CA INTER

PAPER 5 – AUDITING AND ETHICS

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PREFACE

I have always been passionate about teaching and sharing my knowledge with others. I always believe that teaching is an opportunity to learn more. This course book is my attempt to equip you with all the information needed to score good marks in Auditing exam.

This book is designed to provide you with a comprehensive understanding of the subject matter. It is structured to take you through a step-by-step process, starting with the basics and gradually building up to advanced concepts. It is presented in a clear and concise language to facilitate learning and comprehension.

In this course book, you will find detailed explanation to the concepts, practical and scenario-based questions that will help you to handle the complexity of the recent exams. You will also find key terms in each of the concepts are highlighted, in order to grab your attention to those terms, as presenting the key terminology will fetch you good marks.

This course book is not just a resource for your immediate needs, but also serves as a reference for your future practical audit assignments. A lot of effort has been put to bring this book before you, and it is my hope that you will find this book useful it will help you to achieve your academic and professional goals.

So, let's begin this journey of learning together. Thank you for choosing this course book, and I wish you all the best in your academic and professional pursuits.

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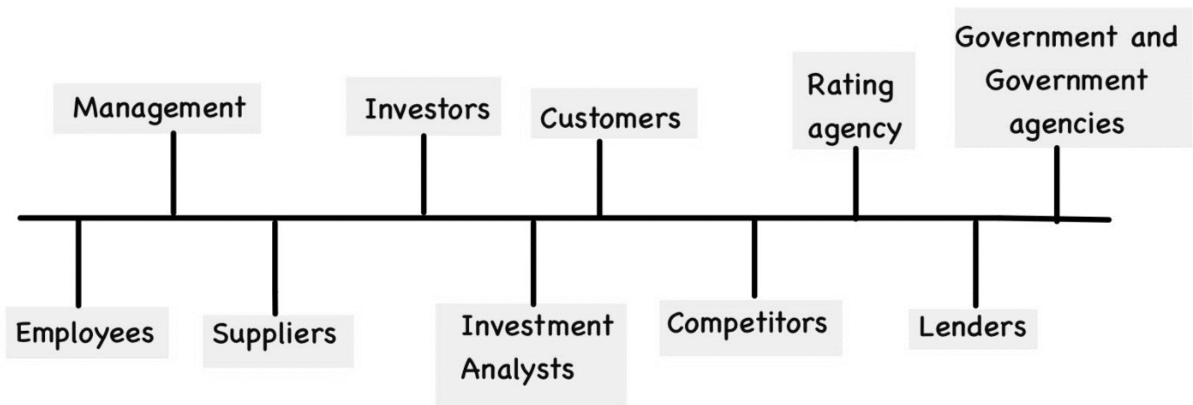
1. INTRODUCTION TO AUDITING

1. **AUDITING:** An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such examination is conducted with a view to expressing an opinion thereon.

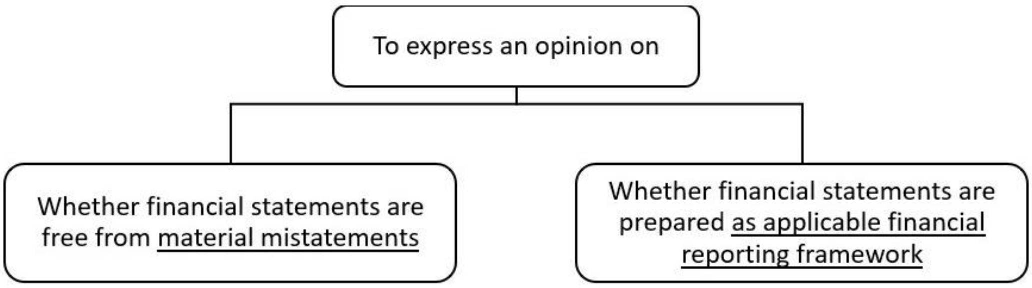
2. **FINANCIAL STATEMENTS:** As per the Companies Act 2013, financial statements in relation to a company, includes
   a. a balance sheet as at the end of the financial year;
   b. a profit and loss account
   c. cash flow statement for the financial year;
   d. a statement of changes in equity, if applicable; and
   e. any explanatory note annexed to, or forming part of the above

3. **BOOKS OF ACCOUNTS:** As per Section 2(13), Books of Accounts includes records maintained in respect of—
   a. all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;
   b. all sales and purchases of goods and services by the company;
   c. the assets and liabilities of the company; and
   d. the items of cost as may be prescribed under section 148 in the case of a company which belongs to any class of companies specified under that section.

4. **USERS OF FINANCIAL STATEMENTS:** The following are various users of financial statements:



5. **OBJECTIVES OF AUDIT/AUDITOR:**



6. **APPLICABLE FINANCIAL REPORTING FRAMEWORK:** Financial Reporting framework means set of rules and regulations that are required to be followed in the process of preparation and presentation of financial statements.
E.g.: Sch III and AS

In view of nature of entity and purpose of financial statements, the management of the entity will adopt applicable financial reporting framework.

7. **TYPES OF FRAMEWORKS ON THE BASIS OF PURPOSE:** On the basis of purpose financial statements are divided into:
- **General Purpose Financial Statements –** The financial statements which are prepared as per General Purpose Framework (GPFW).
- **Special Purpose Financial Statements –** The financial statements which are prepared as per Special Purpose Framework (SPFW).

a. **GENERAL PURPOSE FRAMEWORK:** The framework which fulfil the financial information needs of various users of financial statements is called as General-Purpose Framework.
E.g.: Sch III and AS

Characteristics of GRFW: General purpose framework will have the following characteristics:
- Follow Fundamental Accounting Assumptions
- Follow GAAP
- Comply with Accounting standards
- Prepared periodically

b. **SPECIAL PURPOSE FRAMEWORK:** The framework which fulfil the financial information needs of specific users of financial statements is called as Special-Purpose Framework.
E.g.: Financial statements prepared on cash basis

8. TYPES OF FRAMEWORKS ON THE BASIS OF PRESENTATION: On the basis of presentation financial statements are divided into:

a. COMPLIANCE FRAMEWORK:

i. The framework in which the financial statements are prepared as per the requirements of such framework, without any deviation.

ii. True and fair view may not be guaranteed.

iii. Most of the special purpose financial statements are prepared as per Compliance framework.

b. FAIR PRESENTATION FRAMEWORK

i. The framework in which the financial statements are prepared as per the requirements of such framework, and

- May provide additional disclosures beyond the requirements of the framework or
- May deviate from the requirements of the framework,

so as to achieve fair presentation.

ii. There will always be a true and fair view in this framework.

iii. Most of the general-purpose financial statements are prepared as per Fair presentation framework.

9. MISTATEMENT: The difference between amount, classification, presentation and disclosure in the reported financial statements and amount, classification, presentation and disclosure required as per applicable financial reporting framework.

In simple terms misstatement means, a mistake in the financial statements.

A misstatement can result from either fraud or error. Fraud is intentional, whereas, error is unintentional.

10. MATERIAL: Material means significant or important. A misstatement will be considered as material if it influences the decision of users of financial statements.

11. LEGAL FORM: There are several types of legal forms in which people ordinarily conduct businesses. This is similar to "Person" Definition under Income Tax. The following are the various types of legal forms:

a. Proprietorship firm
b. Partnership firm
c. Limited Liability Partnership
d. Society and
e. Company
f. AOP or BOI
g. Any other artificial Judicial Person

12. AUDITOR: The person or entity, who is conducting the audit will be called as auditor. Generally, auditor refers to the entire engagement team. However, when it comes to acceptance of responsibility and accountability before regulatory authorities, auditor refers to only engagement partner.

13. ENGAGEMENT TEAM: The engagement team includes the following:

a. Engagement partner
b. Audit manager
c. Paid Assistant
d. Senior article assistant
e. Junior article assistant
f. Any other designation.

14. ENGAGEMENT: Engagement means an arrangement to do something. In the context of auditing, it means a formal agreement between auditor and client under which auditor agrees to provide auditing services. It takes the shape of engagement letter.

2.NATURE, OBJECTIVE & SCOPE OF AUDIT AND ETHICS

Q.NO.1 DEFINE THE TERM AUDIT. ALSO, EXPLAIN THE POINTS WHICH THE AUDITOR SHOULD CONSIDER BEFORE EXPRESSING AN OPINION?

ANSWER:

A. **DEFINITION:** An audit is independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such examination is conducted with a view to expressing an opinion thereon.

B. **PURPOSE:** The purpose of audit is to enhance the confidence of users of financial statements, as they are verified for accuracy and authenticity by an independent qualified person.

C. **POINTS TO BE CONSIDERED BY AN AUDITOR:** The person conducting this task should take care to ensure that financial statements would not mislead anybody. This he can do honestly by satisfying himself that:
   1. The accounts have been drawn up with reference to entries in the books of account;
   2. The entries in the books of account are adequately supported by sufficient and appropriate evidence;
   3. None of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements (fictitious entries);
   4. The information conveyed by the statements is clear and unambiguous;
   5. The financial statement amounts are properly classified, described, and disclosed in conformity with accounting standards; and
   6. The statement of accounts presents a true and fair picture of the operational results and of the assets and liabilities.

D. **AUDITORS OPINION NOT A GUARANTEE:** The auditor shall not be taken as a guarantee as to:
   1. Future viability of an entity and
   2. Efficiency or effectiveness with which management has conducted the affairs of the enterprise.

TEST YOUR KNOWLEDGE:

1. **Mr. John has been appointed as an auditor of the company X Ltd. Mr. John is aware of that Audit is independent examination of financial information and ultimate objective of the auditor is to express an opinion on the FS. Explain how a person conducting the audit should take care to ensure that financial statements would not mislead anybody.**

Answer: Refer above answer

2. **An audit is 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. What the auditor is supposed to do to satisfy himself that nothing contained in the statements will mislead anybody?**

Answer: Refer above answer

Q.NO.2 WHAT ARE OBJECTIVES OF AUDITOR AS PER SA 200?

ANSWER:

As per **SA-200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing",** in conducting an audit of financial statements, the overall objectives of the auditor are:

1. To obtain reasonable assurance about
   a. whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and
   b. express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
2. To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

TEST YOUR KNOWLEDGE:

1. **CA N is the auditor of SR Ltd. The auditor expressed his opinion on the financial statements without ascertaining as to whether the financial statements were free from material misstatements or not. In your opinion, whether CA N has complied with objectives of audit considering the applicability of relevant SA? (MAY22-3M)**

Answer: Write above answer and write the below conclusion.

In the given case, the auditor failed to comply with the objectives of SA 200.

Q.NO.3 WRITE A SHORT NOTE ON SCOPE OF AUDIT / WHAT ARE THE POINTS TO BE KEPT IN MIND WHILE DECIDING THE SCOPE OF AUDIT?

ANSWER:

1. **COVER ALL ASPECTS:** The audit should be organized to cover adequately all aspects of the enterprise relevant to the financial statements being audited.

2. **RELIABILITY OF FINANCIAL INFORMATION:** The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by:
   a. Making a study of accounting systems and internal controls and
   b. Carrying out such other tests, enquiries and other verification procedures.

3. **PROPER DISCLOSURES IN FINANCIAL STATEMENTS:** The auditor determines whether the relevant information is properly disclosed in the financial statements by:
   a. Comparing the financial statements with the underlying accounting records and other source data.
   b. Considering the judgments that management has made in preparing the financial statements
   c. The auditor evaluates selection and consistent application of accounting policies by management; whether such a selection is proper and whether chosen policy has been applied consistently on a period-to-period basis.

4. **DUTIES OUT OF SCOPE:**
   a. The auditor is not expected to perform duties which fall outside the scope of his competence. **For example,** the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.
   b. An auditor is not an expert in authentication of documents. The genuineness of documents cannot be authenticated by him because he is not an expert in this field.

5. **CONSTRAINTS ON SCOPE:** If there is any constraints or restrictions on scope of the auditor, then the auditor can mention the same in the auditor's report.

Q.NO.4 WHAT ARE THE PRINCIPAL ASPECTS TO BE COVERED IN AUDIT?

ANSWER:

The principal aspects to be covered in an audit of the financial statements are the following:

1. **ACCOUNTING AND INTERNAL CONTROLS:**
   a. 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.
   b. Reviewing the system and procedures to find out whether they are adequate and comprehensive and whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.
2. Checking of the **arithmetical accuracy** of the books of account by the verification of postings, balances, etc
3. Verification of the **authenticity and validity** of transactions entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.
4. Ascertaining that a **proper distinction** has been made between items of capital and of revenue nature.
5. Amounts of various items of income and expenditure adjusted in the accounts **corresponding to the accounting period**.
6. **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.
7. **Verification of items of financial statements:**

a. Verification of the title, existence and value of the assets appearing in the balance sheet.
b. Verification of the liabilities stated in the balance sheet.
c. Checking the result shown by the profit and loss and to see whether the results shown are true and fair.

8. **STATUTORY COMPLAINCES:** Where audit is of a corporate body, confirming that the statutory requirements have been complied with.
9. **REPORTING:** 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.

TEST YOUR KNOWLEDGE:

1. **SWM is proprietorship firm engaged in the manufacturing of different kind of yarns. It sells its finished products both in the domestic as well as in the international market. The company is making total turnover of Rs. 30 crores. It has also availed cash credit limit of Rs.3 crores from Dena Bank. In the year 2018-19. Proprietor of the firm is worried about the financial position of the company and is under the impression that since he is out of India, therefore firm might not run well. He approaches an Internal Auditor about as to what would be covered in Audit. Advice regarding principal aspects (any four) to be covered in getting accounts audited.**

Answer: Refer above answer

Q.NO.5 EXPLAIN THE VARIOUS TYPES OF AUDITS ON THE BASIS OF REQUIREMENTS OF LAW?

ANSWER:

Audit is not legally obligatory for all types of business organisations or institutions. On this basis audits may be of two broad categories i.e., audits required under law and voluntary audits.

A. STATUTORY AUDIT:

1. The audits which are mandatorily required under law are known as Statutory Audits.
   Example: Company audit required under Companies Act, 2013, Bank Audit required under Banking Regulation Act, Tax audit required under income tax act.
2. In the case of Statutory audit, the scope and objectives of the audit will be decided under respective and also terms of engagement.
3. The statutory audit should always be independent (Mind and Appearance).

B. NON - STATUTORY AUDIT

1. The audits which are done voluntary, even though there is no requirement of the law, are known as Non-statutory audits or Voluntary audits.
2. In the case of Non - Statutory audit, the scope and objectives of the audit will be decided by appointing authority through terms of engagement.
3. Here, the auditor should be independent of mind (Independence of Appearance may not be required).

Q.NO.6 WHAT ARE THE ADVANTAGES/BENIFITS OF AUDIT OF FINANCIAL STATEMENTS?

ANSWER:

The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit, which are as follows:

1. Audited accounts provide high quality information. It gives confidence to users that information on which they are relying is qualitative and it is the outcome of an exercise carried out by following Auditing Standards recognized globally.
2. In case of companies, shareholders may or may not be involved in daily affairs of the company. The financial statements are prepared by management consisting of directors. As shareholders are owners of the company, they need an independent mechanism so that financial information is qualitative and reliable. Hence, their interest is safeguarded by an audit.
3. An audit acts as a moral check on employees from committing frauds for the fear of being discovered by audit. Audited financial statements are helpful to government authorities for determining tax liabilities.
4. Audited financial statements can be relied upon by lenders, bankers for making their credit decisions i.e. whether to lend or not to lend to a particular entity.
5. An audit may also detect fraud or error or both.
6. An audit reviews existence and operations of various controls operating in any entity. Hence, it is useful at pointing out deficiencies.

TEST YOUR KNOWLEDGE:

1. **The auditor of Very Different Limited explained to the audit team members as to how the audited financial statements will help in protecting the financial interests of shareholders of the company. Explain the advantages of audit of financial statements.**

Answer: Refer above answer

2. **The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organizations where audit is not compulsory. Explain. (A)**

Answer: Refer above answer

Q.NO.7 WHAT ARE INHERENT LIMITATIONS OF AUDIT?

ANSWER:

A. **MEANING:** The process of auditing is suffering from some limitations which are unavoidable in nature, known as inherent limitation.

