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Q INTRO

1 *Standards collectively known as the Engagements Standards issued by AASB under the authority of the council of ICAI – Discuss.*

Engagement Standards: The following standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards-

- (i) Standards on Auditing (SAs), to be applied in the audit of historical financial information.
- (ii) Standards on Review Engagements (SREs), to be applied in the review of historical financial information.
- (iii) Standards on Assurance Engagements (SAEs), to be applied in assurance engagements, dealing with subject matters other than historical financial information.

Standards on Related Services (SRSs), to be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

2 *"Statements" and "Guidance Notes" of ICAI- whether mandatory or recommendatory?*

(a) Statements and Guidance Notes of ICAI –whether Mandatory or Recommendatory:

- (i) Statements: The ‘Statements’ have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. ‘Statements’ therefore are mandatory.

Accordingly, while discharging their attest function, it will be the duty of the members of the Institute to ensure that statements are followed and complied with.

(ii)Guidance Notes: ‘Guidance Notes’ are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so.

Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

There are, however a few guidance notes in case of which the Council has specifically stated that they should be considered as mandatory on members while discharging their attest function.

3 What are the objectives and functions of Auditing and Assurance Standards Board (AASB)?

Objectives and Functions of the Auditing and Assurance Standards Board: The following are the objectives and functions of the Auditing and Assurance Standards Board-

(i)To review the existing and emerging auditing practices worldwide and identify areas in which Standards on Quality Control, Engagement Standards and Statements on Auditing need to be developed.

(ii)To formulate Engagement Standards, Standards on Quality Control and Statements on Auditing so that these may be issued under the authority of the Council of the Institute.

(iii)To review the existing Standards and Statements on Auditing to assess their relevance in the changed conditions and to undertake their revision, if necessary.

(iv)To develop Guidance Notes on issues arising out of any Standard, auditing issues pertaining to any specific industry or on generic issues, so that those may be issued under the authority of the Council of the Institute.

(v) To review the existing Guidance Notes to assess their relevance in the changed circumstances and to undertake their revision, if necessary.

(vi) To formulate General Clarifications, where necessary, on issues arising from Standards.

(vii) To formulate and issue Technical Guides, Practice Manuals, Studies and other papers under its own authority for guidance of professional accountants in the cases felt appropriate by the Board.

SA 200

4 The basic objective of audit does not change with reference to nature, size or form of an entity. correct or incorrect:

Correct: An audit is an independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon. It is clear that the basic objective of auditing, i.e., expression of opinion on financial statements does not change with reference to nature, size or form of an entity.

5 'Doing a statutory audit is full of risk'. Narrate the factors which cause the risk.

(a) Factors Causing Risk Under Statutory Audit: As Per SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with standards on auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on

whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with SAs and relevant ethical requirements enables the auditor to form that opinion.

An independent audit whether performed in terms of applicable financial reporting framework or in terms of the engagement, the auditor has to be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable for the preparation of financial statements. Since the entire process of auditing is based on the assessment of judgements made by the management of the entity as well as evaluation of internal controls, the audit suffers certain inherent risks.

Factors which may cause such risk in conducting an audit are discussed below-

Exercising judgement on the part of the auditor: The auditor's work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements.

Nature of audit evidence: Much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. The auditor normally relies upon persuasive evidence rather than conclusive evidence. Even in circumstances where conclusive evidence is available, the cost of obtaining such an evidence may far exceed the benefits.

Inherent limitations of internal control: Internal control can provide only reasonable, but not absolute, assurance on account of several inherent limitations such as potential for human error, possibility of circumstances of control through collusion, etc.

On account of above, it is quite clear that an audit suffers from control risk on account of inherent limitations of internal control and detection risk on account of test nature of audit and judgement and estimates involved in formulating accounting policies.

6 What are the inherent limitations of audit?

Inherent Limitations of Audit: As per SA 200 “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, the objectives of an audit of financial statements, prepared with in a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy him that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The process of auditing, however, is such that it suffers from certain limitations, i.e. the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. The limitations of an audit arise from-

(i)The Nature of Financial Reporting: The preparation of financial statements involves judgment by management in applying the requirements of the entity’s applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures.

(ii)The Nature of Audit Procedures: There are practical and legal limitations on the auditor’s ability to obtain audit evidence. For example:

(1) There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation and presentation of the financial statements or that has been requested by the auditor.

(2) Fraud may involve sophisticated and carefully organised schemes designed to conceal it. The auditor is neither trained as nor expected to be an expert in the authentication of documents.

(3) An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

(iii)Timeliness of Financial Reporting and the Balance between Benefit and Cost: The relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

(iv)Other Matters that Affect the Limitations of an Audit: In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

Fraud, particularly fraud involving senior management or collusion.

The existence and completeness of related party relationships and transactions.

The occurrence of non-compliance with laws and regulations.

Future events or conditions that may cause an entity to cease to continue as a going concern.

Because of the 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 SAs.

7 Write a short note “Audit risk at the account balance level and at the class of transactions level”.

Audit Risk at the Account Balance Level and at the Class of Transactions Level:

Majority of audit procedures are directed to and carried out at the account balance level and the class of transactions level. At these levels, the auditor uses professional judgment to evaluate numerous factors to assess inherent risk-

(i)Financial statement of accounts likely to be susceptible to mismanagement.

(ii)The complexity of underlying transactions which might require the use of the work of an expert.

(iii)The amount of judgment involved in determining account balances.

(iv)Susceptibility of assets to loss or misappropriation.

(v)The completion of unusual and complex transactions, particularly at or near year end.

8 *Audit Risk and inter-relationship of its components.*

(a) Audit Risk: An auditor's judgement as to what is sufficient and appropriate audit evidence is affected by the degree of risk of mis-statement. Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. For example, an auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level, while verifying various transactions and balance sheet items.

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

The nature of each of these types of risk is discussed below-

(i)Inherent risk: It is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.

(ii)Control Risk: It is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. It is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements.

The SAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement". However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.

(iii)Detection Risk: It is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor.

Inter-relationship of Components of Audit Risk: Audit risk is a function of the risks of material misstatement and detection risk. The inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce on acceptable level of detection risk, thereby reducing audit risk to an acceptably low level.

For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

9 Explain the Inherent Risk with reference to the relevant Standards on Auditing.

Inherent Risk: Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

As per SA 330 "The Auditor's Responses to Assessed Risks" , while designing the further audit procedures to be performed, the auditor shall consider the reasons for the assessment given to the risk of material misstatement at the assertion level for the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (i.e., the inherent risk) and obtain more persuasive audit evidence the higher the auditor's assessment of risk.

As per SA 315 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment", for this purpose, the auditor shall:

(i) 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;

(ii) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(iii) 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

(iv) 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.

10 (a) The auditor is responsible for maintaining an attitude of professional skepticism throughout the audit. Do you agree with the statement?

(a) Professional Skepticism: As per SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Therefore, professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of overlooking unusual circumstances, over generalising when drawing conclusions from audit observations or using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Further, while 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. This requirement is also designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Therefore, we do agree with the statement.

11 State briefly the qualities of an Auditor.

Qualities of an Auditor: The auditor should possess specific knowledge of accountancy, auditing, taxation, etc. which are acquired by him during the course of his theoretical education.

The auditor should also have sufficient knowledge of general principles of law of contracts, partnership; specific statutes and provisions applicable, e.g. Companies Act, 2013, Co- operative Societies Act, etc.; client's nature of business and its peculiar features. Apart from the knowledge acquired by the auditor in the formal manner, the auditor should also possess certain personal qualities such as, tact; caution; firmness; good temper; judgement; patience; clear headedness and commonsense; reliability and trust, etc.

In short, all those personal qualities required to make a good person contribute to the making of a good auditor. In addition, the auditor must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, SA 200 mentions integrity, objectivity and independence as one of the basic principles.

Auditing is a profession, calling for wide variety of knowledge to which no one has yet set a limit, the most useful part of the knowledge is probably that which cannot be learnt from books because its acquisition depends on the alertness of the mind in applying to ever varying circumstances, the fruits of his own observation and reflection; only he who is endowed with common sense in adequate measure can achieve it.

SA-210

12 *State the purpose of a 'Letter of Engagement'.*

Letter of Engagement: The legal requirement to get the accounts audited so far extends only to companies, co-operative societies, and registered societies. In these cases, the respective law governs the appointment of auditors and their duties. In all other cases, it is a matter of contract.

The client tells the auditor the nature of service he requires and the auditor, if he is agreeable to undertake the assignment, specifies his terms. He must sign an agreement, if he accepts the work in terms of the agreement subject to professional standards.

Clients who are not statutorily required to get their accounts audited may require preparation of accounts for tax returns, checking of the sales tax -returns, etc. besides audit. In such cases, there may be a misunderstanding about the exact scope of the work; the auditor may think that he is merely required to prepare accounts while the client may think audit of accounts, is also covered. It is, therefore, of the greatest importance, both for the accountant and client, that each party should be clear about the nature of the engagement. It must be reduced in writing and should exactly specify the scope of the work.

The audit engagement letter is sent by the auditor to his client which documents, the objective and scope of the audit, the extent of his responsibilities to the client and the form of report. The ICAI has issued Standard on Auditing 210 “Agreeing the Terms of Audit Engagement” on the subject. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent.

SA 210 lays down the standards on agreeing the terms of the engagement with the client and the auditor’s response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.

13 X, a Chartered Accountant was engaged by PQR & Co. Ltd. for auditing their accounts. He sent his letter of engagement to the Board of Directors, which was accepted by the Company. In the course of audit of the company, the auditor was unable to obtain appropriate sufficient audit evidence regarding receivables. The client requested for a change in the terms of engagement.

(a)Change in Terms of Engagement: According to SA 210 “Agreeing the Terms of Audit Engagements”, an auditor who is required to change the engagement which requires lower level of assurance before the completion of engagement should consider the appropriateness of doing so. But when the terms of engagement are changed, both the auditor and the client should agree on the new terms. However, the auditor should not agree to a change in terms where there is no reasonable justification for doing so.

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

- (i)Withdraw from the audit engagement where possible under applicable law or regulation; and
- (ii)Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

In the instant case, the auditor was unable to obtain sufficient evidence regarding receivables. The client requested him for a change in the terms of the agreement to avoid qualified/adverse opinion. Hence there is no reasonable justification for change in the terms of engagement.

Thus, the auditor should not agree for change in the terms of engagement letter. He may withdraw from the engagement if possible under law; and determine any obligation to report accordingly.

14 *“It is not mandatory to send a new engagement letter in recurring audit, but sometimes it becomes mandatory to send new letter”. Explain those situations where new engagement letter is to be sent.*

Issue of Audit Engagement Letter in Recurring Audits: As per SA 210, “Agreeing the Terms of Audit Engagements”, on recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

It is not necessary to issue audit engagement letter each year for repetitive audit. It is enough if the same had been issued at the time of taking initial engagement. However, in the following situations it is appropriate to revise the terms of the audit engagement or to remind the entity of existing terms-

- (i) Any indication that the entity misunderstands the objective and scope of the audit.
- (ii) Any revised or special terms of the audit engagement.
- (iii) A recent change in senior management or board of directors.
- (iv) A significant change in ownership.
- (v) A significant change in nature or size of the entity's business.
- (vi) A change in legal or regulatory requirements.
- (i) A change in the financial reporting framework adopted in the preparation of the financial statements.
- (ii) A change in other reporting requirements.

15 (a) Y, is the auditor of X Pvt. Ltd. In which there are four shareholders only, who are also the Directors of the company. On account of bad trade and for reducing the expenses in all directions, the directors asked Y to accept a reduced fee and for that he has been offered not to carry out such full audit as he has done in the past. Y accepted the suggestions of the directors.

(a) Restricting Scope of Audit: “Y” may agree to temporary reduction in audit fees, if he so wishes, in view of the suggestions made by the directors (perhaps in accordance with the decision of the company taken in general meeting). But his duties as a company auditor are laid down by law and no restriction of any kind can restrict the scope of his work either by the director or even by the entire body shareholders.

There is no concept of full or part audit under Section 143 of the Companies Act, 2013. Further, remuneration is a matter of arrangement between the auditor and the shareholders. Section 142 specifies the remuneration of an auditor, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

His duties may not necessarily commensurate with his remuneration. Y, therefore, should not accept the suggestions of the directors regarding the scope of the work to be done. Even if Y accepts the suggestions of the directors regarding the scope of work to be done, it would not reduce his responsibility as an auditor under the law. Under the circumstances, Y is violating the provisions of the Companies Act, 2013.

