepared in accordance with a financial reporting framework designed to meet the common financial information needs of a wide range of users (that is, a "general purpose financial reporting framework"); The requirements of the applicable financial reporting framework determine the form and content of the financial information. The financial reporting framework may, in some cases, be referred to as the "basis of accounting."

Commonly used general purpose financial reporting frameworks includes Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006, Indian Accounting Standards (Ind AS) issued by ICAI and Accounting Standards (AS) issued by ICAI etc.

Thus, for not following and omission of some information which was required to be followed in the current situation for Hope Ltd., we should bring this matter to the attention of the management for rectification and, if the same is not rectified by the management, we should include the same in the Notes to the Accounts and the compilation report of the accountant.

Question 2

Your engagement team member, Mr. Shyam, is engaged as practitioner for compilation of historical financial information of Rama Ltd.

You as a senior audit engagement team in-charge, brief him about what are the practitioner's responsibilities as he is engaged to assist management with the preparation and presentation of historical financial information without obtaining any assurance on that information.

Answer

As per SRS 4410 "Compilation Engagements", the engagement partner shall take responsibility for-

1. The overall quality of each compilation engagement to which that partner is assigned;
2. The engagement being performed in accordance with the firm's quality control policies and procedures, by:
 - a) Following appropriate procedures regarding the acceptance and continuance of client relationships and engagements;
 - b) Being satisfied that the engagement team collectively has the appropriate competence and capabilities to perform the compilation engagement;
 - c) Being alert for indications of non-compliance by members of the engagement team with relevant ethical requirements, and determining the appropriate action if matters come to the engagement partner's attention indicating that members of the engagement team have not complied with relevant ethical requirements;

- d) Directing, supervising and performing the engagement in compliance with professional standards and applicable legal and regulatory requirements; and
- e) Taking responsibility for appropriate engagement documentation being maintained.

Question 3

Write a short note on Reporting on a compilation engagements.

Answer

Reporting on a compilation engagements: As per SRS 4410 "Compilation Engagements", the practitioner's report issued for the compilation engagement shall be in writing, and shall include the following elements: The report title;

1. The addressee(s), as required by the terms of the engagement;
2. A statement that the practitioner has compiled the financial information based on information provided by management;
3. A description of the responsibilities of management, or those charged with governance as appropriate, in relation to the compilation engagement, and in relation to the financial information;
4. Identification of the applicable financial reporting framework and, if a special purpose financial reporting framework is used, a description or reference to the description of that special purpose financial reporting framework in the financial information;
5. Identification of the financial information, including the title of each element of the financial information if it comprises more than one element, and the date of the financial information or the period to which it relates;
6. A description of the practitioner's responsibilities in compiling the financial information, including that the engagement was performed in accordance with this SRS, and that the practitioner has complied with relevant ethical requirements;
7. A description of what a compilation engagement entails in accordance with this SRS;
8. Explanations that:
 - a) Since a compilation engagement is not an assurance engagement, the practitioner is not required to verify the accuracy or completeness of the information provided by management for the compilation; and
 - b) Accordingly, the practitioner does not express an audit opinion or a review conclusion on whether the financial information is prepared in accordance with the applicable financial reporting framework.
9. If the financial information is prepared using a special purpose financial reporting framework, an explanatory paragraph that:
 - a) Describes the purpose for which the financial information is prepared and, if necessary, the intended users, or contains a reference to a note in the financial information that discloses this information; and
 - b) Draws the attention of readers of the report to the fact that the financial information is prepared in accordance with a special purpose framework and that, as a result, the information may not be suitable for other purposes;
10. The date of the practitioner's report;
11. The practitioner's signature; and
12. The Place of signature.

The practitioner shall date the report on the date the practitioner has completed the compilation engagement in accordance with this SRS.

Mix Questions

Question 1

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

Answer

The auditor while conducting an audit should critically examine the accounting policies adopted by the client and test them for conformity with the accounting standards and recommendations of the Institute. The Companies Act as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes a 'true and fair' view has not been defined either in the Companies Act or in any other statute. The pronouncements of the Institute seek to describe the accounting principles and the methods of applying these principles in the preparation and presentation of financial statements so that they give a true and fair view. The 'Preface to the Statements of Accounting Standards' issued by the Institute in 1979 states as under:

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

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

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

Question 2

R & Co. is the statutory auditor of S Ltd. For the financial year ended on 31st March 2015, 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.?

Answer

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:

1. 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
2. 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:

- a. 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
- b. 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.

Question 3

Write a short note on Frauds through supplier ledger.

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:

1. Inflating suppliers account with fictitious or duplicate invoices and subsequent misappropriations as if payments are made to the supplier
2. Suppressing credit notes issued by the 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. 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 4

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.

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 5

Comment on the following:

'A' Limited has paid minimum alternate tax under Section 115 JB of the Income Tax Act, 1961, for the year ended 31st March, 2015. The company wants to disclose the same as an 'Asset' since the company is eligible to claim credit for the same.

Answer

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.

Question 6

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

Answer

Situations where external confirmations can be used:

1. Bank balance from bankers
2. Account receivable balances
3. Inventories held by third parties
4. Property title deeds held by third parties
5. Investments purchased but delivery not taken
6. Loan from lenders
7. Account payable balances
8. Long outstanding share application money.

Question 7

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

1. when the financial statements are audited for the preceding period by another auditor; and
2. when financial statements are audited for the first time.
3. 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 above?

Answer

1. **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.
2. **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.
3. **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 8

Write a short note on Intangible Asset vs. Intangible Item.

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.