B. **IMPACT:** Because of inherent limitations:
   1. The auditor can only obtain Reasonable assurance, but not absolute assurance.
   2. The auditor can only express opinion, but not guarantee.
   3. There is a possibility of auditor's opinion going wrong.
   4. The audit risk cannot be eliminated or reduced to zero. It can only be reduced to acceptably low level, by proper conduct of audit.

   Note: Reasonable assurance is a high level of assurance, but not absolute assurance.

C. **INHERENT LIMITATIONS:** The inherent limitations of an audit arise from:
   1. **Nature of financial reporting:**
      a. Preparation of financial statements involves making many judgments by management. These judgments may involve subjective decisions or a degree of uncertainty.
      b. Therefore, auditor may not be able to obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.
      c. One of the premises for conducting an audit is that management acknowledges its responsibility of preparation of financial statements in accordance with applicable financial reporting framework and for devising suitable internal controls.
      d. However, such controls may not have operated to produce reliable financial information due to their own limitations.

   2. **Nature of Audit procedures:**
      a. The auditor carries out his work by obtaining audit evidence through performance of audit procedures. However, there are practical and legal limitations on ability of auditor to obtain audit evidence. For example,
         i. **Sampling:** An auditor does not test all transactions and balances. He forms his opinion only by testing samples. It is an example of practical limitation on auditor's ability to obtain audit evidence.
         ii. **Management may not provide complete information:** Management may not provide complete information as requested by auditor. There is no way by which auditor can force management to provide complete information as may be requested by auditor. In case he is not provided with required information, he can only report. It is an example of legal limitation on auditor's ability to obtain audit evidence.
         iii. **Sophisticated Frauds:** The management may consist of dishonest and unscrupulous people and may be, itself, involved in fraud. It may be engaged in concealing fraud by designing sophisticated and carefully organized schemes which may be hard to detect by the auditor. It may produce fabricated documents before auditor to lead him to believe that audit evidence is valid. However, in reality, such documents could be fake or non-genuine.
         iv. **Related party transactions**: It is quite possible that entity may have entered into some transactions with related parties. Such transactions may be only paper transactions

and may not have actually occurred. The auditor may not be aware of such related party relationships or audit procedures may not be able to detect probable wrong doings in such transactions.

3. **Not in nature of investigation:** Audit is not an official investigation. Hence, auditor cannot obtain absolute assurance that financial statements are free from material misstatements due to frauds or errors.

4. **Timeliness of financial reporting and decrease in relevance of information over time:**
   a. The relevance of information decreases over time and auditor cannot verify each and every matter.
   b. Therefore, a balance has to be struck between reliability of information and cost of obtaining it.
   c. ***Example:*** *an auditor who is conducting audit of a company since last two years. During these two years, he has sought detailed information from management of company regarding various matters. During his thirdyear stint, he chooses to rely upon some information obtained as part of audit procedures of second year. However, it could be possible that something new has happened and that information is not relevant. So, the information being relied upon by auditor is not timely and may have lost its reliability.*

5. **Future events:**
   a. Future events or conditions may affect an entity adversely.
   b. Adverse events may seriously affect ability of an entity to continue its business.
   c. The business may cease to exist in future due to change in market conditions, emergence of new business models or products or due to onset of some adverse events.

TEST YOUR KNOWLEDGE:

1. **MNO Ltd requested the auditor CA P to provide for absolute assurance in respect of its ten branches scattered in Delhi and confirm that the financial statements are free from material misstatement due to fraud or error. Advise.**

Answer:

The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error.

This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. In view of the above, CA P cannot provide audit absolute assurance to MNO Ltd in respect of its branches.

2. **There are practical and legal limitations on the auditor's ability to obtain audit evidence. Explain with examples.**

Answer: Write Point C(2) from above answer

3. **Distinguish between absolute assurance and reasonable assurance. Identify the type of assurance that is expected in an audit of financial statements, clearly outlining the reasons to justify your point of view.**

Answer: Write above answer

4. **Audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. Explain.**

Answer: Write Point C(2) from above answer

Q.NO.8 AN AUDIT IS DISTINCT FROM INVESTIGATION. HOWEVER, IT IS QUITE POSSIBLE THAT SOMETIMES INVESTIGATION RESULTS FROM THE PRIMA FACIE FINDINGS OF THE AUDITOR. DISCUSS?

ANSWER:

1. Audit is distinct from investigation. Investigation is a critical examination of the accounts with a special purpose. For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.
2. The objective of audit, on the other hand as we have already discussed, is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.
3. Therefore, audit is never started with a pre-conceived notion about state of affairs; about wrong-doing; about some wrong having been committed.
4. The auditor seeks to report what he finds in normal course of examination of accounts.
5. However, it is quite possible that sometimes investigation results from the prima facie findings of the auditor.
6. It may happen that auditor has given some findings of serious concern. Such findings may prompt for calling an investigation.

Q.NO.9 EXPLAIN THE RELATIONSHIP OF AUDITING WITH OTHER DISCIPLINES?

ANSWER:

A. AUDITING AND ACCOUNTING: Auditing reviews the financial statements which are nothing but a result of the overall accounting process.

B. AUDITING AND LAW: An auditor should have a good knowledge of business laws affecting the entity.

C. **AUDITING AND ECONOMICS:** Auditor is expected to be familiar with the overall economic environment of the client.

D. **AUDITING AND BEHAVIOURAL SCIENCE:** Knowledge of human behaviour is essential for an auditor to effectively discharge his duties.

E. **AUDITING AND STATISTICS & MATHEMATICS:** Auditor is also expected to have the knowledge of statistical sampling for meaningful conclusions and mathematics for verification of inventories.

F. **AUDITING AND DATA PROCESSING:** EDP auditing in itself is developing as a discipline in itself.

G. **AUDITING AND FINANCIAL MANAGEMENT:** Auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc

H. **AUDITING AND PRODUCTION:** Good auditor is one who understands the client and his business functions such as production, cost system, marketing etc.

TEST YOUR KNOWLEDGE:

1. **Mr. Ganesh, one of the team members of audit team of Straight Forward Limited was of the view that role of computers and data processing in auditing is increasing with each passing day. Explain how computers and data processing helps in conducting audit of a company.**

Answer: Write point F

2. **The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties. Explain.**

Answer: Write point D

Q.NO.10 EXPLAIN THE QUALITIES OF AN AUDITOR?

ANSWER:

A. **PROFESSIONAL/TECHNICAL QUALITIES:** The auditor should have a sound knowledge of
   1. Accounting concepts and principles
   2. Auditing concepts and principles
   3. Taxation laws (Direct and Indirect)
   4. General laws of business
   5. Specific statutes applicable to the client (Companies Act, Banking Regulation Act etc.)
   6. Computers and information systems
   7. Financial Management

8. General Management

The above skills are to be acquired by the auditor practical training and theoretical education.

B. PERSONAL QUALITIES:

1. Auditor should have qualities like tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability.
2. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor.
3. Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities.
4. He said, "an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true."

TEST YOUR KNOWLEDGE:

1. Lord Justice Lindley in the course of the judgment in the famous London & General Bank case had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, "an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care." Explain also stating the qualities of Auditor.

Answer: Write above answer

Q.NO.11 STATE THE ETHICAL REQUIREMENTS RELATING TO AUDIT OF FINANCIAL STATEMENTS.

ANSWER:

"Ethics" are the principles of conduct governing an individual or group. Professions like law, medicine have their code of ethics. Auditing profession is no exception. Rather, in profession of auditing, importance of ethics is manifold.

The IESBA Code establishes the following as the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements:

1. INTEGRITY:

a. It requires auditor to be straight forward and honest in all professional and business relationships.
b. It implies fair dealing and truthfulness.
c. It effectively means that he shall not be associated with reports, returns, communications or other information which he believes contains a materially false or misleading statement.

2. **OBJECTIVITY:** The principle of objectivity requires an auditor not to compromise professional judgment because of bias, conflict of interest or undue influence of others.

3. **PROFESSIONAL COMPETENCE AND DUE CARE:**
   a. It requires that auditor attains and maintains professional knowledge and skill at the level required to render competent professional service based on current technical and professional standards.
   b. The auditor shall also act diligently. Diligence includes responsibility to act carefully, thoroughly and on a timely basis in accordance with requirements of an assignment.

4. **CONFIDENTIALITY:** It requires an auditor to respect the confidentiality of information acquired as a result of professional or business relationships.

5. **PROFESSIONAL BEHAVIOUR:** It requires an auditor to comply with relevant laws and regulations and avoid any conduct that he knows or should know might discredit the profession.

TEST YOUR KNOWLEDGE:

1. **"Integrity'" and "Objectivity" are among the fundamental principles of professional ethics relevant to an auditor enshrined in IESBA code. Distinguish between the two.**

Answer: Write Point 1 and 2 from above answer

Q.NO.12 DEFINE THE TERM INDEPENDENCE AND EXPLAIN THE GENERAL SAFEGUARDS TO INDEPENDENCE.

ANSWER:

A. **INDEPENDENCE OF AUDITORS:**
   1. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.
   2. There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance.
   3. **Independence of mind:** The state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism.
   4. **Independence in appearance:** The avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised."

B. **SAFEGUARDS TO INDEPENDENCE:** The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats. The following are the guiding principles in this regard:

1. For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing
2. In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.
3. Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
4. If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.
5. When such threats exist, the auditor should either desist (withdraw) from the task or put in place safeguards that eliminate them.

Q.NO.13 EXPLAIN THE VARIOUS THREATS TO INDEPENDENCE IDENTIFIED BY IFAC.

ANSWER:

The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

1. **SELF-INTEREST THREATS:**
   a. They occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.
   b. Examples include
      i. Direct financial interest or materially significant indirect financial interest in a client,
      ii. Loan or guarantee to or from the concerned client,
      iii. Undue dependence on a client's fees and, hence, concerns about losing the engagement,
      iv. Close business relationship with an audit client,
      v. Potential employment with the client, and
      vi. contingent fees for the audit engagement.

2. **SELF-REVIEW THREATS**
   a. They occur when the auditor is reviewing the work which he has conducted as a part of previous assignment.
   b. Instances where such threats come into play are
      i. when an auditor having recently been a director or senior officer of the company, and
      ii. when auditors perform services that are themselves subject matters of audit.

3. **ADVOCACY THREATS:**
   a. They occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised,
   b. For example, auditor becomes the client's advocate in litigation and third-party disputes, where auditor can be perceived as backing or supporting the client and it may lead to belief that auditor is not acting and working objectively.

4. **FAMILIARITY THREATS**
   a. These threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests.
   b. This can occur in many ways:
      i. Close relative of the audit team working in a senior position in the client company,
      ii. Former partner of the audit firm being a director or senior employee of the client,
      iii. Long association between specific auditors and their specific client counterparts, and
      iv. Acceptance of significant gifts or hospitality from the client company, its directors or employees.

5. **INTIMIDATION THREATS:**
   a. They occur when auditors are deterred from acting objectively.
   b. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees or being threatened with litigation.

TEST YOUR KNOWLEDGE:

1. **Mr. S and Mr. Ware partners in SW and Associates, a Partnership Firm of Chartered Accountants. During the financial year 2020-21, SW and Associates were appointed as auditors of Capable and Composed Limited. The brother of Mr. W was involved in the management of Capable and Composed Limited. Mr. S being aware of the whole situation, on behalf of SW and Associates did not accept the appointment as auditors of Capable and Composed Limited as it would act as a threat and affect independence of auditors. Identify the threat in the given case.**

Answer: Refer Point 4 from above answer

Q.NO.14 WRITE A SHORT NOTE ON PROFESSIONAL SKEPTICISM.

ANSWER:

1. **MEANING:** Professional skepticism refers to 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.

2. **CIRCUMSTANCES TO WHICH AUDITOR SHOULD REMAIN ALERT:** Professional skepticism includes being alert to, for example:
   a. Audit evidence that contradicts other audit evidence obtained.
   b. Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
   c. Conditions that may indicate possible fraud.

3. **PROFESSIONAL SKEPTICISM REDUCES RISKS:** Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:
   a. Overlooking unusual circumstances.
   b. Over generalising when drawing conclusions from audit observations.
   c. Using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

TEST YOUR KNOWLEDGE:

1. **Mr. H is an audit team member of a Partnership Firm of Chartered Accountants WY and Associates. Mr. H was of the opinion that Professional Skepticism is required only at planning stage of an audit because situations and circumstances which are unusual in nature exist at the beginning of an audit only. Explain whether Professional Skepticism is only required at planning stage of an audit.**

Answer:

Write above answer, then write the below conclusion.

Professional Skepticism is not only required at planning stage of an audit, rather Professional Skepticism is required during the entire process of an audit because situations and circumstances that are not usual in nature exist during the entire process of an audit

Q.NO.15 WRITE A SHORT NOTE ON PROFESSIONAL JUDGEMENT.

ANSWER:

1. **MEANING:** It refers to taking decisions by the auditor during the course of his audit by using his knowledge, training and experience. Judgment includes assumptions and estimations made by auditor.

   Professional judgment is used throughout planning and performing of an audit.

2. **CIRCUMSTANCES WHERE EXERCISING OF PROFESSIONAL JUDGMENT IS REQUIRED:**
   a. Materiality and audit risk.
   b. Nature, timing and extent of audit procedures.
   c. Evaluating whether sufficient appropriate audit evidence has been obtained.
   d. Drawing of conclusions based on the audit evidence obtained.

Q.NO.16 WHAT ARE THE FACTORS TO BE CONSIDERED BEFORE ACCEPTING AND CONTINUING A CLIENT RELATIONSHIP AS PER SA 220?

ANSWER:

As per SA 220 "Quality Control for an Audit of Financial Statements", the auditor shall consider the following factors before accepting and continuing client relationship:

1. The integrity of the principal owners, key management and those charged with governance of the entity;
2. Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
3. Whether the firm and the engagement team can comply with relevant ethical requirements; and
4. Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

TEST YOUR KNOWLEDGE:

1. 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. Explain

Answer: Write above answer

Q.NO.17 WHAT ARE PRECONDITIONS FOR AN AUDIT? / WHAT ARE THE MANAGEMENT RESPONSIBILITIES AS PER SA 210?

ANSWER:

1. As per SA 210 "Agreeing the Terms of Audit Engagements", Preconditions for an audit are those responsibilities which management has to fulfil, in order to conduct audit.
2. They are also known as "Premise" of audit.
3. The following are the preconditions for an audit: Obtain the agreement of management that it acknowledges and understands its responsibility:
   a. For the preparation of the financial statements in accordance with the applicable financial reporting framework;
   b. For the internal control as management considers necessary; and
   c. To provide the auditor with:
      i. Access to all information such as records, documentation and other matters;
      ii. Additional information that the auditor may request from management for the purpose of the audit; and
      iii. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

4. **WHAT HAPPENS IF PRECONDITIONS FOR AN AUDIT ARE NOT PRESENT?**
   If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement: -

a. If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable or
b. If the agreement of management is not obtained on matters relating to understanding of responsibility of management on preparation of financial statements, internal controls for preparation of financial statements, providing access to all information to auditor and unrestricted access to persons within the entity.

TEST YOUR KNOWLEDGE:

1. **TH and Associates, a Partnership Firm of Chartered Accountants are appointed as auditors of Grateful and Cheerful Limited for the financial year 2020-21. Mr. Y is one of the audit team members of TH and Associates. Mr. Y required from the company, its financial statements and other relevant information for which the audit is to be conducted. State who is responsible for providing such an information to the auditor.**

Answer: Write above answer and write the conclusion below.
Management is responsible for providing such information to the auditor.

Q.NO.18 WHAT IS ENGAGEMENT LETTER / LETTER OF ENGAGEMENT? ALSO STATE ITS CONTENTS.

ANSWER:

A. **MEANING:** Engagement letter is a document issued by the auditor to the client, to reduce the chances of misunderstanding regarding scope, objective, rights, and duties of the auditor and of management.

B. **PURPOSE:**
1. In case of Statutory audits, the respective law governs the appointment of auditors and their duties.
2. In all other cases, it is a matter of contract.
3. It is, therefore, important, both for the auditor and client, that each party should be clear about the nature of the engagement.
4. In case of Non statutory audit, the issue of engagement letter is highly recommendatory as there is no governing law regarding rights and duties of an auditor.