16 “An auditor who before the completion of the engagement is requested to change the engagement to one which provides a lower level of assurance should consider the appropriateness of doing so.” Discuss.

Acceptance of a Change in Engagement: An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications.

If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to-

(i) the original engagement; or

(ii) any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall-

(i) Withdraw from the audit engagement where possible under applicable law or regulation; and

(ii) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

SA-220

17 Quality control for audit work at firm level.

(a) Quality Control for Audit Work at Firm Level: SA 220 on Quality Control for an Audit of Financial Statements deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. Quality control systems, policies and procedures are the responsibility of the audit firm. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence. The requirements are-

(i)Leadership Responsibilities for Quality on Audits: The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

(ii)Relevant Ethical Requirements: Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement.

(iii)Acceptance and Continuance of Client Relationships and Audit Engagements: The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate.

(iv)Assignment of Engagement Teams: The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement in accordance with professional standards and regulatory and legal requirements and enable an auditor's report that is appropriate in the circumstances to be issued.

(v)Engagement Performance: The engagement partner shall take responsibility for the direction, supervision and performance of the audit engagement. He shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures and shall take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall determine that an engagement quality control reviewer has been appointed. Further, if differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

(i)Monitoring: The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement.

18 *Mention any four information which assists the auditor in accepting and continuing of relationship with the client as per SA 220.*

(a) Information which assist the Auditor in accepting and continuing of relationship with Client: As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement and when considering acceptance of a new engagement with an existing client. The following information would assist the auditor in accepting and continuing of relationship with the client:

(i)The integrity of the principal owners, key management and those charged with governance of the entity;

(ii)Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources:

(iii)Whether the firm and the engagement team can comply with relevant ethical requirements; and

(iv)Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

19 *Explain the advantages of "Audit Working Papers".*

Advantages of Audit Working Papers: Audit working papers constitute the basic records for the auditor in respect of the audit carried out by him. They constitute the link between the auditor's report and clients' record.

These include retention of permanent record in the nature of a document to show the actual audit work executed the nature of the, work, the extent of the work and important points, facts, dates and decisions having bearing on the audit of the accounts audited. The working papers, if properly maintained, can be used as defense in case of need. The audit working papers are found very useful in the following aspects as they-

- (i) aid in the planning and performance of the audit;
- (ii) aid in the supervision and review of the audit work;
- (iii) provide evidence of the audit work performed to support the auditor's opinion; and
- (iv) act as an evidence in the Court of law when a charge of negligence is brought against the auditor.

20 *What are audit working papers and why should they be carefully preserved by the Auditor?*

Audit Working Papers: As per SA 230 "Audit Documentation", Audit Working Papers are the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached.

Working papers are the-

- (a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and
- (b) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Besides they serve a number of additional purposes, including the following:

- Ø Assisting the engagement team to plan and perform the audit.
- Ø Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220.
- Ø Enabling the engagement team to be accountable for its work.
- Ø Retaining a record of matters of continuing significance to future audits.
- Ø Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
- Ø Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

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”, issued by the Institute, provides that, unless otherwise specified by law or regulation, working papers are the property of the auditor. He may at his discretion, make portions of, or extracts from, working papers 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.

Retention of working papers: Working papers should be retained, long enough, for a period of time sufficient to meet the needs of his practice and satisfy any legal or professional requirement of record retention. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

21 Audit Working Papers.

(a) Audit Working Papers: The audit working papers constitute the link between the auditor's report and the client's records. SA 230 on "Audit Documentation" states that Audit Working papers are the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. The object of Audit working papers is to provide:

(i) Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and

(ii) Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

Besides above, they serve a number of additional purposes, including the following:

·Assisting the engagement team to plan and perform the audit.

·Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220.

·Enabling the engagement team to be accountable for its work.

·Retaining a record of matters of continuing significance to future audits.

·Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.

·Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Working papers should contain audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained. The auditor shall assemble the audit working papers in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. The retention period for audit working papers ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report. Unless otherwise specified by law or regulation, audit working papers are the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients.

22 What are audit working papers? Discuss various contents of Permanent Audit File and Current File.

Audit Working Papers: Working papers are papers prepared and obtained by the auditor and retained by him, in connection with the performance of his audit. Working papers are the property of the auditor. As per SA 230 “Audit Documentation” refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as “working papers” or “work papers” are also sometimes used).

Working papers should record the audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

In case of recurring audits, auditors generally prepare **two types of audit files**.

(1) Permanent Audit file: It includes-

- (i) Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.
- (ii) Extracts or copies of important legal documents, agreements and minutes relevant to the audit.
- (iii) A record of the study and evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- (iv) Copies of audited financial statements for previous years.
- (v) Analysis of significant ratios and trends.
- (vi) Copies of management letters issued by the auditor, if any.
- (vii) Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- (viii) Notes regarding significant accounting policies.

(ix) Significant audit observations of earlier years.

(2) Current Audit file: The current file normally includes-

(i) Correspondence relating to acceptance of annual reappointment.

(ii) Extracts of important matters in the minutes of Board Meetings and General Meetings, as are relevant to the audit.

(iii) Evidence of the planning process of the audit and audit programme.

(iv) Analysis of transactions and balances.

(v) A record of the nature, timing and extent of auditing procedures performed and the results of such procedures.

(vi) Evidence that the work performed by assistants was supervised and reviewed.

(vii) Copies of communications with other auditors, experts and other third parties.

(viii) Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weaknesses in relevant internal controls.

(ix) Letters of representation or confirmation received from the client.

(x) Conclusions reached by the auditor concerning significant aspects of the audit.

(xi) Copies of the financial information being reported on and the related audit reports.

23 Factors affecting form, contents and extent of audit.

(a) Factors Affecting Form, Contents and Extent of audit: As per SA-230 on “Audit Documentation”, the form, content and extent of audit documentation depend on the following factors-

- (i)The size and complexity of the entity.
- (ii)The nature of the audit procedures to be performed.
- (iii)The identified risks of material misstatement.
- (iv)The significance of the audit evidence obtained.
- (v)The nature and extent of exceptions identified.
- (vi)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.
- (vii)The audit methodology and tools used.

24 *M/s Health Zone, a partnership firm, running a nursing home have decided to discontinue you as an auditor for the next year and requests you to handover all the relevant working papers of the previous year.*

Ownership of Working Papers: As per SA 230 on “Audit Documentations” the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

Working papers are the important records of the auditor. They serve as evidence of the auditor’s exercise of due care and conclusion reached regarding significant matters. The client does not have a right to access the working papers and it is up to the discretion of the auditor to make them available or not to others including the client.

Hence in the instant case, management of M/s Health Zone can’t insist upon the auditor to handover the working papers of

25 *Should branch auditor of a company comply with the request of the principal auditor of the company to give photocopy of the working papers pertaining to the branch audit? Explain.*

Ownership of Working Papers: As per SA 230 “Audit Documentation”, working papers are the property of the auditor. He may at his discretion, make available portions or extracts from his working paper to his client. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers.

An auditor is not required to provide the clients or other auditors’ access to his working papers. Main auditor of the company does not have right of access to the working papers of the branch auditor.

In the case of a company, the main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for the copy of working paper and therefore, the branch auditor is under no compulsion to give photocopies of his working paper to the principal auditor.

26 *What does SA 230 says about utility, ownership, custody and retention of working papers?*

Utility of Working Papers: According to SA 230 on ‘Audit Documentation’ working papers help in planning and performance of the audit, supervision and review of the audit work and provide evidence of the audit work performed to support the auditor’s opinion.

Ownership of Working Papers: Working papers are the property of the auditor and he may, at his discretion, make portions of or extracts from his working papers to his client.

Custody of Working Papers: The auditor should adopt reasonable procedures for safe custody and confidentiality of his working papers.

Retention of Working Papers: Working papers should be retained, long enough, for a period of time sufficient to meet the needs of his practice and satisfy any legal or professional requirement of record retention. SQC 1 requires firms to establish policies and procedures for the retention of engagement documentation. The retention period for audit engagements ordinarily is no shorter than seven years from the date of the auditor's report, or, if later, the date of the group auditor's report.

27 Explain in briefly the utility of Working Papers to an auditor.

Utility of Working Papers: Audit working papers are very useful to the auditor in the following way-

- (i) It provides guidance to the audit staff with regard to manner of checking the schedules.
- (ii) The auditor is able to fix responsibility on the staff members who signs each schedule.
- (iii) It acts as an evidence in the court of law when a charge of negligence is brought against the auditor.
- (iv) It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

28 Contents of Audit Note-book.

(a) Contents of Audit Note Book: Audit note book contains large variety of matters observed during the course of audit. Significant matters observed during audit which should be recorded in audit note book are normally the following-

- (i) Audit queries not cleared immediately.
- (ii) Mistakes or irregularities observed during the course of audit.
- (iii) Unsatisfactory book-keeping arrangements, costing method.
- (iv) Important information about the company which is not apparent from the accounts.
- (v) Special points requiring consideration at the time of verification of annual accounts.
- (vi) Important matters for future reference.

29 Write a short note on Auditor's Lien.

Auditor's Lien: In terms of the general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property.

On this premise, auditor can exercise lien on books and documents placed at his possession by the client for nonpayment of fees, for work done on the books and documents.

The Institute of Chartered Accountants in England and Wales has expressed a similar view on the following conditions:

- (i) Documents retained must belong to the client who owes the money.
- (ii) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.
- (iii) The auditor can retain the documents only if he has done work on the documents assigned to him.
- (iv) Such of the documents can be retained which are connected with the work on which fees have not been paid.

Under section 128 of the Companies Act, 2013, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. The company provides reasonable facility to auditor for inspection of the books of account by directors and others authorised to inspect under the Act. Taking an overall view of the matter, it seems that though legally, auditor may exercise right of lien in cases of companies, it is mostly impracticable for legal and practicable constraints. His working papers being his own property, the question of lien, on them does not arise.

Further, as per SA 230 "Audit Documentation", "working papers are the property of the auditor". The auditor may at his discretion make portions of or extracts from his working papers available to his clients.

Thus, documents prepared by the professional accountant solely for the purpose of carrying out his duties as auditor (whether under statutory provisions or otherwise) belong to the professional accountant.

In the case of *Chantrey Martin and Co. v. Martin*, it was held that the following documents were the property of the auditor: working papers and schedules relating to the audit, draft accounts of the company, and the draft tax computation prepared by an employee of the auditor.

It is also clear that the accountant's correspondence with his client (letters written by the client to the accountant and copies of the letters written by the accountant to the client) belong to the accountant. In the case of *Chantrey Martin and Co. v. Martin*, it was also held that the correspondence between the accountant and the taxation authorities with regard to the client's accounts and tax computations was the property of the client since the accountant merely acted as agent of the client.

However, where the accountant communicates with third parties not as an agent, but as a professional man, e.g., as an auditor, the correspondence with third parties would seem to belong to the accountant. According to the statement, where an auditor obtains documents confirming the bank balance or confirming the custody of securities of the client or other similar documents, it is probable that the courts would hold that these documents belong to the auditor.

30 (a) *R.K. & Company are the auditors of PQR Company Ltd. The Managing Director of the Company demands copies of the working papers from the auditors. Are the auditors bound to oblige the Managing Director?*

(a) Ownership and custody of working papers: As per SA 230 "Audit Documentation", the working papers are the property of the auditor, the auditor may, at his discretion make portion of or extracts from his working papers available to the client.

In the instant case the managing director of the company has demanded copies of the working papers from the auditor. He has no right to obtain copies of the working papers from the auditor because they are the property of the auditor. However the auditor may at his discretion make portions of or extracts from the working paper to the managing director of PQR Company Ltd.

Conclusion: The auditor is not bound to oblige the managing director by supplying copies of the audit working papers.

31 Write a short note on Fraudulent financial reporting.

Fraudulent Financial Reporting: Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. It can be caused by the efforts of management to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Such earnings management may start out with small actions or inappropriate adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting.

In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

Fraudulent financial reporting may be accomplished by the following:

(i) Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.

(ii) Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.

(iii) Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.

32 Mention briefly the conditions or events, which increase the risk of fraud or error leading to material misstatement in Financial Statements.

Conditions Which Increases the Risk of Fraud or Error: In planning and performing an examination, the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. Weaknesses in the design of the internal control system and non-compliance with identified control procedures amongst other conditions or events which increase the risk of fraud or error are-

(i)Weaknesses in the design of internal control system and non-compliance with the laid down control procedures, e.g., a single person is responsible for the receipt of all dak and marking it to the relevant sections or two persons are responsible for receipt of dak but the same is not followed in actual practice, etc.

(ii)Doubts about the integrity or competence of the management, e.g., domination by one person, high turnover rate of employees, frequent change of legal counsels or auditors, significant and prolonged understaffing of the accounts department, etc.

(iii)Unusual pressures within the entity, for example, industry is doing well but the company is not performing accordingly, heavy dependence on a single line of product, inadequate working capital, entity needs raising share prices to support the market price in the wake of public offer, etc.

(iv)Unusual transactions such as transactions with related parties, excessive payment for certain services to lawyers, etc.

(i)Problems in obtaining sufficient and appropriate audit evidence, e.g., inadequate documentation, significant differences between the figures as per the accounting records and confirmation received from third parties, etc.

33 (a) Is detection of fraud and error duty of an auditor?

Detection of Fraud and Error - Duty of an Auditor: As per SA-240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud

(a) because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an

active oversight by those charged with governance. In exercising oversight responsibility, those charged with governance consider the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability. Broadly, the general

principles laid down in this regard are:

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. As described in SA 200, "Overall Objectives of the Independent Auditor and the

(i) Conduct of an Audit in Accordance with Standards on Auditing", owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the SAs.

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.

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 an attitude of 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. The requirements in this SA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

It may be concluded from the above that detection of fraud and error is not the duty of the auditor provided that he complies with the requirements given in Standards on Auditing, maintains professional skepticism throughout the audit and is not grossly negligent in the performance of his duties as an auditor.

34 After the statutory audit has been completed a fraud has been detected at the office of the auditee.' What is your defence as an auditor?

(a) Detection of Fraud after Completion of Statutory Audit: As per SA 240, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. Such a system reduces but does not eliminate the possibility of fraud and error.

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 will not be detected, even though the audit is properly planned and performed in accordance with the SAs. 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.

The subsequent discovery of material misstatement of the financial information resulting from fraud or error existing during the period covered by the auditor's report does not, in itself, indicate that whether the auditor has adhered to the basic principles governing an audit. The question of whether the auditor has adhered to the basic principles governing an audit (such as performance of the audit work with requisite skills and competence, documentation of important matters, details of the audit plan and reliance placed on

internal controls, nature and extent of compliance and substantive tests carried out, etc.) is determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor's report based on the results of these procedures. The liability of the auditor for failure to detect fraud exists only when such failure is clearly due to not exercising reasonable care and skill. Thus, in the instant case after the completion of the statutory audit, if a fraud has been detected, the same by itself cannot mean that the auditor did not perform his duty properly. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures necessary for the proper

conduct of an audit, he cannot be held responsible for the same. If however, the same cannot be proved, he would be held responsible.

35 What are the auditor's responsibilities for detection of Frauds and Errors?

Auditor's Responsibilities for Detection of Fraud and Error: As per SA 240 "The Auditor's Responsibilities relating to fraud in an audit of Financial Statements", 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 will not be detected, even though the audit is properly planned and performed in accordance with the SAs. 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. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. 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 an attitude of 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.

As Per SA 200 "Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with standards on auditing", the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

An audit conducted in accordance with the auditing standards generally accepted in India is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

The 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, whether from fraud or error, will be detected. Therefore, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not, in and of itself, indicate:

- (a) failure to obtain reasonable assurance,
- (b) inadequate planning, performance or judgment,
- (c) absence of professional competence and due care, or,
- (d) failure to comply with auditing standards generally accepted in India.

This is particularly the case for certain kinds of intentional misstatements, since auditing procedures may be ineffective for detecting an intentional misstatement that is concealed through collusion between or among one or more individuals among management, those charged with governance, employees, or third parties, or involves falsified documentation. Whether the auditor has performed an audit in accordance with auditing standards generally accepted in India is determined by the adequacy of the audit procedures performed in the circumstances and the suitability of the auditor's report based on the result of these procedures.

In planning and performing his examination the auditor should take into consideration the risk of material misstatement of the financial information caused by fraud or error. He should inquire with the management as to any fraud or significant error, which has occurred in the reporting period, and modify his audit procedures, if necessary. If circumstances indicate the possible existence of fraud and error, the auditor should consider the potential effect of the suspected fraud and error on the financial information. If he is unable to obtain evidence to confirm, he should consider the relevant laws and regulations before expressing his opinion.

The auditor also has the responsibility to communicate the misstatement to the appropriate level of management on a timely basis and consider the need to report to it then changed with governance. He may also obtain legal advice before reporting on the financial information or before withdrawing from the engagement. The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud.

The auditor should also consider the implications of the frauds and errors, and frame his report appropriately. In case of a fraud, the same should be disclosed in the financial statement. If adequate disclosure is not made, there should be a suitable disclosure in his audit report.

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

36 Q37. Chap 7 Pg.7.41

37 (a) *E and S were appointed as Joint Auditors of X and Y Ltd. What will be their professional responsibility in a case where the company has cleverly concealed certain transactions that escaped the notice of both the Auditors?*

(a) Responsibilities of Joint Auditors: In conducting a joint audit, the auditor(s) should bear in mind the possibility of existence of any fraud or error or any other irregularities in the accounts under audit. The principles laid down in SA 200, SA 240 and SA 299 need to be read together for arriving at any conclusion. The principle of joint audit involves that each auditor is entitled to assume that other joint auditor has carried out his part of work properly. However, in this case, if it can be assumed that the joint auditors E and S have exercised reasonable care and skill in auditing the accounts of X & Y Ltd. and yet the concealment of transaction has taken place, both joint auditors cannot be held responsible for professional negligence. However, if such concealment could have been discovered by the exercise of reasonable care and skill, the auditors would be responsible for professional negligence. Therefore, it has to be seen that while dividing the work, the joint auditors have not left any area unattended and exercised reasonable care and skill while doing their work.

38 *Write a short note on Knowledge of Client's business.*

Knowledge of Client's Business: An auditor can obtain this information from-

(i) Clients annual report to shareholders;

- (ii) Minutes of shareholders/board of directors;
- (iii) Internal financial management reports of current & previous year;
- (iv) Previous year audit working papers;
- (v) Discussion with client;
- (vi) Clients policy and procedure manual;
- (vii) Publications like trade journals, magazines, news papers; and
- (viii) Visit to client's premises.

39 Medical Council of India organised a three-day International Conference of Doctors in Delhi. You are asked to audit the accounts of the conference. Draft the audit programme for audit of receipt of participation fees from delegates to the conference. Mention any six points, peculiar to the situation, which you will like to include in your audit programme.

Audit of Receipts of Participation Fees: The organization of three-day International Conference of Doctors in Delhi by Medical Council of India is a one-time event. Normally, in view of mega-size of the event, a special cell is made in the organization to handle the entire event. Since few people would be handling the event, the internal controls may not be that strong and, thus, more emphasis is required to be given on substantive procedure. Audit of receipt of participation fees should be under the following areas-

(I) Internal Control System

- (i) Examine the organization structure of special cell created for the International Conference, if any, and division of responsibilities amongst persons and control/custody over receipt books.
- (ii) Verify the internal control system for restricting the participation of unregistered delegates.

(II)Rate of Participation Fees

- (i)Verify with reference to resolution passed by the Organizing Committee/Medical Council of India.
- (ii)Also verify the rate from the literature/registration form circulated for promotion of conference.

(III)Receipts of Participation Fees

- (i)Verify counter foil of the receipts issued for individual registration.
- (i)Ensure that receipts are issued for all the registration received in cash.
- (ii)Trace the receipts in Bank Statement or Cash Book – as the case may be.
- (iii)Verify Bank Reconciliation Statement and list out dishonoured cheques.
- (iv)Verify subsequent recovery in respect of dishonoured cheques.

(II)Overall Checking

- (i)Verify the total receipts of participation fees shown in the financial statements with reference to total number of receipts issued to participants.
- (ii)Cross check the total number of delegates with reference to the following:
 - (a) Kits distributed to participants.
 - (b) Bill of caterer for providing meals during conference.
 - (c) Capacity of the Hall.
 - (d) Participation Certificate if any issued.

(III) Foreign Delegates: In case of foreign delegates – if registration fees are higher – ensure that they are registered at higher fees.

(IV) Special Issues

(i) Take out list of absentees and in case of nil absentees, probe the issue further.

(ii) If certain participants are exempted from payment of fees – obtain the list along with proper authorization in this regard.

SA-250

40 With reference of SA 250, give some examples or matters indicating to the auditor about non compliance of laws & regulations by management.

Non-compliance of Laws and Regulations by Management: As per SA 250 on “Consideration of Laws and Regulation in an Audit of Financial Statements”, the following are examples or matters indicating to the auditor about non-compliance with laws and regulations by management-

(i) Investigations by regulatory organisations and government departments or payment of fines or penalties.

(ii) Payments for unspecified services or loans to consultants, related parties, employees or government employees.

(iii) 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.

(iv) Purchasing at prices significantly above or below market price.

(v) Unusual payments in cash, purchases in the form of cashiers’ cheques payable to bearer or transfers to numbered bank accounts.

(vi) Unusual payments towards legal and retainership fees.

(vii) Unusual transactions with companies registered in tax havens.

(viii) Payments for goods or services made other than to the country from which the goods or services originated.

(ix) Payments without proper exchange control documentation.

(x) Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.

(xi) Unauthorised transactions or improperly recorded transactions.

(xii) Adverse media comment.

SA-260

41 The auditor shall communicate all significant findings with those charged with Governance.

(a) Communication of Findings with Those Charged with Governance: As per SA-260 “Communication with Those Charged with Governance”, the auditor shall communicate the following significant findings from the audit. with those charged with governance-

(i) 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;

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

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

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

(2) Written representations the auditor is requesting; and

(iv) 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.

42 *State the significant difficulties encountered during audit with reference to SA-260 (communication with those charged with governance).*

(a) Significant Difficulties Encountered During the Audit: As per SA 260 "Communication with Those Charged with Governance", significant difficulties encountered during the audit may include such matters as:

“Significant delays in management providing required information.

“An unnecessarily brief time within which to complete the audit.

“Extensive unexpected effort required to obtain sufficient appropriate audit evidence.

“The unavailability of expected information.

“Restrictions imposed on the auditor by management.

“Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

43 *Factors governing modes of communication of auditor with those charged with governance.*

(a) Factors Governing Modes of Communication of Auditor with Those Charged with Governance: As per SA 260, “Communication with Those Charged with Governance”, the form of communication (e.g. whether to communicate orally, or in writing, the extent of detail or summarisation in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:-

(i) Whether the matter has been satisfactorily resolved.

(ii) Whether management has previously communicated the matter.

(iii) The size, operating structure, control environment, and legal structure of the entity.

(iv) In the case of an audit of special purpose financial statements, whether the auditor also audits the entity’s general purpose financial statements.

(v) Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.

(vi) The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.

(vii) The amount of ongoing contact and dialogue the auditor has with those charged with governance.

(viii) Whether there have been significant changes in the membership of a governing body.

SA-265

44 Write a short note on Letter of Weakness.

Letter of Weakness:

(i) The auditor does compliance procedure to ascertain that the internal control system exist in the entity; it works effectively; it work continuously in the entity during review period.

(ii) When he comes across any weakness in the control points, he issues letter of weakness.

(iii) Letter of weakness is a report issued by auditor stating the weakness in internal control mechanism. It also suggests measures by which the weakness in the system be corrected and the control system be made better protected.

(iv) Lapses in operation of internal control too are reported in the communication of weakness.

(v) The communication of weakness is reporting to management of such weakness in design and operation of internal control as have come to notice of auditor during his auditing and it should not be taken to be a review and comment on adequacy of the control mechanism for management purpose.

45 Letter of weakness is issued by the Management.

Incorrect: Letter of weakness is a report issued by auditor stating the weakness in internal control mechanism. It also suggests measure by which the weakness in the system to be corrected and the control system be made better protected.

SA-299

46 'A Joint Auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the report.'

Justify this statement in the light of responsibilities of Joint Auditors under SA 299.

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-

in respect of the audit work which is not divided among the joint auditors and is carried out by all of them.

(i)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.

(ii)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.

(iii)for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute.

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

(v)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.

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

(vii) 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.

47 Joint Audit.

(a) Joint Audit: The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work.

With a view to providing a clear idea of the professional responsibility undertaken by the joint auditors, the Institute of Chartered Accountants of India had issued a statement on the Responsibility of Joint Auditors which now stands withdrawn with the issuance of SA 299, "Responsibility of Joint Auditors" w.e.f. April, 1996. It requires that where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors.