C. **CONTENTS OF ENGAGEMENT LETTER:** The following are the contents of engagement letter:
1. Title
2. Addressee
3. The objective and scope of the audit of the financial statements
4. The responsibilities of the auditor
5. The responsibilities of management
6. Identification of the applicable financial reporting framework for the preparation of the financial statements and
7. Reference to the expected form and content of any reports to be issued by the auditor
8. Signature of Auditor

9. Signature of client, indicating acceptance to the terms stated therein
10. Date and place

NOTE: If law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities.

Q.NO.19 STATE THE CIRCUMSTANCE IN WHICH ENGAGAMENT LETTER IS REQUIRED TO BE SENT BY THE AUDITOR, IN CASE OF RECURRING AUDITS.

ANSWER:

A. **MEANING OF RECURRING AUDIT:** If the previous years auditor is reappointed as current years auditor, then such an audit engagement will be known as Recurring Audit.

B. **ENGAGEMENT LETTER IN CASE OF RECURRING AUDITS:**

1. 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.
2. The auditor may decide not to send a new audit engagement letter or other written agreement each period.
3. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:
   - Any indication that the entity misunderstands the objective and scope of the audit.
   - Any revised or special terms of the audit engagement.
   - A recent change of senior management.
   - A significant change in ownership.
   - A significant change in nature or size of the entity's business.
   - A change in legal or regulatory requirements.
   - A change in the financial reporting framework adopted in the preparation of the financial statements.
   - A change in other reporting requirements.

TEST YOUR KNOWLEDGE:

1. **R & Co, a firm of Chartered Accountants have not revised the terms of engagements and obtained confirmation from the clients for last 5 years despite changes in business and professional environment. Elucidate the circumstances that may warrant the revision in terms of engagement.**

Answer: Write above answer

Q.NO.20 WHAT IF THE MANAGEMENT IMPOSES A LIMITATION ON SCOPE PRIOR TO AUDIT ENGAGEMENT ACCEPTANCE?

ANSWER:

If management or those charged with governance impose a limitation on the scope of the auditor's work prior to accepting an audit engagement, then the auditor shall not accept such audit engagement.

Because with impose of limitations, the auditor will not be in a position to obtain sufficient and appropriate audit evidence, which will result in expression of disclaiming an opinion on the financial statements.

Q.NO.21 EXPLAIN THE AUDITORS RESPONSIBILITIES, IF THE MANAGEMENT APPROACHES THE AUDITOR REQUESTING TO CHANGE THE TERMS OF AUDIT ENGAGEMENT AS PER SA 210?

ANSWER:

A. REASONS FOR REQUEST FROM CLIENT: A request from the client for the auditor to change the engagement may result from
   1. A change in circumstances affecting the need for the service,
   2. A misunderstanding as to the nature of an audit or related service originally requested.
   3. A restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

B. AUDITORS RESPONSIBILITIES AS PER SA 210:
   1. 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.
   2. First, the auditor shall understand the reasons for request made by management for change in terms.
   3. **If there is reasonable justification:**
      a. If the auditor concludes that there is reasonable justification to change the engagement then the auditor can agree to the changes in terms of audit.
      b. However, the auditor shall issue new engagement letter, containing revised terms and conditions.
      c. 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.
   4. **If there is no reasonable justification:**
      a. The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

b. 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.

TEST YOUR KNOWLEDGE:

1. **"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.**

Answer: Write above answer

2. **Dhruv & Company, a chartered accountancy firm has been appointed to conduct audit of ABC Private Limited for the year 2018- 2019. During the course of audit, the firm has been asked by the managing director to change the terms of audit engagement. The auditor has asked the reasons for the same and found that it would result in limitation on his scope by the management. Mr. Dhruv found the firm to be unable to agree to the change of terms of audit engagement. He requested those charged with governance to continue him with the original engagement. However, the firm is not permitted by them to continue with the original audit engagement. In the present scenario, advice what M/S Dhruv & Company chartered accountant shall do?**

Answer: Write above answer. Then write the below conclusion.

In the given case, the auditors Dhruv & Company shall withdraw from the audit, as the management is not permitting the auditor to continue the audit as per original terms.

Q.NO.22 "THE INDEPENDENT AUDIT OF AN ENTITY'S FINANCIAL STATEMENTS IS A VITAL SERVICE TO INVESTORS, TRADE PAYABLES, AND OTHER PARTICIPANTS IN ECONOMIC EXCHANGE." EXPLAIN?

ANSWER:

1. Auditing along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession.
2. No business or institution can effectively carry on its activities without the help of proper records and accounts, since transactions take place at different of time with numerous persons and entities.

3. Periodical statements of account are drawn up to measure the success or failure of the activities in achieving the objective of the organization. This would be impossible without a systematic record of transactions.
4. Financial statements are often the basis for decision making by the management and for corrective action so as to even closing down the organization or a part of it.
5. All this would be possible only if the statements are reliable, decisions based on wrong accounting statements may prove very harmful or even fatal to the business. For example, if the business has really earned a profit but because of wrong accounting, the annual accounts show a loss, the proprietor may take the decision to sell the business at a loss.
6. Thus, from the point of view of the management itself, authenticity of financial statements is essential.
7. It is more essential for those who have invested their money in the business but cannot take part in its management, for example, shareholders in a company, such persons certainly need an assurance that the annual statements of accounts sent to them are fully reliable.
8. It is auditing which ensures that the accounting statements are authentic. In today's economic environment, information and accountability have assumed a larger role than ever before.
9. As a result, the independent audit of an entity's financial statements is a vital service to investors, trade payable, and other participants in economic exchange.

Q.NO.23 WHO APPOINTS AN AUDITOR? ALSO EXPLAIN TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?

ANSWER:

A. WHO APPOINTS AN AUDITOR?

1. Generally, an auditor is appointed
   a. by owners or
      For example,
      - *In case of companies, auditor is appointed by members (shareholders) in Annual General Meeting (AGM). Shareholders are owners of a company and auditor is appointed by them in AGM.*
      - *In case of a partnership firm, , auditor is appointed by partners of firm.*

   b. by constitutional or government authorities in accordance with applicable laws and regulations, in some cases
      For example
      - *in case of government companies in India, auditor is appointed by Comptroller and Auditor General of India (CAG), an independent constitutional authority.*
      - *An auditor may be appointed under tax laws by a government authority (GST Audit).*

B. TO WHOM REPORT IS SUBMITTED BY AN AUDITOR?

1. The outcome of an audit is written audit report in which auditor expresses an opinion.
2. The report is submitted to person making the appointment.

3. In case of companies, these are shareholders, whereas in case of a firm, to partners who have engaged him.

Q.NO.24 EXPLAIN THE MEANING AND ELEMENTS OF ASSURANCE ENGAGEMENT?

ANSWER:

A. MEANING OF ASSURANCE ENGAGEMENT

1. "Assurance engagement" means an engagement
   a. in which a practitioner expresses a conclusion
   b. designed to enhance the degree of confidence of the intended users
   c. other than the responsible party
   d. about the outcome of the evaluation or measurement of a subject matter against criteria.
2. It means that the practitioner gives an opinion about specific information due to which users of information are able to make confident decisions knowing well that chance of information being incorrect is diminished.

B. ELEMENTS OF AN ASSURANCE ENGAGEMENT: Following elements comprise an assurance engagement: -

1. **A three party relationship involving a practitioner, a responsible party, and intended users:** An assurance engagement involves abovesaid three parties.
   a. A **practitioner** is a person who provides the assurance. The term practitioner is broader than auditor. Audit is related to historical information whereas practitioner may provide assurance not necessarily related to historical financial information.
   b. A **responsible party** is the party responsible for preparation of subject matter.
   c. **Intended users** are the persons for whom an assurance report is prepared. These persons may use the report in making decisions.
2. **An appropriate subject matter:** It refers to the information to be examined by the practitioner.
   For example, financial information contained in financial statements while conducting audit of financial statements.
3. **Suitable criteria:** These refer to benchmarks used to evaluate the subject matter like standards, guidance, laws, rules and regulations.
4. **Sufficient appropriate evidence:**
   a. The practitioner performs an assurance engagement to obtain sufficient appropriate evidence.
   b. It is on the basis of evidence that conclusions are arrived and an opinion is formed by auditor.
   c. "Sufficient" relates to quantity of evidence obtained by auditor.
   d. "Appropriate" relates to quality of evidence obtained by auditor.
   e. One evidence may be providing more comfort to auditor than the other evidence. The evidence providing more comfort is qualitative and, therefore, appropriate.

    f. Evidence should be both sufficient and appropriate.
5. **A written assurance report in appropriate form:** A written report is provided containing conclusion that conveys the assurance about the subject matter. A written assurance report is the outcome of an assurance engagement.

Q.NO.25 BRIEFLY OUTLINE HOW PRINCIPLES-BASED APPROACH DIFFERS FROM RULES-BASED APPROACH TO ETHICS?

ANSWER:

1. Ethical guidance may follow principles-based approach or rules-based approach.
2. **Principal based approach:**
    a. The essence of principles-based approach to ethics is that it requires compliance with spirit of ethics.
    b. It requires accountants to exercise professional judgment in every situation based upon their professional knowledge, skill and expertise.
    c. It requires that accountants should use professional judgment to evaluate every situation to arrive at conclusions.
3. **Rule based approach:**
    a. However, rules-based approach to ethics strictly follows clearly established rules.
    b. It may lead to a narrow outlook and spirit of ethics may be overlooked while strictly adhering to rules.
    c. Further, rules- based approach is somewhat rigid as it may not be possible to deal with every practical situation relying upon rules.
    d. Therefore, it is necessary that spirit of code is followed.

TEST YOUR UNDERSTANDING

1. **Lalji Bhai has purchased shares of a company listed on NSE. The audited financial statements of the company provide picture of healthy financial performance having robust turnover, low debt and good profits. On above basis, he is absolutely satisfied that money invested by him is safe and there is no chance of losing his money. Do audited results and audit reports of companies provide such assurance to investors like Lalji Bhai? Is thinking of Lalji Bhai correct?**

Answer:

An audit does not provide assurance to investor in shares regarding safety of his money. Share prices of securities are affected by range of factors. An audit only provides reasonable assurance that financial statements are free from material misstatement whether due to fraud or error. Hence, thinking of Lalji Bhai is not correct.

2. **Good deeds Limited is engaged in business of recycling of wastes from dumping grounds of municipal corporation of Indore to usable manure. It is, in this way, also, helping to make the city clean. During course of audit by Zoha & Zoha, a firm of auditors, it is observed by auditors that company has received a notice from Central Bench of National Green Tribunal for not following certain environmental regulations involving imposition of hefty monetary penalty on the company. The company is yet to reply to the notice. The auditors point out that same is not stated in notes to accounts in financial statements. The company points out that auditors are going beyond scope of their work. Does such a matter fall within scope of audit?**

Answer:

Proper disclosure of financial information is well within scope of audit.

3. **A huge fire broke out in NOIDA plant of KT Limited. Plant assets comprising building, machinery and inventories were insured from branch of a public sector insurance company. Apart from an insurance surveyor who was deputed for assessing loss, the regional office of insurance PSU also appointed a CA for verification of books of accounts/ financial records of the company and circumstances surrounding the loss. He was also requested to submit an early report. Would the report by CA in nature of audit report?**

Answer:

Appointment of CA for verification of books of accounts/financial records and circumstances surrounding the loss is for a specific objective to determine genuineness of loss and any issue affecting liability of insurance company. It is an investigation and not in nature of audit report.

4. **Zeeba Products is a partnership firm engaged in trading of designer dresses. The firm has appointed JJ & Co, Chartered accountants to audit their accounts for a year. The auditors were satisfied with control systems of firm, carried out required procedures and necessary verifications. In particular, they carried out sample checking of purchases, traced purchase bills to GST portal and also made confirmations from suppliers. They were satisfied with audit evidence obtained by them as part of audit exercise. An audit report was submitted to the firm giving an opinion that financial statements reflected true and fair view of state of affairs of the firm.**
   However, later on, it was discovered that purchase manager responsible for procuring dresses from one location was also booking fake purchases of small values by colluding with unethical dealers. Payments to these dealers were also made in connivance with accountant through banking channel.
   The partners of firm blame auditors for futile audit exercise. Are partners of firm correct in their view point? Imagine any probable reason for such a situation.

Answer:

It is example of failure of internal controls of the firm. The internal control has not operated due to collusion between employees which is a limitation of internal control itself. The auditor has relied upon internal controls. It is very nature of financial reporting that management is responsible for devising suitable internal controls. This is an inherent limitation of audit.

5. **CA P. Suryakantam has conducted audit of accounts of an entity for a particular year. ICAI has issued a letter to him relating to certain matters concerning audit. He didn't even bother to reply to the letter despite reminders. Discuss which fundamental principle governing professional ethics is disregarded by him.**

Answer:

Failure to reply to professional body smacks of lack of courtesy and professional responsibility. The principle of "Professional behaviour" is disregarded

6. **A Chartered accountant in practice issued a certificate showing original cost of plant and machinery installed in premises of a client for Rs. 9 crores to save some regulatory fees for his client. However, original cost of plant and machinery was Rs.15 crore as per records of client. Which fundamental principle governing professional ethics is violated in this case?**

Answer:

"Integrity" requires that a professional accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information contains a materially false or misleading statement; contains statements or information provided negligently or omits or obscures required information where such omission or obscurity would be misleading.

In the given case, a false certificate is knowingly issued showing misstated original cost of machinery. Therefore, fundamental principle of "integrity" is violated.

7. **CA Raman Gupta is offered appointment as auditor of a company. One of his distant uncles held some shares in the same company. Holding of such shares, by a distant relative, is not prohibited under provisions of law nor does it affect his independence. Before he could accept appointment, he received unfortunate news of death of his uncle who had died without any children. He came to know that he was nominee of these shares having substantial value. It landed him in a tricky situation. What should be proper course of action for him?**

Answer:

When threats to independence exist, the auditor should either desist from the task or eliminate the threat or at the very least, put in place safeguards which reduce the threats to an acceptable level.

Holding of shares involves financial interest in the company and is in nature of self-interest threat. He has come to hold shares due to nomination made by his distant relative before accepting the appointment. Considering above, he should take steps to eliminate the threat by selling shares immediately before accepting appointment. Holding of shares of the same company for which he is offered appointment as auditor constitutes threat to his independence.

8. **A Chartered accountant receives about 40% of his total audit fees from a single client. Discuss how it could affect independence of Chartered accountant as auditor of this client. What are such types of threats referred to as?**

Answer:

Undue dependence on fees of a client constitutes a threat as there is fear of losing the client. Such threats are referred to as self-interest threats.

9. **CA Murli Madhavan provides accounting and book keeping services to a leading NGO engaged in environmental protection work. He is also offered audit of the accounts of NGO. Identify and discuss what kind of threat to independence may be involved in accepting such an engagement.**

Answer:

In this case, Chartered Accountant is already rendering accounting and book keeping services to an NGO. If he accepts audit, he would be involved in reviewing own work. Therefore, the same constitutes "self-review" threat.

10. **The auditors of a company have only relied upon management representation letter regarding treatment of certain tax matters under appeal by the company. The auditors have not carried out any other audit procedures to justify management's treatment of the said tax matters under appeal in the financial statements. What is lacking on part of auditors in such a situation?**

Answer:

In the given case, auditors have relied only upon management representation letter regarding treatment of certain tax matters under appeal by the company. No other audit procedures to verify management's treatment of such matters under appeal have been performed by auditors. It shows lack of "professional skepticism" on part of auditors

11. **Chirag, as part of articled training, is part of an engagement team conducting audit of a company. He has read somewhere that engagement letter issued by auditor to client also includes expected form and content of the auditor's report. He was at a loss to understand how could an auditor include form and content of the report beforehand. Try to help Chirag by making things clear to him.**

Answer:

Engagement letter includes reference to expected form and content of audit report. It merely states that auditor would provide opinion in this form. However, engagement letter also includes statement that the form and content of report may need to be amended in the light of audit findings. Therefore, if in light of audit findings, auditor needs to give a modified opinion, he shall do so.

12. The management of an entity feels that it is not necessary for it to give in writing explicitly to the auditor that it understands its responsibilities for preparation of financial statements in accordance with applicable financial reporting framework. Discuss, whether, it is necessary for the management to do so. In case management refuses, why should an auditor not accept the proposed engagement?