Further, it states that in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible-

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

- (ii) 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;
- (iii) 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;
- (iv) For examining that the financial statements of the entity comply with the disclosure requirement of relevant statute; and
- (v) For ensuring that the audit report complies with the requirements of the relevant statute.

48 Explain the concept of joint audit. Discuss its advantage and disadvantage.

Joint Audit: The practices of appointing chartered accountants as joint auditors is quite widespread in big companies and corporations, joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work.

When more than one auditor is appointed to audit large entities, such auditors are called joint auditors. Joint auditors have a collective responsibility to report on the financial statements. SA 299, “Joint Audit” deals with duties, rights and professional responsibilities of joint auditors. The joint auditors should follow the principles of division of work and coordination while conducting joint audits.

“Advantages” of Joint Audit

- (i) Pooling and sharing of expertise.
- (ii) Advantage of mutual consultation.
- (iii) Lower work load.
- (iv) Better quality of work performance.

- (v) Improved service to the client.
- (vi) Displacement of the auditor of the company in a take-over often obviated.
- (vii) In respect of multinational companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- (viii) Lower staff development costs.
- (ix) Lower costs to carry out the work.
- (x) A sense of healthy competition towards a better performance.

“Disadvantages” of Joint Audit

- (i) The fees being shared.
- (ii) Psychological problem where firms of different standing are associated in the joint audit.
- (iii) General superiority complexes of some auditors.
- (iv) Problems of coordination of the work.
- (v) Areas of work of common concern being neglected.
- (vi) Uncertainty about the liability for the work done.
- (vii) Lack of clear definition of responsibility.

49 In Joint Audit, "Each Joint Auditor is responsible only for the work allocated to him".

(a) Responsibility of Joint Auditor: The principles governing to responsibilities of joint auditor are prescribed in SA 299, “Responsibility of Joint Auditor”. As per SA 299, if joint auditors are appointed, they should divide the audit work among themselves by mutual discussion. The division of work would usually be in terms of audit of identifiable units or specified areas. Such division of work should be adequately documented and preferably communicated to the entity.

It is the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the area of work allocated to him. The issue such as appropriateness of using test checks, sampling or other audit techniques should be decided by each joint auditor individually in relation to his work. Thus, the responsibility will not be shared by the other auditor. Therefore, 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.

Hence, in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. However, all the joint auditors are jointly and severally responsible in respect of the audit work which is not divided among the joint auditors and is carried out by all of them, 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, 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, for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute and for ensuring that the audit report complies with the requirements of the relevant statute.

50 Write a short note on responsibilities of Joint auditors.

Responsibilities of Joint Auditors: SA 299 on Responsibilities of Joint Auditors requires that joint auditors should by mutual discussion divide the audit work among themselves. It further states that each joint auditor is responsible only for the work allocated to him, whether or not he has prepared separate report on the work performed by him.

On the other hand, all joint auditors are jointly and severally responsible-

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

- (ii) in respect of decision taken by all joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors;
- (iii) 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;
- (iv) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and
- (v) for ensuring that the audit report complies with requirements of the statute.

51 Responsibilities of Joint auditors.

(a) Responsibilities of Joint Auditors: As per SA 299, in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him. In respect of other works, which are not divided, all the joint auditors are jointly and severally responsible for-

- (i) Audit work which is not divided and is carried on jointly by all the joint auditors.
- (ii) Decision 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.
- (iii) Matters which are brought to the notice of the joint auditors by any one of them and on which there is agreement among the joint auditors.
- (iv) Examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute.
- (v) Ensuring that the audit report complies with the requirement of the relevant statute.

SA-300

52 What are the disadvantages of the use of an audit programme?

(a) Disadvantages of the Use of an Audit Programme:

- (i) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.
- (ii) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on.
- (iii) Inefficient assistants may take shelter behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.
- (iv) A hard and fast programme may kill the initiative and innovation of efficient and enterprising assistants.

53 Write a short note on - Audit Programme.

Audit Programme: An audit programme is a detailed plan of applying the audit procedure in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives. It is framed keeping in view the nature, size and composition of the business, dependability of the internal control and the given scope of work. Audit programme provides sufficient details to serve as a set of instructions to the audit team and also helps to control the proper execution of the work. On the basis of experience while carrying out the audit work, the programme may be altered to take care of situations which were left out originally, but found relevant for the particular audit situation. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, that may be dropped. There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. For the purpose of framing an audit programme the following points should be kept in view:

Ø Audit objective

Ø Audit procedure to be applied

- Ø Extent of check
- Ø Timing of check
- Ø Allocation of work amongst the team members
- Ø Special instructions based on past experience of the auditee.

54 How does an audit programme help to plan and perform the audit?

(a) The Role of Audit Programme in Audit Plan and Performance: The audit programme is helpful both in planning and performance stages of audit-

- (i) The audit programme lists down areas of audit before commencement.
- (ii) The audit timing is built therein; thereby it becomes a schedule of audit plan.
- (iii) The staff who are entrusted with the audit assignment is also specified. It is a plan of resource allocation of the firm.
- (iv) It specifies the procedures to be checked during the audit.
- (v) As the audit work is split into various elements of procedures to be performed, the audit programme acts as a guiding chart or check list during the performance of audit.
- (vi) Since the staff in charge of each work is specified and they sign the programme, it extracts the responsibility from the audit assistants.
- (vii) The working papers of the audit staff can be reviewed against the audit programme which helps a base of reference for evaluation of the performance before reporting on the financial statements.

(viii) It also helps in preparing a diary of the performance and plan and also base for billing the clients for the time and manpower involved in the audit.

SA-315

55 In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment”.

Obtaining Knowledge of the Business: The auditor needs to obtain a level of knowledge of the client’s business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information among other things.

As per SA 315 – “Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment”, the auditor shall obtain an understanding of the following:

(a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework

(b) The nature of the entity, including:

(i) its operations;

(ii) its ownership and governance structures;

(iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

(iv) 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.

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(e) 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.

56 Q.24 chap 3(Understanding entity and its environment)

57 Write a short note on 'Matters that the auditor may consider when obtaining an understanding of the nature of the entity'.

Matters that the Auditor may consider when obtaining an understanding of the nature of the entity: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", following are some of the examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity-

(i) Business operations – such as:

Ø Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as internet sales and marketing activities.

Ø Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).

Ø Alliances, joint ventures, and outsourcing activities.

Ø Geographic dispersion and industry segmentation.

Ø Location of production facilities, warehouses, and offices, and location and quantities of inventories.

Ø Key customers and important suppliers of goods and services, employment arrangements.

Ø Research and development activities and expenditures.

Ø Transactions with related parties.

(ii) Investments and investment activities – such as:

Ø Planned or recently executed acquisitions or divestitures.

Ø Investments and dispositions of securities and loans.

Ø Capital investment activities.

Ø Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.

(iii) Financing and financing activities – such as:

Ø Major subsidiaries and associated entities, including consolidated and non- consolidated structures.

Ø Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.

Ø Beneficial owners (local, foreign, business reputation and experience) and related parties.

Ø Use of derivative financial instruments.

(iv) Financial reporting – such as:

Ø Accounting principles and industry - specific practices, including industry - specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).

Ø Revenue recognition practices.

Ø Accounting for fair values.

Ø Foreign currency assets, liabilities and transactions.

Ø Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

58 What are the various assertions an auditor is concerned with while obtaining audit evidence from substantive procedure?

Assertions while Obtaining Audit Evidence from Substantive Procedure: In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions-

(i) Existence - that an assets or liability exists at a given date.

(ii) Rights and obligations - that an asset is a right of the entity and a liability is an obligation at a given date.

(iii) Occurrence - that a transaction or event took place which pertains to the entity.

(iv) Completeness - that there are no unrecorded assets, liabilities or transaction.

(v) Valuation - that an asset or liability is recorded at an appropriate carrying value.

(vi) Measurement - that a transaction is recorded in the proper amount and revenue or expenses are allocated to proper period.

(vii) Presentation & disclosure - that an item is disclosed, classified and described in accordance with recognized accounting policies, practices and statutory requirements.

59 “Risk of material misstatement at the assertion level for classes of transactions, account balances and disclosures need to be considered.” Explain stating the different categories of assertions used by the auditor.

Risk of Material Misstatement at the Assertion Level: According to SA 315 “Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment”, risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms-

(a) Assertions about classes of transactions and events for the period under audit:

(i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.

(ii) Completeness—all transactions and events that should have been recorded have been recorded.

(iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.

(iv) Cut-off—transactions and events have been recorded in the correct accounting period.

(v) Classification—transactions and events have been recorded in the proper accounts.

(b) Assertions about account balances at the period end:

(i) Existence—assets, liabilities, and equity interests exist.

(ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.

(iv) Valuation and allocation—assets, liabilities, and equity interests are included in the

financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(a) Assertions about presentation and disclosure:

(i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.

(ii) Completeness—all disclosures that should have been included in the financial statements have been included.

(iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.

(iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

60 (a) The auditor may exercise his judgement to identify which risks are significant risks. Explain the above in context of SA-315.

(a) Identification of Significant Risks: SA 315 “Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment” defines ‘significant risk’ as an identified and assessed risk of material misstatement that, in the auditor’s judgment, requires special audit consideration.

As part of the risk assessment, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following-

(i) Whether the risk is a risk of fraud;

(ii) Whether the risk is related to recent significant economic, accounting or other developments like changes in regulatory environment etc. and therefore requires specific attention;

(iii) The complexity of transactions;

(iv) Whether the risk involves significant transactions with related parties;

(v) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

(vi) Whether the risk involves significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

61 Give your assertions for the following items appearing in Balance Sheet of a Limited Company:

(i) Cash in hand 10,000

(ii) Investments 1,00,000

(iii) Secured Loans 10,00,000

(iv) Machinery: = Opening cost 13,00,000 Less: depreciation 1,30,000 = WDV 11,70,000

(i) Cash in Hand ` 10,000

This is the item of current assets, exhibited on the asset side of Balance Sheet. It implies:

- (1) that the firm concerned has ` 10,000 in hand in valid notes and coins on the Balance Sheet date.
- (2) that the cash was free and available for expenditure to the firm.
- (3) that the books of accounts show a cash balance of identical amount at the end of the day on which the Balance Sheet is drawn up.

(i) Investments ` 1,00,000

This is also the item to be exhibited on the asset side of Balance Sheet as per Schedule III to the Companies Act, 2013, as prescribed by Company Law. This description is not giving us a complete picture of investment. We, as an auditor, must know:

- (1) Nature of Investment, type of Investment; whether it is short term or long term investment or trade investment or non-trade investment.
- (2) Rate of interest receivable.
- (3) Face value or market value of investments as on Balance Sheet date.

(ii) Secured Loan ` 10,00,000

It Implies that the company has secured loan from some parties, worth ` 10,00,000. The description does not give us a complete picture. We, as an

auditor, must know:

- (1) the name of the lender,
- (2) the nature of security provided; and

(3) the rate at which interest is payable.

(ii) Machinery ` 11,70,000

(1) The Company owns the Plant and Machinery whose WDV as on date of Balance Sheet is ` 11,70,000. Gross block is ` 13,00,000.

(2) The Machinery physically exists.

(3) The asset is being utilized in the business of the company productively.

(4) Charge of depreciation on this asset is ` 1,30,000 relates to the year in respect of which the accounts are drawn up.

(1) The amount of depreciation, has been calculated on recognized basis and the calculation is correct.

SA-320

62 Explain concept of materiality and factors which act as guiding factors to this concept.

Concept of Materiality: SA 320 “Materiality in Planning and Performing an Audit”, establishes standards on the concept of materiality and the relationship with audit risk while conducting an audit. Hence, the auditor requires more reliable evidence in support of material items. SA 320 defines material items as relatively important and relevant items, i.e., items the knowledge of which would influence the decision of the user of financial statements. Financial statements materially affect if such statement is erroneously stated or omitted to be stated there in and economic decision of the users taken on the basis of such information is influenced by such misstatements or omissions.

The auditor has to ensure that such items are properly and distinctly disclosed in the financial statements.

The concept of materiality is fundamental to the process of accounting. It covers all the stages

from recording to classification and presentation. It is very important for the auditor who has constantly to judge whether a particular item is material or not.

There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

Factors to be considered for determining materiality:

- (i) Item of materiality may be determined individually or in aggregate.
- (ii) The materiality depends on the regulatory or legal considerations.
- (iii) Materiality is not often reckoned with respect to quantitative details above. It has qualitative dimensions as well.
- (iv) Even insignificant items in terms of quality may be material in special circumstances.
- (v) Sometimes the materiality of an item in terms of quantity is described in law itself. For example, Schedule III requires disclosure of items of expenditures which are in excess of one percent of the revenue from operations or ` 1,00,000, whichever is higher.
- (vi) An item whose impact is insignificant at present, but in future it may be significant, may be material item.

63 Explain the Relationship between materiality and audit risk.

Relationship between Materiality and Audit Risk: SA 320 on 'Materiality in Planning and Performing an Audit' requires that the auditor should consider materiality and its relationship with audit risk when conducting an audit. Materiality depends on the size and the nature of the items judged in the particular circumstances of its misstatement.

The audit should be planned so that audit risk is kept at an acceptably low level. There is an inverse relationship between Materiality and the degree of audit risk. Higher the materiality level the lower the audit risk and vice-versa. After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high.

The auditor's assessment of audit risk may change during the course of an audit according to the need and development of the circumstances.

64 Explain concept of 'Materiality'.

(i) Concept of Materiality: According to SA 320 "Materiality in Planning and Performing an Audit", financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both; and
- 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. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

(1) Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred above provides the auditor with such a frame of reference.

(2) The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

(a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

(b) Understand that financial statements are prepared, presented and audited to levels of materiality;

(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

(d) Make reasonable economic decisions on the basis of the information in the financial statements.

(3) The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report.

SA-330

65 Short notes on Substantive Procedures

(a) Substantive Procedures: These procedures are audit tests designed to obtain evidence to verify balance of an account or a specific financial statement assertion i.e. they test the validity and propriety of the accounting treatment of the transaction. They can be classified as either test of details of transactions and balances or as analytical review procedures. They provide assurance to the auditor in respect of the following assertions-

(i)The asset or a liability should exist at a given date.

(ii)The asset should be owned by the entity and the liability is an obligation of the entity at a given date.

(iii)There should not be any unrecorded assets, liabilities or transactions.

(iv) Assets or liabilities should be recorded at appropriate carrying values.

(v) Transaction or event that took place should pertain to the entity during the relevant period.

(vi) Transaction should be recorded in the proper amount and revenue or expense should be allocated to the proper period.

(vii) Various items should be disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

66 Why Tests of Control are performed? Also explain what does they include.

Tests of Control: Tests of control are performed to obtain audit evidence about the effectiveness of the -

(i) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and

(ii) operation of the internal controls throughout the period.

Tests of control include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk.

Tests of control may include:

Ø Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.

Ø Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.

Ø Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.

Ø *Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.*

67 Explain the test of controls and substantive procedures as audit procedure of obtaining sufficient appropriate audit evidence for forming an audit opinion.

Collection of Evidences to Form Audit Opinion: Auditor should obtain sufficient and appropriate audit evidences and test them before framing an opinion about the assertions the financial statements reveal. For this, the auditor checks evidences through (a) Test of Controls and (b) Substantive Procedure.

According to SA 330 “The Auditor’s Responses to Assessed Risks”, ‘test of controls’ means an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

(a) The auditor’s assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

SA 330 further explains the ‘substantive procedure’ as an audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

(i) Tests of details (of classes of transactions, account balances, and disclosures), and

(ii) Substantive analytical procedures.

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures.

SA-500

68 What is “Audit Evidence”?

Audit Evidence: As per SA 500 “Audit evidence”, it is the information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

69 What do you mean by the term 'Sufficient Appropriate Audit Evidence'? State various factors that help the auditor to ascertain as to what is sufficient appropriate audit evidence.

Meaning of Sufficient Appropriate Audit Evidence: SA 500 “Audit Evidence” requires that the auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence.

SA 500 further expounds this concept. According to it, the sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor’s assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

SA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. Further, SA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

In general the various factors which may influence the auditor's judgment as to what is sufficient and appropriate audit evidence are as under:

(i) Degree of risk of misstatements which may be affected by factors such as the nature of items, adequacy of internal control, nature and size of businesses carried out by the entity, situations which may exert an unusual influence on management and the financial position of the entity.

(ii) The materiality of the item.

(iii) The experience gained during previous audits.

(iv) The results of auditing procedures, including fraud and errors which may have been found.

(v) The type of information available.

The trend indicated by accounting ratios and analysis.

70 Discuss "Inquiry is one of the audit procedure to obtain audit evidence".

Inquiry – Audit Procedure to obtain Audit Evidence: 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.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry. In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

71 What are the various audit procedures to obtain audit evidence? Mention the same in brief.

(i) Audit Procedures to Obtain Audit Evidence: According to SA 500 "Audit Evidence", the auditor may obtain evidence by one or more of the following audit procedures-

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 inventory 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.

Observation: Observation consists of looking at a process or procedure being performed by 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.

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.

Recalculation: Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

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

Analytical Procedures: 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.

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.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

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In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

72 Distinguish between Internal evidence and External evidence.

Internal Evidence and External Evidence: Evidence which originates within the organization being audited is internal evidence. Example – sales invoice, copies of sales challan and forwarding note, goods received notes, inspection report, copies of cash memo, debit and credit notes, etc.

External evidence on the other hand is the evidence that originates outside the client's organization; for example, purchase invoice, supplier's challan and forward note, debit notes and credit notes coming from parties, quotations, confirmations, etc.

In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff. The external evidence is generally considered to be more reliable as they come from third parties who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence e.g., an invoice of an associated concern, he should exercise greater vigilance in that matter. As an ordinary rule

the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see to what extent the various internal evidence corroborate each other.

73 Discuss the principles, which are useful in assessing the reliability of audit evidence.

(i) Reliability of Audit Evidence: SA 500 on “Audit Evidence” provides that the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management’s expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- (1) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- (2) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

(3) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

(4) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

74 *The auditor of a limited company has given a clean report on the financial statement on the basis of xerox copies of the books of accounts, vouchers and other records which were taken away by the Income Tax Department in search under section 132 of the I.T. Act, 1961. Comment.*

Reliability of Audit Evidence: As per SA 500 on “Audit Evidence”, the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management’s expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

(i) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

(ii) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

(iii) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

(iv) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

(v) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

Applying the above, the degree of reliance which can be placed by the auditor on the documentary audit evidence available in the present case will be considerably increased if the xerox copies of account books and vouchers are certified to be true copies by the Income Tax Department. If the tax authorities refuse to certify the same, the auditor should get the certificate to this effect from the management of the company.

The auditor should use procedure like confirmation of balances from third parties, inspection of tangible assets, etc. and obtain evidence which corroborates the documentary evidence available. In any case, the auditor has to satisfy himself that he has obtained sufficient and appropriate audit evidence to support the figures contained in the financial statements and formulate his opinion accordingly. Under such circumstances, the auditor should have appropriately modified his report and bring this fact to the attention of shareholders. In case he was satisfied, a simple paragraph of information was enough but in case the auditor failed to establish the reliability of evidence available, he would be required to a disclaimer of opinion.

75 The management has obtained a certificate from an actuary regarding provision of gratuity payable to employees.

(a) Certificate from a Management's Expert: The computation of gratuity liability payable to employees is dependent upon several factors such as age of the employee, expected span of service in the organisation, life expectancy of the employee, prevailing economic environment, etc. Thus, it gives rise to uncertainty in the determination of provisions of liabilities. Under such circumstances, the management is required to make an assessment and estimate the amount of provision. In view of this, the management may engage an expert in the field to assist them in arriving at fair estimation of the liability. Therefore, it is an accepted auditing practice to use the work of a management's expert. SA 500 on "Audit Evidence" also states that the preparation of an entity's financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The entity may employ or engage experts in these fields to obtain the needed expertise to prepare the financial statements. It further requires the auditor to evaluate the competence, capabilities and objectivity of that expert; obtain an understanding of the work of that expert; and evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion, to conclude whether or not to rely upon such a certificate obtained by the management from the actuary. Therefore, the auditor must follow the requirements of SA

76 While conducting audit of a bank, you find that the bank has advanced loan for purchase of machinery on the basis of valuation report prepared by a civil engineer. Will you approve the action taken by bank? Justify the answer.

(a) Using the Work of Management's Expert: The Auditor while considering advances granted by bank for purchase of machinery has to consider valuation report given by civil engineer to the bank.

SA 500 “Audit Evidence” clearly states that 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,

- (i) Evaluate the competence, capabilities and objectivity of that expert;
- (ii) Obtain an understanding of the work of that expert; and
- (iii) Evaluate the appropriateness of that expert’s work as audit evidence for the relevant assertion.

If auditor finds that civil engineer cannot be considered expert for valuation of machinery, he should insert on other analytical procedures to confirm value of machinery. Even after this, if he is not satisfied, he should give qualified opinion.

SA-501

77 Write a short note on “Physical attendance by auditor during inventory taking”.

Attendance at Inventory Taking: According to SA 501 “Audit Evidence- Specific Considerations for Selected Items”, management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity’s perpetual inventory system.

Attendance at physical inventory counting involves-

- Inspecting the inventory to ascertain its existence and evaluate its condition, and performing test counts;
- Observing compliance with management’s instructions and the performance of procedures for recording and controlling the results of the physical inventory count; and
- Obtaining audit evidence as to the reliability of management’s count procedures.

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.

Observing the performance of management's count procedures, for example those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management's instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cut off information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

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.

Performing test counts, for example by tracing items selected from management's count records to the physical inventory and tracing items selected from the physical inventory to management's count records, provides audit evidence about the completeness and the accuracy of those records.

In addition to recording the auditor's test counts, obtaining copies of management's completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

78 How would an auditor proceed to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory? Also state reporting requirements for the same in the case of a company.

As per SA 501 on "Audit Evidence- Specific Considerations for Selected Items", the following principles are laid down in this respect:

(i) When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

(1) Attendance at physical inventory counting, unless impracticable, to:

(i) Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting;

(ii) Observe the performance of management's count procedures;

(iii) Inspect the inventory; and

(iv) Perform test counts; and

(2) Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

(ii) If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures as stated above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

(iii) If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

(iv) If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

(v) When inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(1) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(2) Perform inspection or other audit procedures appropriate in the circumstances.

Audit Conclusions and Reporting: As per clause (ii) of Para 3 of Companies (Auditor's Report) Order, 2016 [CARO 2016], the auditor has to report on whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.

If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence of inventory or adequacy of procedures adopted by the management in respect of physical inventory count the auditor should make a reference to a scope limitation in his audit report. If the inventory is not disclosed appropriately in the financial statements, the auditor should issue a qualified opinion.

79 (a) SK Ltd. has fully computerised its accounting operations. The inventory records are maintained up to date with timely entries passed for all receipts and issues. The company has hired a professional security agency, which monitors and implements a close vigilance over the operations of the company. As such, the company had dispensed with the practice of taking inventory of their inventories at the year-end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations.

(a) Verification of Inventories – Auditors' Duties: The audit procedures to be performed by an auditor to obtain sufficient appropriate audit evidence in relation to inventories have been recommended in the Guidance Note on Audit of Inventories issued by ICAI. On the basis of his evaluation of the effectiveness of the internal controls, the auditor should carry out appropriate substantive procedures in relation to inventories. These substantive procedures include examination of records, attendance at inventory-taking, examination of valuation and disclosure of inventories, carrying out analytical procedures, and obtaining confirmations from third parties and representations from the management.

In view of above, an auditor should insist on the company to do physical verification of inventory. Verification must be done at least yearly, if not more frequently within a year. Dispensing with physical verification altogether is unacceptable. It is not enough that the company had installed good control procedures. It must be tested, for example, in case of inventory, physically verifying the same as to see that no discrepancy exists. Pilferage, misappropriation is not the only cause for discrepancies. Inherent product qualities like shrinkage, evaporation, handling loss, etc. may also account for discrepancies. The auditor should require the management to conduct physical verification by or near the year end. If the management does not accept to the auditor's view the auditor may appropriately make modification in his audit report.

Additionally, as per clause (ii) of Para 3 of Companies (Auditor's Report) Order, 2016 [CARO 2016], the auditor has to report on whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.

80 Comment on the "Responsibility for properly determining the quantity and value of inventories rests with the management of the entity".

(a) Responsibility for Determining Quantity and Value of Inventories: The Guidance Note on Audit of Inventories specifies that the responsibility for properly determining the quantity and value of inventories rests with of the management of the entity. Therefore, it is the responsibility of the management of the entity to ensure that the inventories included in the financial information are physically in existence and represent all owned by the entity

The management can satisfy this responsibility by carrying out appropriate procedures such as verification of all items of inventory at least once in every financial year. The auditor is expected to examine the adequacy of the methods and procedures of physical verification followed by the entity. He is also required to determine whether the procedures for identifying defective, damaged, obsolete, excess and slow-moving items are well-designed and operate properly.