Answer:

Refer Q.No 17 Point no 4

13. CA PK Nair is offered appointment as auditor of a company engaged in providing tourism services. While making due diligence of the proposed client, he comes to know that there have been raids on premises of the company and residences of its directors by National Investigation Agency (NIA) on suspicion of links with terror outfits. It has been followed up with searches by Enforcement Directorate hunting for illicit money trail. There is a strong suspicion of tourism services provided by company being façade of terror funds. Should proposed offer be accepted by him?

Answer:

Integrity of principal owners has to be considered before accepting an audit engagement in accordance with SA 220. In this regard, SA 220 states requirements on lines of SQC 1. SQC 1 clearly states that in cases where there are indications that the client might be involved in money laundering or other criminal activities, appointment should not be accepted.

In the instant case, there have been raids of NIA on suspected links with terror outfits which is a criminal activity. Further, raids by Enforcement Directorate also point towards money laundering. Therefore, proposed offer should not be accepted.

14. CA Arpita has joined a mid-sized CA firm recently. She finds that partners remain too busy and the firm is proposing to accept audit work in areas in which it has no experience or capabilities. The firm is proposing to accept audit of some entities engaged in emerging "fin-tech" sector. Such audits may be requiring extensive use of technology and data analytics. However, the said firm has no such capabilities and trained personnel. Discuss, whether, firm should accept such audits with reason.

Answer:

SA 220 requires that before accepting an engagement, competence (including capabilities, time and resources) to perform engagement have to be considered.

In the given case, the proposed engagements involve use of technology and data analytics. The firm has no prior experience of audits in emerging “fintech” sector. The firm does not have trained personnel to carry out these audits. Hence, offer for these audits should not be accepted

3. AUDIT REPORTING

SA 700 - "FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS"

A. OBJECTIVE: The objectives of the auditor as per SA 700 (Revised) are:

1. To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and
2. To express clearly that opinion through a written report.

B. TO FORM OPINION – AUDITOR TO OBTAIN REASONABLE ASSURANCE:

1. The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.
2. In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:
   a. Whether sufficient appropriate audit evidence has been obtained;
   b. Whether uncorrected misstatements are material, individually or in aggregate;
   c. The evaluations.

C. EVALUATIONS BY THE AUDITOR: The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework. The auditor shall consider the following evaluations:

1. **Qualitative aspects of the entity's accounting practices:**
   a. Management makes a number of judgements about the amounts and disclosures in the financial statements.
   b. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements.
   c. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated.
   d. Indicators of a lack of neutrality include the following:
      i. The selective correction of misstatements brought to management's attention during the audit. **For example,** Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.
      ii. Possible management bias in the making of accounting estimates.

2. **Specific Evaluations by the Auditor:**
   In particular, the auditor shall evaluate whether:
   a. The financial statements adequately disclose the significant accounting policies selected and applied;

b. The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
c. The accounting estimates made by management are reasonable;
d. The information presented in the financial statements is relevant, reliable, comparable, and understandable;
e. The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
f. The terminology used in the financial statements, including the title of each financial statement, is appropriate.

D. UNMODIFIED OPINION: The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, and also, they are free from material misstatements.

E. CONTENTS OF THE AUDITORS REPORT: The following shall be the contents of the audit report:

1. Title
2. Addressee
3. Opinion
4. Basis for Opinion
5. Material Uncertainty relating to Going Concern (SA 570)
6. Key Audit Matters (SA 701)
7. Emphasis of Matter Paragraph (SA 706)
8. Other Matter Paragraph (SA 706)
9. Responsibilities of Management for Financial Statements
10. Auditor's Responsibilities for the Audit of the Financial Statements
11. Reporting on Legal and Other regulatory requirements
12. Signature of Auditor
13. Date of Signature
14. Place of Signature
15. UDIN (Unique Document Identification Number)

F. DETAILED EXPLAINATION TO CONTENTS OF AUDITORS REPORT:

1. **TITLE:** The auditor’s report shall have a title that clearly indicates that it is the report of an independent auditor. For example, “Independent Auditor’s Report.”

2. **ADDRESSEE:** The auditor’s report shall be addressed, as appropriate, based on the circumstances of the engagement. Law, regulation or the terms of the engagement may specify to whom the auditor’s report is to be addressed.

3. **OPINION PARAGRAPH:** The first section of the auditor’s report shall include the auditor’s opinion, and shall have the heading “Opinion.” The Opinion section of the auditor’s report shall also:

a. Identify the entity whose financial statements have been audited;
b. State that the financial statements have been audited;
c. Identify the title of each statement comprising the financial statements;
d. Refer to the notes, including the summary of significant accounting policies; and
e. Specify the date of, or period covered by, each financial statement comprising the financial statements.

4. **BASIS FOR OPINION:** The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that:
   a. States that the audit was conducted in accordance with Standards on Auditing;
   b. Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
   c. Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.
   d. States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

5. **RESPONSIBILITIES OF MANAGEMENT FOR THE FINANCIAL STATEMENTS:** This section of the auditor's report shall describe management's responsibility for:
   a. **Preparing the financial statements** in accordance with the applicable financial reporting framework, and
   b. **For such internal control** as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.
   c. **Assessing the entity's ability to continue as a going concern** and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern.
   d. **Oversight of the financial reporting process:** This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process. This section shall also include reference to 'Those Charged With Governance.'

6. **AUDITOR'S RESPONSIBILITIES FOR THE AUDIT OF THE FINANCIAL STATEMENTS:** This section of the auditor's report shall state his responsibilities as follows:
   a. That the objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.
   b. To Issue an auditor's report that includes the auditor's opinion.
   c. That reasonable assurance is a high level of assurance, but is not a guarantee.
   d. That misstatements can arise from fraud or error, and either and describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

e. The auditor exercises professional judgment and maintains professional skepticism throughout the audit.
f. To identify and assess the risks of material misstatement of the financial statements.
g. To obtain an understanding of internal control.
h. To evaluate the appropriateness of accounting policies.

7. **SIGNATURE OF THE AUDITOR:**
   a. The auditor's report shall be signed. The report is signed by the auditor (i.e., the engagement partner) in his personal name.
   b. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm.
   c. The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India.
   d. They also include the registration number of the firm, wherever applicable, as allotted by ICAI, in the audit reports signed by them.

8. **PLACE OF SIGNATURE:** The auditor's report shall name specific location, which is ordinarily the city where the audit report is signed.

9. **DATE OF THE AUDITOR'S REPORT:** The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.

10. **UDIN:**
    a. It was noticed that financial documents/ certificates attested by third person misrepresenting themselves as CA Members were misleading the Authorities and Stakeholders.
    b. ICAI also received number of complaints of signatures of CAs being forged by non CAs.
    c. To curb the malpractices, the Professional Development Committee of ICAI implemented in phased manner an innovative concept of UDIN i.e. Unique Document Identification Number.
    d. All Certificates were made mandatory to contain UDIN with effect from 1st February, 2019.
    e. Chartered Accountants having full-time Certificate of Practice can register on UDIN Portal and generate UDIN by registering the certificates attested/certified by them.
    f. Accordingly, an auditor is required to mention the UDIN with respect to each audit report being signed by him, along with his membership number while signing an audit report.

TEST YOUR KNOWLEDGE:

1. **M/s Smart & Associates are the statutory auditors of Hotmeals Ltd. for the FY 2020-21. How will the auditor address the audit report issued on the financial statements for the FY 2020-21? Also give a title to the report.**

Answer:

INDEPENDENT AUDITOR'S REPORT
To the Members of Hotmeals Ltd.

2. **Richa International is a partnership firm dealing in export of blankets. The partners of the firm are Richa and Ashish. Explain how the statutory auditor of the firm will address the auditor's report.**

Answer:

INDEPENDENT AUDITOR'S REPORT

To the Partners of Richa International.

3. **M/s Amitabh & Associates are the statutory auditors of Ringston Ltd. which is a company engaged in the business of manufacture of pen drives. The auditor has started drafting the audit report for the FY 2020-21. CA Amitabh, the engagement partner is of the view that the financial statements of Ringston Ltd. represent a true and fair view. Give the draft of the opinion paragraph of the audit report.**

Answer:

Opinion

We have audited the financial statements of Ringston Limited which comprise the Balance Sheet as at 31.03.2021 and the statement of Profit and Loss Account and the notes to the financial statements, including a summary of significant accounting policies and other explanatory information.

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the company as at 31.03.2021 and the Profit & Loss for the year ending on that date.

4. **M/s Kite Rite & Associates are the statutory auditors of Prime Deluxe Limited, for the FY 2020-21. At the time of finalising the audit report, one of the engagement team members, Mr. Robin, asked the engagement partner, CA Kite as to what all should be included in the Basis of Opinion Paragraph. The engagement partner CA Kite, explained the team in detail and asked Mr. Robin to draft such section for the auditor's report of Prime Deluxe Limited. Help Mr. Robin to draft the Basis for opinion section.**

Answer:

Basis for Opinion

We conducted our audit in accordance with the Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the Code of Ethics issued by the Institute of Chartered Accountants of India together with the ethical requirements that are relevant to our audit of the financial statements under the provisions of the Companies Act, 2013 and the Rules thereunder, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code of Ethics. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

5. **Diamond Shine Ltd. is a company engaged in the manufacture of detergent. M/s Bright & Associates are the statutory auditors of the company. Explain how the paragraph related to the management's responsibility will come in the auditor's report.**

Answer:

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance, (changes in equity) and cash flows of the Company in accordance with the accounting principles generally accepted in India, including the accounting Standards specified under section 133 of the Act. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgements and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statement that give a true and fair view and are free from material misstatement, whether due to fraud or error. In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so. Those Board of Directors are also responsible for overseeing the Company's financial reporting process.

6. **M/s TUV & Associates are the statutory auditors of Venus Ltd. for the FY 2020-21. At the time of finalising the auditor's report, one of the audit team members asked the engagement partner, CA Tarun, to explain as to how the auditor's report will be signed. Help CA Tarun in explaining the same.**

Answer:

The following is the correct way of signing an audit report.

M/s TUV & Associates
Chartered Accountants
(Firm's Registration No.)
Signature
(Name of the Member Signing the Audit Report)
(Designation)
(Membership No. XXXXX)
UDIN: 20037320AAAAAH1111

Place of Signature:
Date:

7. **"The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgements." Discuss stating clearly qualitative aspects of the entity's accounting practices.**

Answer: Refer SA 700 Point C(1)

8. **In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgements. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Explain and analyse the indicators of lack of neutrality with examples, wherever required.**

Answer: Refer SA 700 Point C(1)

9. **The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion." The Opinion section of the auditor's report shall also identify the entity whose financial statements have been audited. Apart from the above, explain the other relevant points to be included in opinion section.**

Answer: Refer SA 700 Point F(3)

10. **"An auditor is required to make specific evaluations while forming an opinion in an audit report." State those evaluations.**

Answer: Refer SA 700 Point C(2)

11. The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." SA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with SAs is conducted. Explain.

Answer: Refer SA 700 Point F(5)

12. The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion". Explain what is included in this "Basis for Opinion" section.

Answer: Refer SA 700 Point F(4)

13. M/s S & Associates are the statutory auditors of Real Ltd., a company engaged in the business of manufacturing of garments. The auditor has completed the audit and is in the process of forming an opinion on the financial statements for the FY 2020- 21. CA. K, the engagement partner, wants to conclude that whether financial statements as a whole are free from material misstatements, whether due to fraud or error. What factors he should consider to reach the conclusions?

Answer: Refer SA 700 Point C(2)

14. SA promotes consistency in the auditor's report, but doesn't recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. Correct/Incorrect.

Answer:

SA promotes consistency in the auditor's report, but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions.

SA 701 - "COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT"

A. DEFINITION: Key Audit Matters are those matters that, in the auditor's professional judgement were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

B. PURPOSE:

1. The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed.
2. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters of most significance in the audit of the financial statements of the current period.

3. Communicating key audit matters in the auditor's report is Communicating key audit matters in the auditor's report is
    a. Not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make.
    b. Not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705
    c. Not a substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
    d. Not a separate opinion on individual matters.

C. APPLICABILITY: The auditor shall communicate the key audit matters in the following circumstances:

1. For audits of complete sets of general-purpose financial statements of listed entities.
2. Law or regulation may require communication of key audit matters for audits of entities other than listed entities.
3. The auditor may also decide to communicate key audit matters for other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business.

D. PRESENTATION OF KEY AUDIT MATTERS:

1. The auditor shall describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters."
2. The introductory language in this section of the auditor's report shall state that:
    a. Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements [of the current period]; and
    b. These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

E. DETERMINING KEY AUDIT MATTERS: In determining the Key audit matters, the auditor shall take into account the following:

1. Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.
2. Areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty.
3. The effect on the audit of significant events or transactions that occurred during the period.

F. CIRCUMSTANCES WHERE KEY AUDIT MATTERS SHALL NOT BE COMMUNICATED:

1. SA 705 prohibits the auditor from communicating Key audit matter, when auditor disclaims an opinion on the financial statements.
2. In the following circumstances, the auditor shall not communicate KAM (Even when Disclaimer of opinion is not expressed):

a. Law or regulation prohibits such disclosure about the matter.
b. The auditor determines that the matter should not be communicated because of the possible adverse consequences.
c. If the auditor concludes that the matter is highly confidential or sensitive at the interest of the company.

TEST YOUR KNOWLEDGE

1. **Communicating Key Audit Matter is not a substitute for disclosure in the Financial Statements rather Communicating key audit matters in the auditor's report is in the context of the Auditor having formed an opinion on the financial statements as a whole. Analyse.**

Answer: Write Point B

2. **Explain the circumstances in which the auditor is prohibited from communicating Key audit matters in Audit Report.**

Answer: Write Point F

3. **Instead of modifying an opinion in accordance with SA 705, the statutory auditor can use Key Audit Matter paragraph in the audit report with an unmodified opinion.**

Answer:

Incorrect: Communicating key audit matters in the auditor's report is not a substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705

SA 705 - "MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT"

A. DEFINITION OF MODIFIED OPINION / OBJECTIVES OF AUDITOR AS PER SA 705 / CIRCUMSTANCES IN WHICH AUDITOR WILL GIVE MODIFIED OPINION: The auditor shall modify the opinion in the auditor's report in the following circumstances:

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.

B. FACTORS IN DECIDING THE TYPE OF MODIFIED OPINION: The decision regarding which type of modified opinion is appropriate depends upon:

1. The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated (availability or non-availability of audit evidence); and
2. The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

C. TYPES OF MODIFIED OPINION:

1. **QUALIFIED OPINION:** The auditor shall express a qualified opinion when:
   a. 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
   b. 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.

   Note:
   - The title of opinion paragraph shall be **'Qualified Opinion.'**
   - The title of Basis for Opinion paragraph shall be **'Basis for Qualified Opinion.'**
   - The terminology to be used in opinion paragraph, **"except for the effects of the matter(s) described in the Basis for Qualified Opinion section, financial statements give true and fair view or present fairly in all material respects"**

2. **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.

   Note:
   - The title of opinion paragraph shall be **'Adverse Opinion.'**
   - The title of Basis for Opinion paragraph shall be **'Basis for Adverse Opinion.'**
   - The terminology to be used in opinion paragraph, **"because of the significance of the matter(s) described in the Basis for Adverse Opinion section, the accompanying financial statements do not present fairly or do not give a true and fair view."**

3. **DISCLAIMER OF OPINION:** The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

   Note:
   - The title of opinion paragraph shall be **'Disclaimer of Opinion.'**
   - The title of Basis for Opinion paragraph shall be **'Basis for Disclaimer Opinion.'**
   - The terminology to be used in opinion paragraph, **"We do not express an opinion on financial statements because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, as we are not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements;"**

D. DEFINITION OF 'PERVASIVE':

1. Pervasive is a term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of

misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence.

2. Pervasive effects on the financial statements are those that, in the auditor's judgement:
   a. Are not confined to specific elements, accounts or items of the financial statements;
   b. If so confined, represent or could represent a substantial proportion of the financial statements; or
   c. In relation to disclosures, are fundamental to users' understanding of the financial statements.