This responsibility of the management is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence. The entities usually maintain detailed inventory records in the form of Stores/Inventory ledgers showing in respect of each major item the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents (e.g., goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case. In valuation aspects, compliance with AS 2 should also be ensured.

SA-505

81 *What is meant by external confirmation? Mention four situations where external confirmation may be useful for auditors.*

External Confirmation: As per SA 505 “External Confirmations”, external confirmation is an audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.

The auditor should determine whether the use of external confirmation is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. Following are examples of situations where external confirmations may be useful-

(i) Bank balances and other information from bankers

(ii) Account receivables balances

(iii) Inventory held by third parties

Account payable balances.

82 *Balance confirmations from trade receivables/trade payables can only be obtained for balances standing in their accounts at the year-end.*

(a) Confirmation of Balances: Direct confirmation of balances from trade receivables/trade payables in respect of balances standing in their accounts at the year-end is, perhaps, the best method of ascertaining whether the balances are genuine, accurately stated and undisputed particularly where the internal control system is weak. The confirmation date, method of requesting confirmation, etc. are to be determined by the auditor.

“Guidance Note on Audit of Debtors, Loans and Advances” issued by the ICAI recommends that the trade receivables may be requested to confirm the balance either:

(i) As at the date of the balance sheet; or

(ii) As at any other selected date which is reasonably close to the date of the balance sheet.

The date should be settled by the auditor in consultation with the entity. Where the auditor decides to confirm the trade receivables at a date other than the balance sheet date, he should examine the movements in trade receivable balances which occur between the confirmation date and the balance sheet date and obtain sufficient evidence to satisfy himself that trade receivable balances stated in the balance sheet are not materially mis-stated.

Therefore, it is not necessary that balances of trade receivables/ trade payables should necessarily be verified only at the end of the year only. In fact, in order to incorporate an element of surprise, the auditor may consider different confirmation dates periodically,

i.e., December 31 as a cut-off date in one year and June 30 in another year and so on. Therefore, the statement that balance confirmation from trade receivables/trade payables can only be obtained for balances standing in their accounts at the year-end is not correct.

83 Point out any eight areas where external confirmation used as an audit procedure.

External Confirmation as an Audit Procedure: SA 505, “External Confirmations”, lays down standards for external confirmation of balances. External confirmations are frequently used in relation to account balances and their components but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so, the relevant details thereof. Other areas where external confirmations may be used include the following.

Ø Bank balances and other information from bankers.

Ø Accounts receivable balances.

Ø Inventories held by third parties.

Ø Property title deeds held by third parties.

Ø Investments purchased but delivery not taken.

Ø Loans from lenders.

Ø Accounts payable balances.

Ø Long outstanding share application money.

84 Discuss the recognition principles of contingent liability.

Recognition Principles of Contingent Liability: An enterprise should not recognize the contingent liability but it should be disclosed in financial statement, unless the possibility of an outflow of resource embodying economic benefit is remote. In some cases an enterprise is jointly and severally liable for an obligation in that case, the part of the obligation that is expected to be met by other parties is treated as contingent liability. Contingent liabilities are continuously assessed and if it becomes probable that an outflow of future economic benefit will be required to settle obligation which is previously assessed as contingent liabilities, a provision is recognised.

From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. An enterprise should disclose for each class of contingent liability at the balance sheet date:

(i) A brief description of the nature of the contingent liability, where practicable.

(ii) An estimate of the amount as per measurement principle.

(iii) Indication of the uncertainty relating to outflow.

(iv) The possibility of any reimbursement.

Where any of the information as required above is not disclosed because it is not practicable to do so, that fact should be stated.

85 Reliability of external confirmations.

(a) A Reliability of External Confirmations: As per SA 505 “External Confirmation”, the reliability of external confirmations depends among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures.

SA 500 indicates that even when audit evidence is obtained from sources external to the entity, circumstances may exist that affect its reliability. All responses carry some risk of interception, alteration or fraud. Such risk exists regardless of whether a response is obtained in paper form, or by electronic or other medium.

Factors that may indicate doubts about the reliability of a response include that it-

(i) was received by the auditor indirectly; or

(ii) appeared not to come from the originally intended confirming party.

If the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

SA-510

86 *Auditors of M/s Fortune India (P) Ltd. were changed for the accounting year 2015-16. The closing inventory of the company as on 31.3.2015 amounting to ` 100 lacs continued as it is and became closing inventory as on 31.3.2016. The auditors of the company propose to exclude from their audit programme the audit of closing inventory of ` 100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor.*

(a) Verification of Inventory: As per SA 510 “Initial Audit Engagements – Opening Balances”, in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether-

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

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

When the financial statements for the preceding period were audited by predecessor 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 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.

General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the Balance Sheet date. The contention of the management that the inventory has not undergone any change cannot be accepted, it forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the inventory lying as it is might have deteriorated and the same need to be examined. The auditor is advised not to exclude the audit of closing inventory from his audit programme.

SA-520

87 *Extent of Reliance on Analytical Procedures.*

(a) Extent of Reliance on Analytical Procedures: As per SA 520 “Analytical procedures” means the analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts. The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor’s assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists. The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

(i) materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;

(ii) other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectability of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers’ accounts;

(iii) accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and

(iv) assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The tests of accounting-related controls. For example, an entity in establishing recording of unit sales. In these circumstances, the auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

88 Write a short note on “Analytical review”.

Analytical Review: SA 500 on Audit Evidence defines analytical review as those tests of details which consists of studying significant ratios and trends and investigating unusual fluctuation and items. Thus, analytical reviews are substantive audit procedure with the help of which auditor can perform tests of details in more efficient and effective manner. Therefore, analytical reviews are nothing but analytical review procedures which have been considered at length in SA 520 on “Analytical Procedures”. According to SA 520, analytical procedures include the consideration of comparisons of the entity’s financial information with, for example, comparable information for prior periods or anticipated results of the entity, such as budgets or forecasts. Consideration of relationships among elements of financial information that would be expected to conform to a predictable pattern based on the entity’s experience, such as gross margin percentages, between financial information and relevant non-financial information, such as payroll costs to number of employees also constitute analytical review procedures.

Analytical review procedures are used for the following purposes:

(a) to assist the auditor in planning the nature, timing and extent of other audit procedures;

(b) as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and

(c) as an overall review of the financial statements in the final review stage of the audit.

The extent of reliance that the auditor places on the results of analytical review procedures depends on materiality of the items involved, assessment of inherent and control risks, etc.

89 What do you mean by Analytical procedures? How such procedures are helpful in auditing?

(i) SA 520 'Analytical Procedures': As per SA 520, the term “analytical procedures” means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. The auditor's choice of procedures, methods and level of application is a matter of professional judgement.

Analytical procedures include the consideration of comparisons of the entity's financial information with, for example: comparable information for prior periods; anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation; and similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships, for example: among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages; and between financial information and relevant non-financial information, such as payroll costs to number of employees.

Various methods may be used to perform analytical procedures. These methods range from performing simple comparisons to performing complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Analytical procedures are used for the following purposes:

(a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

90 What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures".

Extent of Reliance on Analytical Procedures (SA-520): The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures-

(a) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(b) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(c) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and

(d) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

The auditor may consider testing the operating effectiveness of controls, if any, over the entity's preparation of information used by the auditor in performing substantive analytical procedures in response to assessed risks. When such controls are effective, the auditor generally has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The operating effectiveness of controls over non-financial information may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, an entity may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices. Alternatively, the auditor may consider whether the information was subjected to audit testing.

91 "The auditor is faced with sampling risk in both tests of control and substantive procedures." Comment on this statement with reference to SA 530 on "Audit Sampling".

Sampling Risk: As per SA 530 "Audit Sampling", audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.

The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions-

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

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a substantive procedure i.e. 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.

SA-530

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

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

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

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

93 *Chap1 Q.21*

94 *"The auditor is faced with sampling risk in both tests of control and substantive procedures." Comment on this statement with reference to SA 530 on "Audit Sampling".*

Sampling Risk: As per SA 530 “Audit Sampling”, audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

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

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a substantive procedure i.e. 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.

95 With reference to Standard on Auditing 530, state the requirements relating to audit sampling, sample design, sample size and selection of items for testing.

Audit Sampling: As per SA 530 on “Audit Sampling”, the meaning of the term Audit Sampling is – the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The requirements relating to sample design, sample size and selection of items for testing are explained below-

Sample design - When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.

Sample Size- The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.

Selection of Items for Testing- The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection.

96 What is the meaning of Sampling? Also discuss the methods of Sampling. Explain in the light of SA 530 “Audit Sampling”.

Meaning of Audit Sampling: “Audit Sampling” means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected.

There are many methods of selecting samples. The principal methods are as follows-

(a) Random Selection: This method is applied through random number generators, for example, random number tables. Stratified Sampling is one of the methods of Random Sampling. This method involves dividing the whole population to be tested in a few groups called strata and taking a sample from each of them. Each stratum is treated as if it were a separate population and if proportionate items are selected from each of the stratum. The groups into which the whole population is divided is determined by the auditor on the basis of his judgement e.g. entire expense vouchers may be divided into:

(i) Vouchers above ₹ 1,00,000

(ii) Vouchers between ₹ 25,000 and ₹ 1,00,000

(iii) Vouchers below ₹ 25,000

The auditor can then decide to check all vouchers above ₹ 1,00,000, 50% between ₹ 25,000 and ₹ 1,00,000 and 25% of those below ₹ 25,000.

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

97 Advantages of Statistical sampling in Auditing.

Advantages of Statistical Sampling in Auditing: The advantages of using statistical sampling technique in auditing are-

- (i) Sample size does not increase in proportion to the increase in the size of population.
- (ii) Sample selection is more objective and based on law of probability.
- (iii) This provides a means of estimating the minimum sample size associated with a specified risk and precision level.
- (iv) It also provides a means for deriving a calculated risk and corresponding precision.
- (v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistake are not large.

98 Write a short note on Random sampling.

Answer

Random Sampling: Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below—

(i) Simple random sampling: Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum. It is considered that random number tables are simple and easy to use and also provide assurance that the bias does not affect the selection. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range. For example the population can be considered homogeneous, if say, trade receivables balances fall within the range of ` 5,000 to ` 25,000 and not in the range between ` 25,000 to ` 2,50,000.

(ii) Stratified Sampling: This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment. For example in the above case, trade receivables balances may be divided into four groups as follows -

(a) balances in excess of ` 1,00,000;

(b) balances in the range of ` 75,000 to ` 1,00,000;

(c) balances in the range of ` 25,000 to ` 75,000; and

(d) balances below ` 25,000.

99 “In cases where audit sample selection has been done on a random basis, no statistical process for selection of samples needs to be followed”. Comment.

Selection of Audit Sample: Audit Sampling means the application of audit procedures to less than 100% of the items within an account balance or class of transactions to enable the auditor to obtain and evaluate audit evidence about some characteristics of the items selected in order to form or assist in forming a conclusion concerning the population.

The audit sample collection on a random basis ensures that all items in the population have an equal chance of selection, for example, by use of random number tables. This method is considered appropriate, provided the population to be sampled consists of reasonably similar units and fall within a reasonable range.

Thus, strictly speaking, in case of selection of an audit sample on the basis of random tables there is no need to follow any other statistical process for selection of sample.

In fact, selection of an audit sample on random basis is the pre-requisite for application of statistical techniques. However, certain methods such as Haphazard Sampling and Block Sampling may result in selection of a sample which is not free from bias.

Therefore, whenever audit sample selection has been done on a random basis i.e. selection of a representative sample, no statistical process for selection of sample needs to be followed.

*Stratified sampling.*

(a) Stratified Sampling: This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgement.

The reason behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

*What precautions should be taken by an auditor while applying test check techniques?*

Answer

Precautions While Applying Test Check Techniques: While adopting test check technique, an auditor should take following precautions-

- (i) The transactions of the concern should be classified under appropriate heads and may be stratified in case of wide variations between the transactions of the same kind.
- (ii) Authorisations, documentations, recording of the transactions should be studied right from the beginning to end.
- (iii) Evaluating the system of internal control for its efficiency, soundness and capability to produce reliable accounting and financial data.
- (iv) Preparation of test check plan with clear audit objective understood by the audit staff.
- (v) Un-biased selection of the transactions with reference to the random number tables or other statistical methods.
- (vi) Identification of the areas where test check may not be done.
- (vii) Based on degree of reliance and the confidence level required in the audit, the number of transactions to be selected for each test plan should be pre-determined.
- (viii) Setting up criteria to judge what constitute material or immaterial errors. Further investigation of only material errors be carried out and all immaterial errors may be avoided.

SA-540

What are accounting estimates according to the Standards on Auditing 540? Give examples.

Accounting Estimates: According to the SA 540, “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosure”, accounting estimate means an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. SA 540 addresses only accounting estimates involving measurement at fair value, the term “fair value accounting estimates” is used.

Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific.

Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Ø Accounting estimates arising in entities that engage in business activities that are not complex.
- Ø Accounting estimates that are frequently made and updated because they relate to routine transactions.

For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Ø Accounting estimates relating to the outcome of litigation.
- Ø Fair value accounting estimates for derivative financial instruments not publicly traded. Additional examples of accounting estimates are:
 - Ø Allowance for doubtful accounts.
 - Ø Inventory obsolescence.
 - Ø Warranty obligations.
 - Ø Depreciation method or asset useful life.
 - Ø Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
 - Ø Outcome of long term contracts.

Ø Financial Obligations / Costs arising from litigation settlements and judgments.

SA-550

Define shortly arm's length transaction.

Arm's length transaction - A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

Identification of significant related party transaction outside business.

(a) Identification of Significant Related Party Transaction Outside Business: As per SA 550 on "Related Parties", for identified significant related party transactions outside the entity's normal course of business, the auditor shall:

(i) 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; and

(ii) Obtain audit evidence that the transactions have been appropriately authorized and approved.

(a) Self-revealing Errors: These are such errors the existence of which becomes apparent in the process of compilation of accounts.

A few illustrations of such errors are given hereunder, showing how they become apparent-

1. Omission to post a part of a journal entry to the ledger. =
Trial balance is thrown out of agreement.

2. Wrong totaling of the Purchase Register.=

Control Account (e.g., the Sundry Creditors Account) balances and the aggregate of the balances in the personal ledger will disagree.

3. A failure to record in the cash book amounts paid into or withdrawn from the bank.=
Bank reconciliation statement will show up error.

4. A mistake in recording amount received from X in the account of Y=
Statements of account of parties will reveal mistake.

From the above, it is clear that certain apparent errors balance almost automatically by double entry accounting procedure and by following established practices that lie within the accounting system but not being generally considered to be a part of it, like bank reconciliation or sending monthly statements of account for confirmation.

SA-560

*Inquiry from Management is helpful for Auditor to evaluate subsequent events. Discuss specific enquiries in reference of SA 560, which might have effect on the financial statements.*

(a) Inquiring from Management to Evaluate Subsequent Event: As per SA 560 “Subsequent Events”, in inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters-

(i) Whether new commitments, borrowings or guarantees have been entered into.

(ii) Whether sales or acquisitions of assets have occurred or are planned.

(iii) Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.

(iv) Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.

(v) Whether there have been any developments regarding contingencies.

(vi) Whether any unusual accounting adjustments have been made or are contemplated.

(vii) Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the

(viii) Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the

(ix) Whether any events have occurred that are relevant to the recoverability of assets.

“The auditors should consider the effect of subsequent events on the financial statement and on auditor’s report” according to SA 560 – Comment.

Effect of Subsequent Events: SA 560 “Subsequent Events”, establishes standards on the auditor’s responsibility regarding subsequent events.

According to it, ‘subsequent events’ refer to those events which occur between the date of 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. It lays down the standard that the auditor should consider the effect of subsequent events on the financial statements and on the auditor’s report.

The auditor should obtain sufficient appropriate evidence that all events upto the date of the auditor’s report requiring adjustment or disclosure have been identified and to identify such events. The auditor should-

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

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

Examples of inquiries of management on specific matters are:

Ø Whether new commitments, borrowings or guarantees have been entered into.

Ø Whether sales or acquisitions of assets have occurred or are planned.

Ø Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.

Ø Whether there have been any developments regarding contingencies.

Ø Whether there have been any developments regarding risk areas and contingencies.

Ø Whether any unusual accounting adjustments have been made or are contemplated.

Ø Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.

Ø Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.

Ø Whether any events have occurred that are relevant to the recoverability of assets.

(iii) Read 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.

(iv) Read the entity's latest subsequent interim financial statements, if any.

(v) Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.

(vi) Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims.

Explain the meaning of the term “subsequent events” as used in the SA 560.

(a) Meaning of Subsequent Events: SA 560 on “Subsequent Events” defines the term “subsequent events” as 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., “subsequent events” also refer to significant events which occurred upto the date of report of the auditor of that component. Thus, subsequent events are those events which occur after the date of the balance sheet till the audit report is signed by the auditor

Indicate briefly the procedures to identify subsequent events requiring adjustment of or disclosure in the financial statements.

(a) Audit Procedures: The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified. The procedure to identify “subsequent events” requiring adjustment or disclosure in financial statements as laid down in SA 560 is as under-

(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 change with governance as to whether any subsequent events have occurred which might affect the financial statements.

Examples of inquiries of management on specific matters are:

- Ø Whether new commitments, borrowings or guarantees have been entered into.
 - Ø Whether sales or acquisitions of assets have occurred or are planned.
 - Ø Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
 - Ø Whether there have been any developments regarding contingencies.
 - Ø Whether there have been any developments regarding risk areas and contingencies.
 - Ø Whether any unusual accounting adjustments have been made or are contemplated.
 - Ø Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
 - Ø Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
 - Ø Whether any events have occurred that are relevant to the recoverability of assets.
- (a) 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.
- (b) Reading the entity's latest subsequent interim financial statements, if any.
- (c) Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.

(d) Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or

(e) Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

When 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. If such events have not been considered by the management and which in the opinion of the auditor are material, the auditor shall modify his report accordingly.

SA-570

Explain with reference to the relevant Standard on Auditing - Appropriateness of going concern assumption.

Appropriateness of Going Concern Assumption: As per SA 570 "Going Concern", in some enterprises, for example, those where the funding arrangements are guaranteed by the Central Government, going concern risks may arise, but are not limited to, situations where such type of entities operate on a for-profit basis, where government support may be reduced or withdrawn, or in the case of privatisation. Events or conditions that may cast significant doubt on an entity's ability to continue as a going concern may include situations where such type of entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by such an entity. However, the auditor should consider the risk that the going concern assumption may no longer be appropriate. The following are examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.

- Indications of withdrawal of financial support by trade payables.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay trade payables on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

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

Other

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

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

The risk assessment procedures help the auditor to determine whether management's use of the going concern assumption is likely to be an important issue and its impact on planning the audit. These procedures also allow for more timely discussions with management, including a discussion of management's plans and resolution of any identified going concern issues.

(a) Procedures to be performed by the auditor in expressing opinion on 'going concern' assumption.

(a) Procedures to be performed by the Auditor in Expressing Opinion on 'Going Concern' Assumption: As per SA 570, "Going Concern", the following are the relevant procedures that are relevant in this connection-

- (i) Analyse and discuss cash flow, profit and other relevant forecasts with management.
- (ii) Analyse and discuss the entity's latest available interim financial statements.
- (iii) Read the terms of debentures and loan agreements and determine whether any have been breached.

- (iv) Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.
- (v) Inquire the entity's legal counsel regarding the existence of litigation and claims; and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- (vi) Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.
- (vii) Evaluate the entity's plan to deal with unfilled customer orders.
- (viii) Perform audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
- (ix) Confirm the existence, terms and adequacy of borrowing facilities.
- (x) Obtain and review reports of regulatory actions.
- (xi) Determine the adequacy of support for any planned disposals of assets.

*"Operating Conditions" that may cast doubt about going concern assumption.*

(a) Operating Conditions Casting Doubt About Going Concern Assumption: The following are examples of operating events or conditions that, may cast significant doubt about the going concern assumption-

- (i) Management intentions to liquidate the entity or to cease operations.
- (ii) Loss of key management without replacement.
- (iii) Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- (iv) Labour difficulties.

(v) Shortages of important supplies.

(vi) Emergence of a highly successful competitor.

*TT Ltd. has suffered recurring losses due to steep fall in production and has negative net worth. Its production head, an expert, has also left the company. Reply of the management is inadequate to these developments and there is no sound action plan to mitigate these situations. Comment.*

Appropriateness of Going Concern Assumption: As per SA 570 on “going concern”, when planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption. The auditor should evaluate the risk that the going concern assumption may no longer be appropriate. If in the auditor’s judgement, the going concern is not satisfactory resolved, he should consider various appropriate options.

To judge and evaluate the continuance as a going concern, he should evaluate and gather indications from financial, operating and other resources.

In the instant case, TT ltd. has suffered continuous losses and having negative net worth also. Besides, its production head have also left the company resulting in steep fall in production. 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.

SA-580

What do you mean by "Written Representations"? As an auditor, how you will deal if management does not provide requested written representations?

(a) Written Representations: As per SA 580, "Written Representation" is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. These representations are an important source of audit evidence. 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. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

Requested Written Representations not provided by Management: If management does not provide one or more of the requested written representations, the auditor shall-

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

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

Auditor of AAS Ltd. was unable to confirm the existence and valuation of imported goods lying with the transporter and accepted a certificate from the management without obtaining other audit evidence.

(a) Accepting Management Certificate without obtaining other Audit Evidence: As per SA 580 on “Written Representations” in the course of audit, an auditor comes across various matters in respect of which he is not able to obtain sufficient appropriate audit evidence. In such a situation he may rely on the submission by the management but he should seek corroborative audit evidence from sources inside or outside the entity and evaluate the representation made by management

Management representation is not a substitute for other audit evidence. The auditor should seek and apply normal audit procedure. Mere possession of a certificate does not absolve the auditor from his liability. He should not seek or accept certificates when subject matter is such that it is capable of verification from internal and/or external evidences.

In the instant case, the inventory of imported material lying with the transporter can be easily verified with purchase order, invoice, bill of entry, custom document, payment of F.C. etc.

Therefore, the auditor in this instant case has not used available evidences. He should not have rested with the certificate obtained from the management and could have evaluated other evidences. He may be held liable for negligence and professional misjudgment.

*Briefly explain Management Representation.*

Management Representation: SA 580 “Written Representations” deals with the auditor’s responsibility to obtain written representations from management and, where appropriate, those charged with governance. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. 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. In certain instances such as where knowledge of facts is confined to management or where matter is principally of intention, a representation by management may be the only audit evidence which can reasonably be expected to be available for example, intention of management to hold a specific investment for long term. However, it cannot be a substitute for other audit evidences expected to be available.

*The management of Ankita Limited suggested for quick completion of the statutory audit that it would give its representation about the receivables in terms of their recoverability. The management also acknowledged to the auditors that the management would give their representation after scrutinizing all accounts diligently and they own responsibility for any errors in these respects. It wanted auditors to complete the audit checking all other important areas except receivables. The auditor certified the account clearly indicating in his report the fact of reliance he placed on representation of the management. Comment.*

Management Representation: According to SA 580 “Written Representations”, the management representation cannot substitute other audit evidence that the auditor could reasonably expect to be available to the auditor.

The audit evidences available for checking receivables- say, invoices, debt acknowledgement documents, receipts, statement of accounts, confirmations etc., are available evidences which auditor is duty bound to verify.

In the given case, the management of Ankita Limited wants the auditor to carry out audit on all areas except on area of receivables. The management of the company also committed to give representation and further owned responsibility for any errors in these respects.

However, just because management had owned responsibility for the correctness of its evaluation of receivables, the auditor cannot shirk his responsibility. This is negligence on his part if he relies on the management representation without assessing the corroborative available evidences. There cannot be any restriction on scope of audit in case of statutory audit.

*State with reasons (in short) whether the following statement is correct or incorrect:*

Written representation by management as to the quality of inventory is substitute for verification.

Incorrect: 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 its quality for example, obsolete, damaged or ageing inventory. Written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available

Alternative Reason for incorrect answer may be given as: One of the objectives of the written representation is to support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representation. So it is clear that written representations cannot be a substitute for other evidence that the auditor could expect to be reasonably available

SA-600

(a) You are a Principal Auditor of Sri Company Limited which has three branches the accounts of which are subject to audit by qualified branch auditors. One of the branch auditors qualified his report for non-provision of doubtful debts which he considered to be material for the company as a whole. Subsequent to their reporting, but before you could sign the audit report on the accounts of the company as a whole, the management informed you that the debt under the subject-matter of qualification in Branch Auditor's report had been fully recovered.