E. CHANGES TO BE MADE TO BASIS FOR OPINION PARAGRAPH IN CASE OF MODIFIED OPINION:

1. Amend the heading "Basis for Opinion" to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate.
2. If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements the auditor shall include in the Basis for Opinion section a description and quantification of the financial effects of the misstatement, unless impracticable.
3. If it is not practicable to quantify the financial effects, the auditor shall so state in this section.
4. If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.
5. When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include the following elements required by SA 700
   a. A reference to the section of the auditor's report where the auditor's responsibilities are described; and
   b. A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

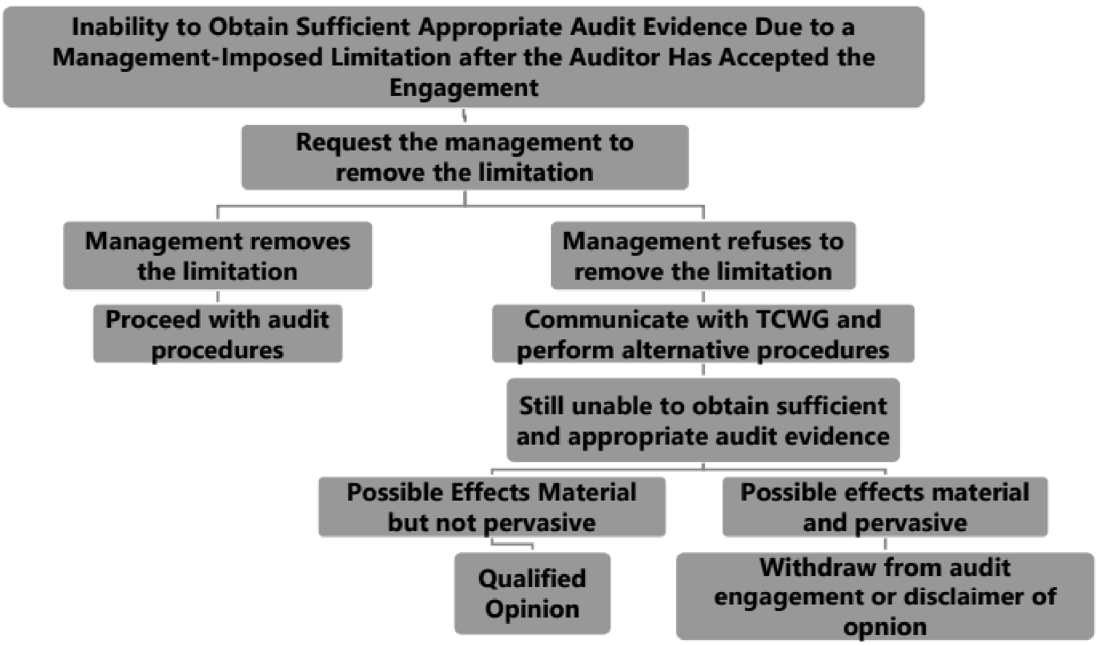
F. CHANGES TO BE MADE TO AUDITORS RESPONSIBILITY PARAGRAPH IN CASE OF DISCLAIMER OF OPINION: When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditors responsibility paragraph shall include only the following:

1. A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;
2. A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
3. The statement about auditor independence and other ethical responsibilities required by SA 700.

G. COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE: When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification.

H. CONSEQUENCE OF AN INABILITY TO OBTAIN SUFFICIENT APPROPRIATE AUDIT EVIDENCE DUE TO A MANAGEMENT-IMPOSED LIMITATION AFTER THE AUDITOR HAS ACCEPTED THE ENGAGEMENT:

1. If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit, the auditor shall request that management remove the limitation.
2. If management refuses to remove the limitation referred above, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity.
3. Determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.
4. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:
   a. If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or
   b. If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive:
      i. Withdraw from the audit, where practicable and possible under applicable law or regulation; or
      ii. If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.
5. If the auditor withdraws as above , before withdrawing, the auditor shall communicate to those charged with governance.



TEST YOUR KNOWLEDGE

1. **Super Duper Ltd. is a company engaged in the manufacture of office furniture. M/s Young Old & Associates are the statutory auditors of the company for the FY 2020-21. During the year under audit, the engagement partner CA Young noticed that the company has not bifurcated its loans into long term and short term. CA Young understands that such misstatement is not pervasive though the same is material. Explain the type of opinion that should be given by M/s Young Old & Associates in this case.**

Answer:

M/s Young Old & Associates should give a qualified opinion as the effect of the misstatement on account of the non-bifurcation of loans into long term and short term loans, is material but not pervasive.

2. **M/s Taj Raj & Associates are the statutory auditors of Polex Ltd. engaged in the manufacture of premium watches, for the FY 2020-21. During the course of audit, CA Taj, the engagement partner found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Both the facts are not reflected in the financial statements for the year ending 31.03.2021. Accordingly, CA Taj is of the view that the impact of both the situations on the financial statements is material and pervasive and thus, the financial statements represent a distorted view of the state of affairs of the company. Explain the reporting requirements of CA Taj.**

Answer:

In the case Polex Ltd., CA Taj found that the stocks and debtors of the company constituting about 80% of the total assets of the company are not realisable. Further, the cashier of the company has committed a fraud during the year under audit. Such situations are not reflected in the financial statements of the company despite having a material and pervasive impact on the financial statements. As such, CA Taj should give an adverse opinion.

Further, CA Taj should also consider the reporting responsibilities under CARO 2020 and section 143(12) of the Companies Act, 2013.

3. **Delightful Ltd. is a company engaged in the production of smiley balls. During the FY 2020-21 the company transferred its accounts to computerised system (SAP) from manual system of accounts. Since the employees of the company were not well versed with the SAP system, there were many errors in the accounting during the transition period. As such the statutory auditors of the company were not able to extract correct data and reports from the system. Such data was not available manually also. Further, the employees and the management of the company were not supportive in providing the requisite information to the audit team. Explain the kind of audit report that the statutory auditor of the company should issue in this case.**

Answer:

When the statutory auditor of the company is unable to obtain sufficient and appropriate audit evidence, the auditor should give disclaimer of opinion as per SA 705.

In the present case, the statutory auditor of the company is unable to extract correct data and reports from the SAP system for conduct of audit. Also, such data and reports are not available manually. As such, the statutory auditor of Delightful Ltd. should give a disclaimer of opinion.

4. **M/s Daisy & Associates are the statutory auditors of Zebra Ltd. for the FY 2020-21. CA Daisy, the engagement partner wants to verify the cash in hand as on 31.03.2021. The cash balance of the company as on 31.03.2021 is Rs. 1,00,000/- and the turnover of the company for the year is Rs. 6 crores. The management of the company informs CA Daisy that such cash verification is not possible as the cashier is on leave for his marriage and no other employee of the company is available as all are busy in year ending activities. Explain the relevant provisions to deal with such a situation.**

Answer:

Refer SA 705 Point H and then write the below conclusion.

In the present case CA Daisy, the statutory auditor is unable to verify the cash in hand of Zebra Ltd. as on 31.03.2021. The same is due to a limitation imposed by the management of Zebra Ltd. which is due to the non-availability of the cashier. In such situation, CA Daisy should perform alternate procedures to verify the cash on hand of the company. Further, CA Daisy should consider the impact on the auditor's report and may consider issuing a qualified opinion in this case.

SA 706 - "EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT"

A. DEFINITIONS:

1. **EMPHASIS OF MATTER PARAGRAPH:** Emphasis of Matter paragraph is a paragraph included in the auditor's report that refers to a <u>matter appropriately presented or disclosed</u> in the financial statements that, in the auditor's judgement, is of such importance that it is <u>fundamental to users' understanding</u> of the financial statements.
2. **OTHER MATTER PARAGRAPH:** Other Matter paragraph is a paragraph included in the auditor's report that refers to a matter <u>other than those presented or disclosed in the financial statements</u> that, in the auditor's judgement, is relevant to users' understanding of the audit, <u>the auditor's responsibilities</u> or the auditor's report.

B. USAGE OF EMPHASIS OF MATTER PARAGRAPH:

1. The auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:
   a. The auditor would <u>not be required to modify the opinion</u> in accordance with SA 705 as a result of the matter; and

b. When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.

2. Some examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph.
   a. An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
   b. A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
   c. Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
   d. A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

C. PRESENTATION OF EMPHASIS OF MATTER PARAGRAPH: When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

1. Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter."
2. Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and
3. Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

D. EMPHASIS OF MATTER PARAGRAPH IS NOT A SUBSTITUTE: An Emphasis of Matter paragraph is not a substitute for:

1. A modified opinion in accordance with SA 705 when required by the circumstances of a specific audit engagement;
2. Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or
3. Reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

E. USAGE OF OTHER MATTER PARAGRAPH:

1. The auditor shall include an Other Matter paragraph in the auditor's report, provided:
   a. This is not prohibited by law or regulation; and
   b. When SA 701 applies, the matter has not been determined to be a key audit matter to be communicated in the auditor's report.
2. When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading.

F. **COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE:** If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph.

TEST YOUR KNOWLEDGE:

1. **Lomaxe Ltd. is a company engaged in the business of manufacture of candles. CA Kamalnath is the statutory auditor of the company for the FY 2020-21. During the year under audit, there was a fire in the company's factory as a result of which, some of the company's plant and machinery was destroyed. The same was disclosed by the company in the notes to accounts annexed to the financial statements for the year ending 31.03.2021. CA Kamalnath decided to communicate this matter in the auditor's report as he is of the view that the matter is of such importance that it is fundamental to the user's understanding of the financial statements. Help CA Kamalnath to deal with this situation in the auditor's report.**

Answer:

In the present case there is a need to add Emphasis on Matter Paragraph in the Auditor's Report. The draft of the same is as under:

Emphasis of Matter – Effects of Fire in Company's Factory

We draw attention to Note Y of the financial statements, which describes the effects of a fire in the Company's factory. Our opinion is not modified in respect of this matter.

2. **D Ltd. is a company engaged in publishing business magazines. CA P is the statutory auditor of the company. The company takes property in the barter deal from its real estate customers against publication of their advertisements. The properties obtained during the year through such barter deals have been considered in the books of accounts on the basis of possession letter only and have been included in PPE in the financial statements. Considering this matter of such importance that is fundamental to the users understanding, CA P has decided to communicate the same in his report. CA P seeks your guidance in reporting this matter in his audit report.**

Answer:

Emphasis of Matter paragraph: A paragraph included in the auditor's report that refers to a matter presented or disclosed in the financial statements.

USAGE OF EMPHASIS OF MATTER PARAGRAPH: Emphasis of Matter paragraph is used to draw user's attention to a matter which is important for user's understanding of F/S's in view of the auditor's judgment.

The auditor shall include an Emphasis of Matter paragraph only he has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the F/S's.

In the given case, the auditor of D Ltd considers that the matter of such importance that is fundamental to the users understanding, hence it needs to be highlighted in Emphasis of Matter Paragraph.

REPORTING REQUIREMENTS AS PER COMPANIES ACT

Q.NO.1 EXPLAIN THE REPORTING RERQUIREMENTS OF THE AUDITOR U/S 143(1)?

ANSWER:

REPORTING REQUIREMENTS UNDER SECTION 143(1): The auditor has to make inquires on following matters under section 143(1) of Companies Act, 2013:-

a. whether loans and advances made by the company
    i. on the basis of security have been properly secured and
    ii. whether the terms on which they have been made are prejudicial to the interests of the company or its members;
b. whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;
c. where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;
d. whether loans and advances made by the company have been shown as deposits;
e. whether personal expenses have been charged to revenue account;
f. where it is stated in the books and documents of the company that any shares have been allotted for cash,
    i. whether cash has actually been received in respect of such allotment, and
    ii. if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading

Note: The auditor is required to report on the above matters only he finds answer to any of these matters in adverse (negative remarks).

Q.NO.2 EXPLAIN THE REPORTING RERQUIREMENTS OF THE AUDITOR U/S 143(3)?

ANSWER:

As per section 143(3), the auditor's report shall also state–

a. whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
b. whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
c. whether the report on the accounts of any branch office of the company audited by a person other than the company's auditors has been sent to him and the manner in which he has dealt with it in preparing his report;
d. whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
e. whether, in his opinion, the financial statements comply with the accounting standards;
f. the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
g. whether any director is disqualified from being appointed as a director under sub- section (2) of the section 164;
h. any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
i. whether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls;

   Note: However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall not be applicable to a private company which is a–
   i. One person company; or
   ii. Small company; or
   iii. Company having turnover less than Rs. 50 crores as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less than Rs. 25 crores.
j. such other matters as may be prescribed. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 prescribes the other matters to be included in auditor's report, which are as follows:
   i. whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
   ii. whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;
   iii. whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.
   iv.
      1. Whether the management has represented that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been advanced or loaned or invested (either from borrowed funds or share premium or any other sources or kind of funds) by the company to or in any other person(s) or entity(ies), including foreign entities **("Intermediaries"),** with the understanding, whether recorded in writing

or otherwise, that the Intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company **("Ultimate Beneficiaries")** or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries;

2. Whether the management has represented, that, to the best of it's knowledge and belief, other than as disclosed in the notes to the accounts, no funds have been received by the company from any person(s) or entity(ies), including foreign entities **("Funding Parties"),** with the understanding, whether recorded in writing or otherwise, that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party **("Ultimate Beneficiaries")** or provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries; and
3. Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to their notice that has caused them to believe that the representations under sub-clause (i) and (ii) contain any material misstatement.

v. Whether the dividend declared or paid during the year by the company is in compliance with section 123 of the Companies Act, 2013.

vi. Whether the company, in respect of financial years commencing on or after the 1st April, 2022, has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility and the same has been operated throughout the year for all transactions recorded in the software and the audit trail feature has not been tampered with and the audit trail has been preserved by the company as per the statutory requirements for record retention.

Note: The auditor is required to report on matters specified under section 143(3) in all the cases (irrespective of positive or negative comments).

TEST YOUR KNOWLEDGE:

1. **State the matters to be included in the auditors report as per Rule 11 Companies (Audit and Auditors) Rules, 2014.**

Answer: Write clause (j) from above answer.

Q.NO.3 EXPLAIN THE REPORTING RERQUIREMENTS OF THE AUDITOR COMPANIES (AUDITOR'S REPORT ORDER, 2020 [CARO, 2020]?

ANSWER:

COMPANIES (AUDITOR'S REPORT ORDER, 2020 [CARO, 2020] is an additional reporting requirement prescribed by the Central Government, after consultation with the National Financial Reporting Authority constituted

A. **APPLICABILITY OF THE ORDER:** The order applies to every company including a foreign company. However, it shall not apply to following classes of companies:

1. A banking companies
2. An insurance company
3. A company licensed to operate under section 8 of the Companies Act;
4. A One Person Company.
5. A Small company and
6. A Private Limited Company:
   a. Not being a subsidiary or holding company of a public company and
   b. The Total Paid up capital and reserves & surplus shall not exceed Rs. 1 Crore as on the balance sheet date and
   c. The Total Borrowings from banks and financial institutions shall not exceed Rs. 1 Crore at any point of time during the financial year and
   d. Total Turnover calculated as per Schedule III (including revenue from discontinuing operations) shall not Exceed Rs. 10 crores during the financial year as per the financial statements.

B. **POINTS TO BE KEPT IN MIND WHILE CALCULATING ABOVE PARAMETERS:**

1. **Paid up share capital:**
   a. **Inclusions:** It includes both equity share capital as well as the preference share capital.
   b. **Exclusions:** It excludes share application money received pending allotment, calls in arrears and calls in advance.
2. **Reserves and surplus:**
   a. It includes all the reserves (whether capital or revenue reserves) as disclosed in the Schedule III of the companies act, 2013.
   b. Revaluation reserve, if any, should be taken into consideration while determining the applicability of CARO.
   c. The debit balance of the profit and loss account, if any, should be reduced from the figures of Reserves & Surplus same as per Schedule III.
   d. If there any excess debit balance of profit and loss account after adjustment to Reserves & Surplus, then such excess can be netted off against Paid up Capital also.
   e. Provisions are excluded whether they are made for depreciation or for Diminution in the value of assets or for any known liability.
3. **Borrowing:**
   a. Loans taken from banks and financial institutions are only to be considered.
   b. It includes all the loans irrespective of nature of loans:
      i. Whether term loans, demand loans, working capital loans, cash credits, and overdraft, bills purchased and discounted.
      ii. Whether loans whether secured or unsecured.
   c. The limit shall be computed with reference to the aggregate borrowings from all banks and financial institutions cumulatively but not as per each bank or financial institute basis.

d. The limit shall be considered at any point of time during the financial year i.e., on any day during the year but need not on the date of balance sheet.
e. Where the company has taken any overdraft facility against Fixed Deposits, the gross amount outstanding in overdraft facility (without adjusting Fixed Deposit) shall be considered for the purpose of CARO.
f. Amounts outstanding in respect of credit Cards also would also be considered.

4. **Turnover:**
   a. Revenue means the aggregate amounts of sales affected by the company including the revenue from discontinuing operations.
   b. It includes sale of goods, services & any other operating revenues earned by the company.
   c. GST shall be deducted from the Turnover.
   d. It excludes sales returns and trade discounts, if any.
5. **Additional points:**
   a. **In the case of holding and subsidiary companies:**
      i) The limits for applicability of CARO should be computed on the basis of standalone financial statements of holding and subsidiary companies separately but not on the basis of consolidated financial statements.
      ii) CARO, 2020 reporting shall not apply to the Auditor's Report on Consolidated Financial Statements "EXCEPT Clause XXI".
   b. **In the case of companies having branches:**
      i) The limits for the purpose of Applicability of CARO shall be computed from the entire company's view including the amounts form all the branches but not w.r.t each branch wise.
      ii) Once it is applicable to the company as a whole, then each and every branch of the company will be covered under CARO. Therefore, all the branch auditors of the company are also required to report on these 21 matters in their branch audit report of the concerned branches.

C. CLAUSES TO BE REPORTED: The following matters are required to be reported by the auditor in his audit report as per CARO 2020

I. PROPERTY, PLANT AND EQUIPMENT:

a. **Maintenance of Records:** Whether the company is maintaining proper records showing full particulars including:
   i) Quantitative details of PPE and Intangible Assets and
   ii) Situation of PPE.
b. **Physical verification:**
   i) Whether these fixed assets have been physically verified by the management at reasonable intervals.
   ii) Whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of accounts.

c. **Immovable Properties:** Whether the title of immovable properties is held in the name of the company. If not, provide the details of the same:
   i) Description of the Property
   ii) Gross Carrying Value
   iii) Held in Name of
   iv) Whether Promoter or director or employees
   v) Period held
   vi) Reason for Not being held in name of Company.

d. **Revaluation:** Whether the company has revalued its Property, Plant and Equipment or intangible assets or both during the year and, if so:
   i) Whether the revaluation is based on the valuation by a Registered Valuer.
   ii) Specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets.

e. **Benami transactions:** Whether any proceedings have been initiated or are pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made there under, if so, whether the company has appropriately disclosed the details in its financial statements.

II. INVENTORY:

a. **Physical verification:** Whether physical verification of inventory has been conducted at reasonable intervals by the management.
   i) Whether the coverage and procedure of such verification by the management is appropriate
   ii) Whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account.

b. **Working capital loans:** Whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets;
   i) Whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details

III. INVESTMENTS, GUARANTEE, SECURITY, LOANS OR ADVANCES GIVEN BY COMPANY:

a. **Loans to related parties:** Whether during the year the company has provided loans or provided advances in the nature of loans, or stood guarantee, or provided security to any other entity [not applicable to companies whose principal business is to give loans], if so, indicate:
   i) The aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to subsidiaries, joint ventures and associates.

ii) The aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to parties other than subsidiaries, joint ventures and associates.

b. **Terms and conditions:** Whether the investments made, guarantees provided, security given and the terms and conditions of the grant of all loans and advances in the nature of loans and guarantees provided are not prejudicial to the company's interest.

c. **Repayment:** In respect of loans and advances in the nature of loans, whether the schedule of repayment of principal and payment of interest has been stipulated and whether the repayments or receipts are regular.

d. **Overdue > 90 days:** If the amount is overdue, state the total amount overdue for more than ninety days, and whether reasonable steps have been taken by the company for recovery of the principal and interest.

e. **Rescheduling or extension of overdue loans:** Whether any loan or advance in the nature of loan granted which has fallen due during the year, has been renewed or extended or fresh loans granted to settle the over dues of existing loans given to the same parties, if so,
   i) Specify the aggregate amount of such dues renewed or extended or settled by fresh loans and
   ii) The percentage of the aggregate to the total loans or advances in the nature of loans granted during the year [not applicable to companies whose principal business is to give loans].

f. **Demand loans without repayment period:** Whether the company has granted any loans or advances in the nature of loans either repayable on demand or without specifying any terms or period of repayment, if so,
   i) Specify the aggregate amount, percentage thereof to the total loans granted,
   ii) Aggregate amount of loans granted to Promoters, related parties

IV. OTHER LOANS, INVESTMENTS, GUARANTEES MADE BY COMPANY:

In respect of loans, Investments, Guarantees, and securities provided by company, whether provisions of section 185 & 186 have been complied with? If not, provide the details thereof.

V. ACCEPTANCE OF DEPOSITS: In case the company has accepted deposits from the public,

a. Verify the compliance with the following:
   i) The provisions of Sections 73 to 76 of the Co.'s Act, 2013 or
   ii) Whether the directives issued by the RBI and
   iii) An order passed by CLB or any court or any other Tribunal, if any.

b. If there is any Non-compliance, the nature of contraventions should be stated.

VI. MAINTAINING COST RECORDS:

a. Whether maintenance of cost records has been prescribed by the Central Government under sub section (1) of section 148 of the Co.'s Act, 2013 is applicable.

b. If applicable, whether such accounts and records have made and maintained.

VII. STATUTORY DUES:

a. **UNDISPUTED DUES:**

   i) Is the company regular in depositing undisputed statutory dues e.g. provident fund, ESI, Income Tax, service tax and any other statutory dues with the appropriate authorities, and

   ii) if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date, they became payable, shall be indicated by the auditor.

b. **DISPUTED DUES:**

   In case dues have not been deposited on account of any dispute, the auditor shall indicate

   i) The amounts involved in dispute and

   ii) The forum where dispute is pending.

   Note: A mere representation to the concerned department shall not constitute a dispute.

VIII. DISCLOSURE OF UNDISCLOSED INCOME: Whether any transactions not recorded in the books of account have been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (43 of 1961), if so, whether the previously unrecorded income has been properly recorded in the books of account during the year.

IX. REPAYMENT OF LOANS:

a. **Default in repayment:** whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported lender wise.

b. **Wilful defaulter:** Whether the company is a declared willful defaulter by any bank or financial institution or other lender.

c. **Purpose of term loans:** Whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported.

d. **Usage of Short term loans:** Whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated.

e. **Loans taken to meet subsidiary company needs:** Whether the company has taken any funds from any entity or person on account of or to meet the obligations of its subsidiaries, associates or joint ventures, if so, details thereof with nature of such transactions and the amount in each case.

f. **Loan against pledge of securities of subsidiaries:** Whether the company has raised any loans during the year "on pledge of securities held in subsidiary/associate/joint venture and if so,

   i) Give details thereof

   ii) Also report whether the company has defaulted in repayment of such loans.

X. UTILISATION OF IPO/FPO:

a. **IPO / FPO:**

   i) Whether the money raised by way of initial or further public offer (including debt instruments) were utilized for the purposes for which those are raised.

ii) If not, the details along with the defaults, delays & subsequent rectifications, if any, to be reported.

b. **Preferential allotment / Private placement of shares:**

i) Whether the company has made any preferential allotment or private placement of shares or fully or partly convertible debentures during the year under review &

ii) If so, verify the following:

- Compliance with section 42 and 62 of the act. and
- The amount raised have been used for the purpose for which they are raised.

iii) If not provide the details in respect of the amount involved & nature of non-compliance

XI. REPORTING OF FRAUDS:

a. Whether any fraud by the company or on the company has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

b. Whether any report under sub-section (12) of section 143 of the Companies Act has been filed by the auditors in Form ADT-4 as prescribed under rule 13 of Companies (Audit and Auditors) Rules, 2014 with the Central Government.

c. Whether the auditor has considered whistle-blower complaints, if any, received during the year by the company.

XII. NIDHI COMPANY:

a. Whether Nidhi Company has complied with the net owned funds (i.e., net worth) to deposits in the ratio of **1:20** to meet out the liability.
i.e., for every one rupee of net owned funds, Nidhi company cannot accept more than 20 rupees of deposits.

b. Whether Nidhi Company is maintaining 10% Unencumbered term deposits as specified in Nidhi Rules, 2014 to meet out the liability.

c. Whether there has been any default in payment of interest on deposits or repayment thereof for any period and if so, the details thereof.

XIII. RELATED PARTY TRANSACTION: Whether all transaction with related parties is

a. In compliance with section 177 & 188 where applicable, &

b. Details have been disclosed in the financial statements etc., as required by applicable accounting standards.

XIV. INTERNAL AUDIT SYSTEM:

a. Whether the company has an internal audit system commensurate with the size and nature of its business.

b. Whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor.

XV. NON-CASH TRANSACTION: Whether Company has entered into any Non-Cash Transactions with directors & if so provisions of section 192 have been complied with.

XVI. NON-BANKING FINANCIAL INSTITUTION:

a. **Registration under 45IA of RBI act:** Whether the company is required to be registered under section 45-IA of Reserve Bank of India Act 1934, and If so, whether the registration has been obtained.
b. **Certificate of Registration:** Whether the company has conducted any Non-Banking Financial or Housing Finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934.
c. **Core investment company:**
   - **i)** Whether the company is a Core Investment Company (CIC) as defined in the regulations made by the Reserve Bank of India, if so,
   - **ii)** Whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria.
   - **iii)** Whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICs which are part of the Group.

XVII. CASH LOSSES: Whether the company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the amount of cash losses.

XVIII. RESIGNATION OF AUDITORS:

a. Whether there has been any resignation of the statutory auditors during the year, if so,
b. Whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors.

XIX. INFORMATION ABOUT FINANCIAL ASSETS AND LIABILITIES ETC:

a. On the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans,
b. Whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date.

XX. UNSPENT CSR EXPENDITURE AMOUNT:

a. Whether, in respect of other than ongoing projects, the company has transferred unspent amount to a Fund specified in Schedule VII to the Companies Act within a period of six months of the expiry of the financial year in compliance with second proviso to sub-section (5) of section 135 of the said Act.
b. Whether any amount remaining unspent under sub-section (5) of section 135 of the Companies Act, pursuant to any ongoing project, has been transferred to special account in compliance with the provision of sub-section (6) of section 135.

XXI. QUALIFICATION/ADVERSE REMARKS:

a. Whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies included in the consolidated financial statements,

b. if yes, indicate the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.

NOTE:

a. Where, in the auditor's report, the answer to any of the above matters, are unfavourable or qualified, the auditor's report shall also state the basis for such unfavourable or qualified answer, as the case may be.

b. Where the auditor is unable to express any opinion on any specified matter, his report shall indicate such fact together with the reasons as to why it is not possible for him to give his opinion on the same.

TEST YOUR KNOWLEDGE:

1. Gill Pvt Ltd's Paid Up Capital and Reserves are less than Rs.100 Lakhs and it has no Borrowings from any Bank or Financial Institution. Its Sales are Rs.12 Crores before deducting Trade Discount Rs. 20 Lakhs and Sales Returns Rs.190 Lakhs. The services rendered by the Company amounted to Rs.20 Lakhs. Comment on applicability of CARO to this Company.

Answer:

CARO will be exempted for a Private Limited Company:

1 Not being a subsidiary or holding company of a public company and

2 The Total Paid up capital and reserves & surplus shall not exceed Rs. 1 Crore as on the balance sheet date and

3 The Total Borrowings from banks and financial institutions shall not exceed Rs. 1 Crore at any point of time during the financial year and

4 Total Turnover calculated as per Schedule III (including revenue from discontinuing operations) shall not Exceed Rs. 10 crores during the financial year as per the financial statements

In the given case, Total revenue = 12crores – 0.2 crores – 1.9 crores + 0.2 crores = 10.1 crores.

Hence CARO will be applicable for Gill Pvt Ltd.

2. Royal Pvt. Ltd. is the Holding Company of Goyal Ltd. and the following are the details w.r.t Royal Pvt Ltd:

Paid Up Capital and Reserves	**Rs. 30 Lakhs**
The Borrowings from SBI is	**Rs. 60 Lakhs**

Total Revenue from Operations (including from Discontinuing Operations) Rs. 8 Crores

The Auditors of Royal Pvt Ltd is of the view that CARO is not applicable since it is a Private Limited Company satisfying the condition relating to Paid up Capital, Borrowings and Total Revenue. Is their contention valid?

Whether CARO reporting is applicable for reporting on Consolidated Financial Statements?

Answer:

Write about applicability of CARO for Private Limited Company.
In the given case Royal Pvt Ltd is the holding company of Goyal Ltd, which is a public company.

Hence CARO is applicable for Royal Pvt Ltd.
Further, CARO reporting shall not be applicable for consolidated financial statements except clause XXI

3. APPLICABILITY OF CARO 2020

The following particulars are given in relation to private companies.

Sales	**9 Crores**
Excise duty collected and accounted separately	**50 Lakhs**
Sales tax collected and accounted separately	**75 Lakhs**
Sales return	**20 Lakhs**
Commission paid to third party	**30 Lakhs**

Answer:

Write about applicability of CARO for Private Limited Company.

In the given case, Excise Duty and Sales Tax are recorded separately. Hence should not be considered for turnover. Sales Return should be deducted from sales. Commission on the sales should not be considered. Therefore, CARO 2020 is not applicable assuming all other conditions are satisfied.

Hence Total Revenue is 8.8 crores.

Assuming all other conditions are satisfied CARO will not be applicable.

4. FN Ltd, a Benefit Fund, registered under NBFC Regulations, is in existence for the past two decades. On 31st December 2021, this Company is converted into a Bank. You have been appointed as an Auditor for the Financial Year 2020-21. Comment whether CARO is applicable for this Company.

Answer:

1. Banking Companies are exempted from CARO Reporting Requirements.

2. As on the date of B/Sheet, the Company is a Banking Company. Hence, CARO is not applicable, irrespective of the fact that the Company was converted from NBFC during the year.

5. **CA Jayesh is appointed as the Auditor of KP Pvt Unlimited, a Company registered under Companies Act, with Unlimited Liability. For Financial Year 2020-21, the Company had a total Revenue of Rs.8 Crores, Borrowings from Banks and FI of Rs.86 Lakhs and Paid - Up Capital with Reserves of Rs.97 Lakhs. Explain whether his Audit Report must include CARO.**

Answer:

- The term "Private Limited Company", as used in the exemption from CARO, should be construed to mean a Company registered as a "Private Company" [as defined in Sec.2(68)], and which has a Limited Liability.
- So, CARO would be applicable to Private Unlimited Companies, irrespective of the size of their Paid- Up Capital and Reserves, Total Revenue, Borrowings from Banks/Financial Institutions.
- Hence, in the present case, Total Revenue / Capital Base / Borrowings Criterion need not be considered for the Company and CARO is applicable fully to KP Pvt. Unlimited.

6. **Enter Pvt. Ltd has 2 Branches - in Chennai and in Mumbai. Each Branch has a separate Statutory Auditor and the Company, as a whole, has a Central Statutory Auditor. Comment which of these Auditors must comply with CARO.**

Particulars	Chennai Branch	Mumbai Branch	Total
Paid up capital and reserves	40 lakhs	70 lakhs	110 Lakhs
Borrowings from Banks	10 lakhs	26 lakhs	36 lakhs
Total Revenue	3 crores	6 crores	9 crores

Answer:

Conditions to be satisfied for being exempt from CARO are laid down for the Company taken as a whole. So, if CARO is applicable to the Company as a whole, then each and every Branch of the Company will also be automatically covered under CARO (irrespective of the fact that the Branch's transactions are within the limits).

The Branch Auditor has the same reporting responsibilities in respect of the Branch, as those of the Company Auditor in respect of the Company. The comments of the Branch Auditor in respect of the Branch are dealt with by the Central Statutory Auditor of the Company while finalizing his report under CARO.

In the given case, the Company has a Paid up Capital and Reserves of Rs.110 Lakhs, which exceeds the exemption limit Rs.100 Lakhs /1 Crore. CARO is applicable for the Company.

So, in this case, all the 3 Auditors. (2 Branch Auditors + Central Statutory, Auditor) must comply with CARO.