(a) Qualification in Branch Auditor's Report-Subsequent Events: The Branch auditor had qualified on non-provision of a major debt. After his report but before the issue of report by Principal auditor an event happened which has thrown new light on the facts that existed as on the date of balance sheet date. This is a subsequent event within the meaning of SA 560 "Subsequent Events" i.e. event that had taken place between the date of balance sheet date and the date of signing the audit report. In relation to the cases where the component (i.e. branch) is audited by another auditor, the subsequent event would include events that had taken place between the date of audit report of the component and the date of signing the audit report of the entity as a whole by the principal auditor. On becoming aware of the subsequent events, the auditor should consider whether the accounts had been drawn so as to give effect to the facts of subsequent events. Accordingly, the auditor should omit qualification as the debt is no more doubtful in view of its recovery in full. However, the auditor may check that it has in fact been received by a substantial vouching of the subsequent events which had been considered by him to make himself fully satisfied about his report in the matter.

SA-610

Can the External Auditor rely upon the work of an Internal Auditor?

Answer

Reliance on the Work of Internal Auditor: The external auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor. As per SA 610 “Usingthe Work of Internal Auditors”, factors that may affect the external auditor’s determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include-

Objectivity:

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

Technical competence:

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

- Whether there are established policies for hiring and training internal auditors.

Write a short note on - Statutory Auditor versus Internal Auditor.

Statutory Auditor versus Internal Auditor:

Explain in brief the Relationship between Statutory Auditor and Internal Auditor.

Relationship Between Statutory Auditor and Internal Auditor: The function of an internal auditor is an integral part of the system of internal control. It is statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. However, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor.

Though the roles and primary objectives of internal and statutory audit differs, some of their means of achieving their respective objectives are similar. Thus, much of the work of the internal auditor may be useful to the statutory auditor in determining the nature, timing and extent of his audit procedures. Depending upon such evaluation, the statutory auditor may be able to adopt less extensive procedures.

If the statutory auditor is satisfied on an examination of the work of the internal auditor, that the internal audit has been efficient and effective, he may accept the checking/evaluation carried out by the internal auditor in the area of internal control, verification of assets and liabilities etc.

It must however be mentioned that the area of co-operation between the statutory and internal auditor is limited by the fact that both owe their allegiance to separate authorities, the shareholders in the case of statutory auditor and the management in the case of internal auditor.

Write a short note on - Independence of Internal Auditor.

Independence of Internal Auditor: As per section 138 of the Companies Act, 2013, the internal auditor, who shall either be a chartered accountant whether engaged in practice or not or a cost accountant, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies auditor may or may not be an employee of the company. Further, the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. It may also be noted that the Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

So, the concept of independence is equally relevant for internal auditor also. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. As mentioned above, the internal auditor may be part of the management, but he evaluates the functioning of the management at different levels.

Therefore, to be efficient and effective, the internal auditor must have adequate independence. It may be noted that by its very nature, the internal audit function cannot be expected to have the same degree of independence as is essential when the external auditor expresses his opinion on the financial information. To ensure his independence he is made responsible directly to the Board of Directors through audit committee. Such a channel of communication provides an independent mode whereby an internal auditor can communicate and share his views on the scope of internal audit, findings, etc. If internal auditor is made subordinate to lower level, his independence will be effected which will affect his functioning and effectiveness. An outsider, like a firm of chartered accountants, if acting as internal auditor, is likely to be more independent than an employee of the organization.

SA-700

*State the basic elements of the Auditor's Report.*

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

(i) Title;

(ii) Addressee;

- (iii) Introductory Paragraph;
- (vi) Management's Responsibility for the Financial Statements;
- (v) Auditor's Responsibility;
- (vi) Auditor's Opinion;
- (vii) Other Reporting Responsibilities;
- (viii) Signature of the Auditor;
- (ix) Date of Auditor's Report;
- (x) Place of signature.

Discuss the concept of "True and Fair".

Concept of "True and Fair": The concept of "true and fair" is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit.

This requires that the auditor should examine the accounts with a view to verifying that all assets and liabilities, incomes and expenses are stated at the amounts which are in accordance with accounting principles and policies, and no material item has been omitted.

The importance of the concept of true and fair view can also be understood and appreciated from the facts that sections 128, 129 and 143 of the Companies Act, 2013 also discusses this concept in relation to account books, financial statements and reporting on financial statements respectively.

Section 128(1) of the said Act provides that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any. The company shall be in a position to explain the transactions effected both at the registered office and its branches. Such books of Accounts shall be kept on accrual basis and according to the double entry system of accounting.

Section 129(1) of the Companies Act, 2013 provides that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 of the Companies Act, 2013, (in which the Central Government may prescribe the standards of accounting or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority) and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III to the said Act.

The term “financial statement” shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes under the said Act.

It may be noted that nothing contained in sub-section (1) shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company.

However, the financial statements shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose-

(a) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;

(b) in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;

(c) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;

(d) in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

It may be noted that where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation.

Further, according to section 143(2) of the said Act, the auditor is required to make a report to the members of the company indicating that, to the best of his information and knowledge, the financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

SA 700 "Forming an Opinion and Reporting on Financial Statements", requires the auditor to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and express clearly that opinion through a written report that also describes the basis for the opinion. The auditor is required to express his opinion on the financial statements that it gives a true and fair view in conformity with the accounting principles generally accepted in India (a) in the case of the Balance Sheet, of the state of affairs of the Company as at March 31, 20XX; (b) in the case of the Statement of Profit and Loss, of the profit/ loss for the year ended on that date; and (c) in the case of the Cash Flow Statement, of the cash flows for the year ended on that date.

State the matters which the statutory Auditor should look into before framing an opinion on accounts on finalisation of audit of accounts. Discuss overall audit approach.

Formation of Opinion on Accounts: The principal aspect to be covered in an audit to form an opinion, an auditor has to look into following matters-

(i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by such tests and enquiries as are considered necessary to ascertain whether the system is in actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.

- (ii) Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.
- (iii) Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.
- (iv) Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.
- (v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.
- (vi) Comparison of the Balance Sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.
- (vii) Verification of the title, existence and value of the assets appearing in the Balance Sheet.
- (viii) Verification of the liabilities stated in the Balance Sheet.
- (ix) Checking the result shown by the profit and loss and to see whether the results shown are true and fair.
- (x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.
- (xi) Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

It will thus be realised that the duties of auditor are not limited to the verification of the arithmetical accuracy of the books of account kept by his client; he must also satisfy himself that entries in the books are true and contain a complete record of all the transactions of the business and these are recorded in such a manner that their real nature is revealed. On that account, he must examine all vouchers, invoices, minutes of directors or partners correspondence and other documentary evidence that is available to establish the nature and authenticity of the transactions. Besides, he must verify that there exists a proper authority in respect of each transaction; that each transaction is correctly recorded, etc. Finally, he must verify that the form in which the final accounts are drawn up is the one prescribed by law or is the one that ordinarily would present a true and fair picture of state of affairs of the business.

*How would you as an auditor distinguish between Reports and Certificates?*

Distinction Between Audit Reports and Certificates: The term 'certificate', is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. When an auditor certifies a financial statement, it implies that the contents of that statement can be measured and that the auditor has vouchsafed the exactness of the data. The term certificate is, therefore, used where the auditor verifies certain exact facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain precise figures and is in a position to vouch safe their accuracy as per the examination of documents and books of account.

An auditor's report, on the other hand, is an expression of opinion. When we say that an auditor is reporting, we imply that he is expressing an opinion on the financial statements.

The term report implies that the auditor has examined relevant records in accordance with generally accepted auditing standards and that he is expressing an opinion whether or not the financial statements represent a true and fair view of the state of affairs and of the working results of an enterprise. Since an auditor cannot guarantee that the figures in the Balance Sheet and Statement of Profit and Loss are absolutely precise, he cannot certify them. This is primarily because the accounts itself are product of observance of several accounting policies, the selection of which may vary from one professional to another and, thus, he can only have an overall view of the accounts through normal audit procedures. Therefore, the term certificate cannot be used in connection with these, statements.

Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.

Process of Judgement formation by Auditor.

(a) Process of Judgement Formation by Auditor: After the audit, the opinion that the auditor expresses is the result of exercise of judgement on facts, evidence and circumstances which he comes across in the course of audit. The judgement is formed on the following basis-

- (i) Identification of the assertions to be examined.
- (ii) Evaluation of the assertion as to relative importance.
- (iii) Collection of the information or evidence about the assertions to enable him to give an informed opinion.
- (iv) Evaluation of evidence as valid or invalid, pertinent or not pertinent, sufficient or insufficient.
- (v) Formulation of judgement as to the fairness of the assertions under consideration.

When does an auditor issue unqualified opinion and what does it indicate?

Unqualified Opinion: The auditor should express an unqualified opinion when he concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for preparation and presentation of the financial statements.

An unqualified opinion indicates that:

- (i) The financial statements have been prepared using the generally accepted accounting principles and being constantly followed.
- (ii) The financial statements comply with relevant statutory requirements and regulations.

(iii) All material matters relevant to proper presentation of the financial information, subject to statutory requirement, if applicable, have been adequately disclosed.

SA-705

State the circumstances which could lead to any of the following in an Auditor's Report:

(a) A modification of opinion

(b) Disclaimer of opinion

(c) Adverse opinion

(d) Qualified opinion.

(a) Modification of Opinion: The auditor shall modify the opinion in the auditor's report when-

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

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

(b) 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.

(c) Adverse Opinion: The auditor shall express an 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.

(d) Qualified Opinion: The auditor shall express a qualified opinion when-

(i) 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

(ii) 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.

Disclaimer of Opinion.

(a) Disclaimer of Opinion: As per SA 500 “Audit Evidence”, the auditor must collect sufficient and appropriate audit evidence, on the basis of which he draws his conclusion to form an opinion, on the financial statements. But, if the auditor fails to obtain sufficient information to form an overall opinion on the matter contained in the financial statements, he issues a disclaimer of opinion.

The reasons due to which the auditor is not able to collect the audit evidence are:

(i) Scope of audit is restricted;

(ii) The auditor may not have access to the books of accounts, e.g.-

(1) Books of A/c's of the company seized by IT authorities.

(2) Sometimes, inventory verifications at locations outside the city bound the scope of duties of the auditor.

In such a case, the auditor must state in his audit report that-

“He is unable to express an opinion because he has not been able to obtain sufficient and appropriate audit evidence to form an opinion”.

*What are Modified Reports? Discuss disclosure pattern when the auditor includes an Emphasis of Matter paragraph in the Auditor's Report.*

Modified Reports: As per SA 705 “Modifications to the Opinion in the Independent Auditor’s Report”, an auditor’s report is considered to be modified

when it includes-

(a) Matters That Do Not Affect the Auditor’s Opinion

- ü emphasis of matter

- ü Other Matter

(b) Matters That Do Affect the Auditor’s Opinion

- ü qualified opinion

- ü disclaimer of opinion

- ü adverse opinion

Therefore, Modified Reports can be of two types (a) Matters that do not affect auditor’s opinion

(b) Matters that do affect auditor’s opinion.

The auditor shall modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Further, as per SA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", the inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion. When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (i) Include it immediately after the Opinion paragraph in the auditor's report;
- (ii) Use the heading "Emphasis of Matter", or other appropriate heading;
- (iii) Include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements; and
- (iv) Indicate that the auditor's opinion is not modified in respect of the matter emphasised.

Examples:

- v An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- v Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.
- v A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

The auditor shall not modify the opinion in the auditor's report.

Incorrect: The auditor shall modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

The auditor's report is considered to be modified under certain circumstances. Discuss.

Modified Report: An auditor's report is considered to be modified when it includes -

(A) Matters That Do Not Affect the Auditor's Opinion

(i) Emphasis of Matter paragraph: Sometimes 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.

(ii) Other Matter paragraph: If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report and this is not prohibited by law or regulation, the auditor shall do so in a paragraph in the auditor's report, with the heading "Other Matter", or other appropriate heading.

(B) Matters that Do Affect the Auditor's Opinion

(i) Qualified Opinion: 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.

(ii) *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.*

(iii) *Adverse Opinion: The auditor shall express an 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.*

The auditor shall modify the opinion in the auditor's report when:

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

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

SA-710

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

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

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

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

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.

Disclosure of Bank Balance

*Mention disclosure requirements of the following in the financial statements (in case of a company):*

Bank Balances.

(a) Disclosure Requirements for Bank Balance: As per Part I of Schedule III to the Companies Act, 2013, the disclosure of bank balances is under the head "Cash and Cash Equivalents" in Current Assets as:

- (i) Balances with Banks.
- (ii) Earmarked balances with banks (for example, for unpaid dividend).
- (iii) Balances with banks to the extent held as margin money or security against borrowings, guarantees, other commitments.