7. **H Private Ltd had taken Overdrafts from SBI & HSBC with a limit of Rs. 40 Lakhs each against the security of Fixed Deposit it had with those Banks and an Unsecured Overdraft from a Financial Institution of Rs.29 Lakhs. The said loans were outstanding as at 31st March. The Paid Up Capital and Reserves of the Company as at that date was Rs. 80 Lakhs and its Total Revenue during the financial year ended on 31st March was Rs.6 Crores. The Management of the Company is of the opinion that CARO is not applicable to it because Total Revenue and Paid-Up Capital were within the limits prescribed and Borrowings against the Fixed Deposit cannot be considered. The Company further contended that Borrowings Limit is to be reckoned per Bank or Financial Institution and not cumulatively. Comment.**

Answer:

Points to be kept in mind while calculation borrowings:

1. BORROWINGS AGAINST FD: Amount Outstanding must be included in determining the limit. It should not be netted off against the amount of Fixed Deposit
2. "BORROWINGS FROM ANY BANK": Total Borrowings from all Banks & Financial Institutions should be considered cumulatively, and not on "per Bank / FI basis". Thus, all Loans / Borrowings (secured or unsecured) should be included.

Total Borrowings in this case = Rs.40 + Rs.40 + Rs.29 = Rs.109 Lakhs = Rs.1.09 Crores.

Since Borrowings > Rs.1 Crore, CARO Reporting is applicable to the Company.

8. **G Pvt. Ltd. Had fully paid up Capital and Reserves of X 1.20 crore as at the end of F.Y 2020- 2021. During the F.Y 2021-2022, business was interrupted due to Covid restrictions and therefore the company incurred losses to the tune of 25 lacs. During the year, the company also borrowed X 55 lakh each from a bank and a financial institution independently. It had a turnover of X 850 lakh (other than revenue of X 250 lakh from discontinuing operations). Ascertain whether CARO, 2020 is applicable to the company.**

Answer:

First write the conditions for applicability of CARO for Private limited company.

In the given case,

Paid up capital as on Balance sheet date (i.e., on 31/02/22) = 120 Lakhs -25 Lakhs = 95 Lakhs

Borrowings = 55 Lakhs *2 = 110 Lakhs

Total Revenue = 850 Lakhs + 250 Lakhs = 1100 Lakhs

In the given case, since the condition relating to borrowings and revenue is violated, CARO will be applicable.

9. **The company has 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. Explain reporting requirement under CARO, 2020.**

Answer:

Clause (ii) of Para 3 of CARO, 2020, requires the auditor to report

a. whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account;
b. whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

In the given case, the above requirement of physical verification of inventory by the management has not been taken place and therefore the auditor should point out the same under CARO, 2020. He may consider the impact on financial statement and report accordingly.

Q.NO.4 WHAT ARE THE DUTIES OF THE AUDITOR REGARDING THE REPORTING ON FRAUD IDENTIFIED BY THE AUDITOR IN ACCORDANCE WITH SEC. 143(12)?

ANSWER:

According to section 143(12) and Rule 13 of the Companies (Audit and Auditors) Rules, 2014, the following are the duties of auditor in relation to any fraud identified during the course of his audit:

A. IF THE AMOUNT OF FRAUD IS ₹ 1 CRORE OR MORE:

1. **Reporting to the Central Government:** If the auditor has reason to believe that an offence of fraud involving an amount of **₹** 1 crore or above, is being or has been committed in the company **by its officers or employees**, the auditor shall report the matter to the CG in the following manner.

2. **The manner of reporting the matter to the Central Government is as follows: [Rule 13]**

a. First, the auditor shall report the matter to the Audit Committee or BOD (if there is no Audit Committee), as the case may be, within 2 days of his knowledge of the fraud, seeking their reply or observations within 45 days.
b. On receipt of such reply or observations, the auditor shall forward his report and the reply or observations of the Board or the Audit Committee along with his comments on such reply or observations to the CG within 15 days from the date of receipt of such reply or observations.
c. In case the auditor fails to get any reply or observations within the stipulated period of 45 days, he shall forward his report to the CG along with a note containing the details of his report that was earlier forwarded to the Board or the Audit Committee for which he has not received any reply or observations;
d. The report shall be on the letter-head of the auditor containing postal address, e-mail address and contact telephone number or mobile number and be signed by the auditor with his seal and shall indicate his Membership Number; and
e. The report shall be in the form of a statement as specified in Form ADT-4**.**

B. IF THE AMOUNT OF FRAUD IS LESS THAN ₹ 1 CRORE:

1. **Reporting to the Audit Committee or Board:** If the auditor has reason to believe that an offence of fraud involving an amount of less than ₹ 1 Crore, is being or has been committed in the company **by its officers or employees**, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases, within 2 days of knowledge of fraud, specifying the following:
   a. Nature of Fraud with description;
   b. Approximate amount involved; and
   c. Parties involved.

2. **Disclosure in the Board's Report:** The following details of each of the fraud reported to the Audit committee or the Board but not reported to CG, shall be disclosed in board's report:
   a. Nature of Fraud with description;
   b. Approximate Amount involved;
   c. Parties involved, and
   d. Remedial actions taken.

C. APPLICBILITY TO COST AUDITOR AND SECRETARIAL AUDITORS:

The provisions regarding fraud reporting shall also apply, mutatis mutandis, to a cost auditor and a secretarial auditor during the performance of his duties under section 148 and section 204 respectively.

D. PUNISHMENT FOR NONCOMPLIANCES:

If any auditor, Cost Accountant, or company secretary in practice does not comply with the provisions of sub-section (12), he shall:

1. In case of a listed company, be liable to a penalty of 5 lakh rupees; and
2. In case of any other company, be liable to a penalty of 1 lakh rupees.

Besides, auditor has also to report matters pertaining to fraud at point (xi) of paragraph 3 of CARO,2020 which is discussed subsequently.

TEST YOUR KNOWLEDGE:

1. **Mr. A is appointed as Statutory auditor of a company for the financial year ended 31st March 2018.During the course of Audit it was found that few doubtful transactions had been committed by Finance manager who retired in March 2018.The Fraud was going on Since last 2-3 years and the total amount misappropriated exceeding ₹ 100 lakhs. As a statutory auditor. What would be reporting responsibilities of Mr. A?**

Answer: Write point A from the above question

2. **The head accountant of a company entered fake invoices of credit purchases in the books of account aggregate of ₹ 50 lakh and cleared all the payments to such bogus creditor. Here, the auditor of the company is required to report the fraudulent activity. Explain the reporting requirements of the auditor in this regard.**

Answer: Write point B from the above question

Q.NO.5 WHAT ARE THE DISCLOSURE REQUIREMENTS IN AUDITOR REPORT REGARDING AS -1?

ANSWER:

In the case of a company, members should qualify(modify) their audit reports in case –

1. Accounting policies required to be disclosed under Schedule III or any other provisions of the Companies Act, 2013 have not been disclosed, or
2. Accounts have not been prepared on accrual basis, or
3. The fundamental accounting assumption of going concern has not been followed and this fact has not been disclosed in the financial statements, or
4. Proper disclosures regarding changes in the accounting policies have not been made.

Note: Where a company has been given a specific exemption regarding any of the matters stated above but the fact of such exemption has not been adequately disclosed in the accounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.

BRANCH AUDIT

Q.NO.6 WRITE ABOUT AUDIT OF BRANCH OFFICE ACCOUNTS?

ANSWER:

1. **MAINTANANCE OF BRANCH ACCOUNTS:**

a. Section 128(1) of the Companies Act, 2013 provides that every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statements for every financial year, including that of its branch office or offices, on accrual basis and according to the double entry system of accounting.
b. The Board of Directors may, however, decide to keep all or any of the aforesaid books of account and other relevant papers at such other place in India.
c. In such circumstances, the company shall, within seven days thereof, file with the Registrar a notice in writing giving the full address of that other place.
d. Where a company has a branch office in India or outside India, proper books of account relating to the transactions at the branch office can be kept at that office and proper summarised returns periodically shall be sent by the branch office to the company at its registered office

2. **WHO CAN BE APPOINTED AS A BRANCH AUDITOR:** Where a company has a branch office, the accounts of that office shall be audited either by:
   a. The auditor appointed for the company (i.e., Principal auditor) or
   b. Any chartered accountant holding certificate of practice, or
   c. Where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country.

3. **WHO CAN APPOINT BRANCH AUDITORS:**
   a. Usually, the branch auditors are also appointed by the members
   b. However, the shareholders can delegate such power to BOD to appoint branch auditor.

4. **REPORTING REQUIREMENTS OF BRANCH AUDITORS:**
   a. The branch auditor shall prepare a report on the accounts of the branch examined by him.
   b. The branch auditor shall submit his report to the company's auditor.
   c. The reporting requirements u/s 143(1), (3), (11) and (12) are equally applicable to branch auditors.

TEST YOUR KNOWLEDGE:

1. **M/s Seeman & Co. had been the company auditor for Amudhan Company limited for the year 2015-16. The company had three branches located at Chennai, Delhi and Mumbai. The audits of branches-Chennai, Delhi were looked after by the company auditors themselves. The audit of Mumbai branch had been done by another auditor M/s Vasan & co.; a local auditor situated at Mumbai. The branch auditor had completed the audit and had given his report too. After this, but before finalization, the company auditor wanted to visit the Mumbai branch and have access to the inventory records maintained at the branch. The management objects to this on the grounds of the company auditor is transgressing the scope of audit areas agreed. Comment.**

Answer:

Provision : The audit of the branch of a company is dealt with in Section 143(8) of the Companies Act, 2013. According to this section, the audits of the branches can be done by the company auditor himself or by another auditor. Even where, the branch accounts are audited, the company auditor has right to visit the branch if he deems it necessary to do so for the performance of his duties as auditor.

He has also right of access at all times to the books and accounts and vouchers of the company maintained at the branch office. He can appropriately deal with the repot of the branch auditor in framing his main repot. He will disclose how he had dealt with the branch audit report.

Analysis: In this case, the audits of two branches were done by the company auditor and one branch was done by a separate branch auditor.

Applying the above provisions, to the instant case, management's objection that the company auditor is transgressing the scope of audit areas agreed, is absolutely, wrong. The right of company auditor in visiting and accessing the records of branch cannot be forfeited.

Conclusion: Even where the branch accounts are audited by another local auditor, the company auditor has right to visit the branch and can have access to the books and vouchers of the company maintained at the branch office.

Q.NO.7 WHAT PROCEDURES ARE REQUIRED TO BE PERFORMED BY PRINCIPAL AUDITOR WHEN USING THE WORK OF OTHER AUDITOR AS PER SA 600?

ANSWER:

A. DEFINITIONS:

1. **Principal auditor** means the auditor with responsibility for reporting on the financial information of an entity when that financial information includes the financial information of one or more components audited by another auditor.
2. **Other auditor** means an auditor, other than the principal auditor, with responsibility for reporting on the financial information of a component which is included in the financial information audited by the principal auditor.
3. **Component** means a division, branch, subsidiary, joint venture, associated enterprises or other entity whose financial information is included in the financial information audited by the principal auditor.

B. **USING THE WORK OF ANOTHER AUDITOR:** As per SA 600, "Using the Work of another Auditor", the principal auditor shall perform the following procedures when using the work of branch auditor:

1. Advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit.

2. The principal auditor would inform the other auditor of matters such as are as requiring special consideration and the time-table for completion of audit.
3. Advise the other auditor of the significant accounting, auditing, and reporting requirements and obtain representation as to compliance with them.
4. The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list.
5. The principal auditor may also wish to visit the other auditor.

JOINT AUDIT

Q.NO.8 WRITE ABOUT JOINTAUDIT OF FINANCIAL STATEMENTS?

ANSWER:

1. **MEANING:** Joint audit refers to the process of conducting the audit of a single organisation by more than one auditor. Large Companies with diversified business operations often resort to this process of auditing where they employ multiple auditors to conduct statutory audit. **SA 299, "Joint Audit of Financial Statements"** lays down the principles for effective conduct of joint audit

2. **BENEFITS/ADVANTAGES OF JOINT AUDIT:**
   a. Sharing of expertise.
   b. Advantage of mutual consultation.
   c. Lower workload.
   d. Better quality of performance.
   e. Improved service to the client.
   f. There may be healthy competition among the auditors which improves the quality and speed of the audit work.
   g. Under joint audit, it is possible to get the benefit of extensive knowledge of different auditors at the same time.

3. **LIMITATIONS/DISADVANTAGES OF JOINT AUDIT:**
   a. Well experienced auditors may have a superiority complex over the less experienced one.
   b. It is not suitable for a small entity due to increased costs.
   c. Lack of coordination among the auditors may slow down the speed of work.
   d. There may be uncertainty about the liability of any work.
   e. Areas of common concern may be neglected.
   f. The auditors have to share the fees.

4. **DIVISION OF WORK:**
   a. Where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves.
   b. Generally, work will be divided on the following basis:

   i. Items of assets, liabilities, incomes and expenditure
   ii. Geographical areas
   iii. Period of financial statements
   iv. Identified units

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

5. **RELATIONSHIP AMONG JOINT AUDITORS AND THEIR RESPONSIBILITY:**
   a. In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him.
   b. However, in some cases, all the joint auditors are jointly and severally responsible:
      i. In respect of audit work not divided among themselves
      ii. In respect of decisions taken by all the joint auditors
      iii. In respect of matters brought to the notice of all joint auditors
      iv. Presentation and disclosure of the financial statements as required by the applicable financial reporting framework.
      v. For ensuring that the audit report complies with relevant statute.

6. **REPORTING RESPONSIBILITIES:**
   a. Generally, all the joint auditors arrive common conclusions and express common opinion through a single audit report.
   b. However, any joint auditor is not bound by majority's opinion.
   c. If there is a difference of opinion among joint auditors, then such disagreeing auditor can express his own opinion by a separate report.
   d. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit reports

7. **DEPENDENCE ON OTHER JOINT AUDITORS:**
   a. Each joint auditor is entitled to rely upon the other joint auditors for bringing to his notice any material error noticed in the course of the audit.
   b. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner.

8. **SPECIAL CONSIDERATIONS AS PER SA 299:** This Standard deals with the special considerations in carrying out audit by joint auditors. It requires that–
   a. The engagement partner and other key members of the engagement team from each of the joint auditors should be involved in planning the audit.
   b. The joint auditors should jointly establish an overall audit strategy which sets the scope, timing, and direction of the audit, and also guides the development of the audit plan.
   c. In developing the joint audit plan, the joint auditors should:
   i. Identify division of audit areas and common audit areas;
   ii. Ascertain the reporting objectives of the engagement;

iii. Consider and communicate among all joint auditors the factors that are significant in directing the engagement team's efforts;
iv. Consider the results of preliminary engagement activities, or similar engagements performed earlier.
v. Ascertain the nature, timing and extent of resources necessary to accomplish the engagement.

d. Each of the joint auditors should consider and assess the risks of material misstatement and communicate to other joint auditors.
e. The joint auditors should discuss and document the nature, timing, and the extent of the audit procedures for common and specific allotted areas of audit to be performed.
f. The joint auditors should obtain common engagement letter and common management representation letter.
g. The work allocation document should be signed by all the joint auditors and communicated to those charged with governance.

TEST YOUR KNOWLEDGE:

1. Before the commencement of the audit, the joint auditors should discuss and develop a joint audit plan. In developing the joint audit plan, the joint auditors should identify division of audit areas and common audit areas. Explain stating the other relevant considerations in this regard.

Answer: Refer Point 8 from above answer

2. The concept of "joint audit" has legal foothold under the Companies Act, 2013. Correct/Incorrect.

Answer:

Correct: Under provisions of section 139(3), the members of a company may resolve to provide that audit shall be conducted by more than one auditor. Hence, the concept of "joint audit" has legal foothold also under Companies Act, 2013.

INTERNAL AUDIT

Q.NO.9 DESCRIBE THE PROVISIONS RELATING TO INTERNAL AUDIT AS PER COMPANIES ACT, 2013.

ANSWER:

A. MEANING: Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations.

B. APPLICABILITY OF INTERNAL AUDIT: As per section 138 of the Companies Act, 2013 the following class of companies (prescribed in Rule 13 of Companies (Accounts) Rules, 2014). Shall be required to appoint an internal auditor or a firm of internal auditors, namely:

1. Every listed company.

2. Every unlisted Public Company having:
   a. Paid up share capital of Rs. 50 crores or more as on preceding balance sheet date or
   b. Turnover of Rs. 200 crores or more as per preceding financial statements or
   c. Outstanding loans or borrowings from banks or public financial institutions Rs. 100 crores or more at any point of time during preceding financial year or
   d. Outstanding deposits of Rs. 25 crores or more at any point of time during preceding financial year.
3. Every Private Company having-
   a. Turnover of Rs. 200 crores or more as per preceding financial statements or
   b. Outstanding loans or borrowings from banks or public financial institutions Rs. 100 crores or more at any point of time during preceding financial year.

C. ELIGIBILITY TO ACT AS INTERNAL AUDITOR:

2. As per section 138, the following persons can be appointed as internal auditor which may be either an individual or a partnership firm or a body corporate:
   a. A Chartered Accountant whether engaged in practice or not.
   b. A Cost Accountant whether engaged in practice or not.
   c. Such other professional as may be decided by the Board

Internal auditor may or may not be an employee of the company.

D. OBJECTIVE AND SCOPE OF INTERNAL AUDITOR: The functioning, periodicity and methodology for conducting the internal audit i.e., objective and scope are determined by the Audit Committee or the Board after consultation with the Internal Auditor.

TEST YOUR KNOWLEDGE:

1. Windy Limited is an unlisted public limited company. During the financial year 2019-20, the paid-up share capital of Windy Limited was Rs. 60 crores. During the financial year 2020-21, Board of Directors of the company , in order to comply with the provisions of Companies Act, 2013 appointed an internal auditor. Give the justification of this appointment done by Board of Directors of Windy Limited according to the provisions of Companies Act, 2013.

Answer:

The appointment done by Board of Directors of Windy Limited is justified because according to Section 138 of the Companies Act, 2013, every unlisted public company having a paid-up share capital of Rs. 50 crore or more during the preceding financial year is required to appoint an internal auditor.

2. Extremely Fine Limited is an unlisted public limited company . For the financial year 2019-20, the turnover of the above-mentioned company was Rs. 256 crores. In order to comply with provisions of Companies Act, 2013 the Board of Directors of Extremely Fine Limited during the financial year 2020-21, appointed an internal auditor. Comment on the appointment of Internal Auditor.

Answer:

The appointment done by Board of Directors of Extremely Fine Limited is justified because according to Section 138 of the Companies Act, 2013 every unlisted public company having a turnover of Rs. 200 crore or more during the preceding financial year is required to appoint an internal auditor.

In the above-mentioned question, Extremely Fine Limited is an unlisted public company having a turnover of Rs. 256 crores for the financial year 2019-20, which is more than Rs. 200 crores, therefore during the financial year 2020-21, Extremely Fine Limited is required to appoint an internal auditor.

SA 610 – USING THE WORK OF INTERNAL AUDITORS

A. DEFINITIONS:

1. **INTERNAL AUDIT FUNCTION:** A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.
2. **DIRECT ASSISTANCE:** The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor.

B. WAYS IN WHICH THE EXTERNAL AUDITOR MAY MAKE USE OF THE FUNCTION FOR PURPOSES OF THE AUDIT:

1. While the objectives of an entity's internal audit function and the external auditor differ, the function (internal audit) may perform audit procedures similar to those performed by the external auditor in an audit of financial statements.
2. If so, the external auditor may make use of the function for purposes of the audit in one or more of the following ways:
   a. To obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud.
   b. Unless prohibited, or restricted to some extent, by law or regulation, the external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function during the period in partial substitution for audit evidence to be obtained directly by the external auditor **(Type -1)**.
   c. Unless prohibited, or restricted to some extent, by law or regulation, the external auditor may use internal auditors to perform audit procedures under the direction, supervision and review of the external auditor (referred to as "direct assistance")**(Type -2)**

C. OBJECTIVES: The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the internal audit function are:

1. To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent.
2. If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit **(Type -1)**.

3. If using internal auditors to provide direct assistance, to appropriately direct, supervise and review their work **(Type -2)**.

D. USING THE WORK OF INTERNAL AUDIT FUNCTION (TYPE-1):

1. **Factors to evaluate:** The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:
   a. The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors.
   b. The level of competence of the internal audit function; and
   c. Whether the internal audit function applies a systematic and disciplined approach, including quality control.

2. **Objectivity and its evaluation:**
   a. Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgments.
   b. Factors that may affect the external auditor's evaluation in relation to Objectivity include the following:
      i) Whether the organizational status of the internal audit function, including the function's authority and accountability, supports the ability of the function to be free from bias, conflict of interest or undue influence of others to override professional judgments.
      For example whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.
      ii) Whether those charged with governance oversee employment decisions related to the internal audit function.
      For example determining the appropriate remuneration policy.
      iii) Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.
      For example, in communicating the internal audit function's findings to the external auditor.
      iv) Whether the internal audit function is free of any conflicting responsibilities.
      For example, having managerial or operational duties or responsibilities that are outside of the internal audit function.

3. **Competence and its evaluation:**
   a. Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards.
   b. Factors that may affect the external auditor's determination in relation to competence include the following:
      i) Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.

ii) Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.
iii) Whether the internal auditors have adequate technical training and proficiency in auditing.
iv) Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework.

4. **Application of a Systematic and Disciplined Approach:**
   a. The application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity.
   b. Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:
      i) The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.
      ii) Whether the internal audit function has appropriate quality control policies and procedures.

5. **Examples of work of the internal audit function that can be used by the external auditor include the following:**
   a. Testing of the operating effectiveness of controls.
   b. Substantive procedures involving limited judgment.
   c. Observations of inventory counts.
   d. Tracing transactions through the information system relevant to financial reporting.
   e. Testing of compliance with regulatory requirements

6. **Circumstances When Work of the Internal Audit Function Cannot Be Used**: The external auditor shall not use the work of the internal audit function if the external auditor determines that:
   a. The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
   b. The function lacks sufficient competence; or
   c. The function does not apply a systematic and disciplined approach, including quality control.

7. **Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used:**
   a. As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan.

b. In other words, once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established.

8. **Circumstances in which the external auditor shall plan to use less of the work of the Internal audit function and perform more of the work directly:** The external auditor shall make all significant judgments in the audit engagement and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly if:
   a. The more judgment is involved in:
      (i) Planning and performing relevant audit procedures; and
      (ii) Evaluating the audit evidence gathered;
   b. The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant;
   c. The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and
   d. The lower the level of competence of the internal audit function.

9. **Using the Work of the Internal Audit Function:** If the external auditor plans to use the work of the internal audit function, the external auditor shall
   a. discuss the planned use of its work with the function as a basis for coordinating their respective activities.
   b. read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.
   c. perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit.

10. **Discussion and Coordination with the Internal Audit Function:** In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:
    a. The timing of such work.
    b. The nature of the work performed.
    c. The extent of audit coverage.
    d. Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.
    e. Proposed methods of item selection and sample sizes.
    f. Documentation of the work performed.
    g. Review and reporting procedures.

11. **Coordination between the external auditor and the internal audit function is effective when, for example;**
    a. Discussions take place at appropriate intervals throughout the period.
    b. The external auditor informs the internal audit function of significant matters that may affect the function.
    c. The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

E. USING THE WORK OF INTERNAL AUDITORS (TYPE - 2):

1. **Factors to be considered:** If using internal auditors to provide direct assistance, the external auditor shall evaluate:
    a. The level of independence and objectivity and
    b. The level of competence of the internal auditors who will be providing such assistance.

2. **Prohibition on using Type -2 work:** The external auditor shall not use an internal auditor to provide direct assistance if:
    a. There are significant threats to the objectivity of the internal auditor or
    b. The internal auditor lacks sufficient competence to perform the proposed work.

Note: The external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with SA 220

3. **The following areas shall not be allocated to internal auditors for direct assistance:** The external auditor shall not use internal auditors to provide direct assistance to perform procedures that:
    a. Involve making significant judgments in the audit.
    b. Relate to higher assessed risks of material misstatement where in depth audit procedures are required.
    c. Relate to work with which the internal auditors have been involved.

4. **Obtain written agreement:** Prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor shall:
    a. Obtain written agreement from an authorized representative of the entity (management) that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor; and
    b. Obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity.

F. EXTERNAL AUDITOR'S RESPONSIBILITY FOR THE AUDIT:

2. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function or internal auditors to provide direct assistance on the engagement.
3. Although they may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of financial statements in accordance with SA 200.
4. This SA, therefore, defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors.
5. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function, or internal auditors providing direct assistance, is adequate for the purposes of the audit.
6. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work.

G. DOCUMENTATION:

1. **When using type-1 work:** If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:
   a. The evaluation of:
      i. Whether the function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors;
      ii. The level of competence of the function; and
      iii. Whether the function applies a systematic and disciplined approach, including quality control;
   b. The nature and extent of the work used and the basis for that decision; and
   c. The audit procedures performed by the external auditor to evaluate the adequacy of the work used.

2. **When using Type-2 work:** If the external auditor uses internal auditors to provide direct assistance on the audit, the external auditor shall include in the audit documentation:
   a. The evaluation of the existence and significance of threats to the objectivity of the internal auditors, and the level of competence of the internal auditors used to provide direct assistance.
   b. The basis for the decision regarding the nature and extent of the work performed by the internal auditors.
   c. Who reviewed the work performed and the date and extent of that review.
   d. The written agreements obtained from an authorized representative of the entity and the internal auditors.

The working papers prepared by the internal auditors who provided direct assistance on the audit engagement.

TEST YOUR UNDERSTANDING

1. **Maithili Thakur, a CA student, was perusing audit report of a company. Her eyes fell on an 18-digit alpha numeric number stated at end of audit report below the signatures of auditor and membership number. Make her understand objective and significance of such a randomly generated number. Is it required to be stated in case of audit reports only?**

Answer:

The 18-digit alpha numeric number noticed by her at end of audit report is Unique Document Identification number (UDIN). It is a system generated unique number. Its basic objective is to curb the malpractices of non-CAs impersonating themselves as CAs. It helps in securing reports and documents issued by practising CAs. It is required to be stated in case of audit reports and certificates.

2. **CA. Maya Memani has conducted audit of a company. She has asked Sana, a CA student undergoing training in her office, to prepare draft audit report. Sana was part of engagement team conducting the audit. She has been further told to prepare draft report expressing unmodified opinion. After drafting para comprising unmodified opinion, Sana feels no need to provide basis for opinion. Discuss why her thinking is not proper.**

Answer:

"Basis for Opinion" is one of basic elements of an audit report in accordance with SA-700. Even in cases where unmodified opinion is expressed by auditor, "Basis for opinion" has to be provided by auditor. Basis for opinion section provides context about auditor's opinion. Therefore, Sana's thinking is not proper.

3. **CA. Sarasbhai Patel, while conducting audit of an entity, feels that there is an atmosphere of non-cooperation all around. He has not been provided with necessary support for attending inventory count process of entity as at year end. Besides, CFO is not providing him present addresses of customers as well as suppliers for sending external confirmations. Even mail ids have not been provided on the pretext of business confidentiality.**
   He was not able to verify revenues of entity due to lack of complete details. For verifying expenses, he has been asking for bills on a sample basis, but staff has been making lame excuses. The matter was brought to knowledge of higher echelons of management, but of no avail. The auditor feels that there could be misstatements and their possible effects would be material and affecting many aspects of financial statements.
   Assuming it is not possible to withdraw from engagement, what type of opinion should be expressed by auditor?

Answer:

In the given case, auditor has not been able to obtain sufficient appropriate audit evidence relating to inventories, debtors, creditors, revenues and expenses. The matter has brought to knowledge of management but no result has been achieved. Besides, auditor opines that there could be misstatements and their possible effects could be both material and pervasive. In such circumstances, he should make disclaimer of opinion in accordance with SA 705.

4. **CA. Dicky Yadav is auditor of a company having four branches. The four branches are audited by another auditor CA. Yamini Jain. The reports in respect of accounts of branches examined by her have already been sent to company auditor. During the course of audit, CA Dicky Yadav asks the branch auditor to share with her summary of audit procedures and findings in respect of accounts of branches examined. CA. Yamini Jain feels it as encroachment of her domain. Discuss the issue.**

Answer:

As per SA 600 - "Using the Work of Another Auditor", the principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. Such review of audit procedures and findings can be undertaken if principal auditor feels that it is necessary to apply such procedures to obtain sufficient appropriate audit evidence. It is not an encroachment of another auditor's domain.

5. **CA. Ravi Patnaik is conducting audit of a company for which reporting requirements under CARO, 2020 are applicable. He finds that cash credit facilities amounting to ₹ 4 crores were released to the company by branch of a bank for meeting its working capital requirements. He finds that out of above funds, ₹ 1 crore have been used by company for installing effluent treatment plant to meet State pollution control Board requirements. Is there any reporting obligation upon him under CARO,2020?**

Answer:

Clause (ix) (d) of CARO, 2020 whether funds raised on short term basis have been utilised for long term purposes, if yes, the nature and amount to be indicated. In the given situation, funds have been raised for meeting working capital requirements for ₹ 4 crores. Cash credit facilities for meeting working capital requirements are, by their very nature, short term borrowings. Out of above, ₹ 1 crore have been used by the company for investment in effluent treatment plant which is ostensibly for a long-term purpose. Hence, the matter needs to be reported in accordance with requirements of Clause (ix) (d) of CARO, 2020.

6. **CA Sukesh is external auditor of an entity. He comes to know that there is also an internal auditor in the entity. However, he finds that internal auditor is not reporting directly to higher echelons of the management. CA Sukesh has also assessed risk of material misstatement to be high. Discuss, whether it would be proper for CA Sukesh to rely upon work of internal auditor extensively in above situation.**

Answer:

In the given case, the organizational status of internal audit function is not commensurate with his duties. He is not reporting directly to higher echelons of management. It shows that such a function is not given its due importance in entity. Since risk of material misstatements has also been assessed as high by CA Sukesh, both the above factors suggest that he should not rely upon work of internal auditor extensively.

4.CO-OPERATIVE SOCIETIES AUDIT

INTRODUCTION

A Cooperative society is "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned enterprise."

Co-operative society is a business organisation with a special mode of doing business, by pulling together all the means of production co-operatively, elimination of middlemen and exploitation from outside forces.

TYPES OF COOPERATIVE SOCIETIES: Co-operative societies are of various types:

1. Consumers cooperative society
2. Producers cooperative society
3. Housing cooperative society
4. Cooperative credit society

GOVERNING LAWS:

The Co-operative Societies Act, 1912, a Central Act, contains the fundamental law regarding the formation and working of the co-operative societies in India and is applicable in many states with or without amendments. In many states, viz., Maharashtra, West Bengal, Orissa, the co-operative societies are governed by specific state Acts.

Besides the above, multi-state co-operative societies Act, 2002 is applicable for Multi-state co-operative societies.

Q.NO.1 EXPLAIN THE PROVISIONS RELATING TO MAINTENANCE OF BOOKS OF ACCOUNT BY CO-OPERATIVE SOCIETIES?

ANSWER:

1. **STATUTORY REQUIREMENT:** Under section 43(h) of the Central Act, a state government can frame rules prescribing the books and accounts to be kept by a co-operative society subject to covering minimum of the following details:
    a. All sums of money received and expended by the society and the matters connected therewith.
    b. All sales and purchases of goods by the society.
    c. Assets and liabilities of the society
    d. In case of societies engaged in manufacturing of goods, then the records pertaining to utilisation of material, labour etc.

2. **MAINTENANCE OF ADDITIONAL RECORDS:** The statutory provisions provide a directive, but they are not conclusive. The society is at liberty to maintain such additional records for providing

clarity and detailed explanation of financial transactions and the results in the best possible manner.

Q.NO.2 WRITE ABOUT THE SERVICES THAT CHARTERED ACCOUNTANTS CAN RENDER TO COOPERATIVE SOCIETIES APART FROM AUDIT?

ANSWER:

Apart from audit, some other professional services could be rendered by chartered accountants such as:

1. Guidance in accounts writing
2. Installation of accounting systems
3. Internal audit
4. Management accounting services
5. Taxation etc.

Q.NO.3 EXPLAIN VARIOUS RESTRICTION REGARDING THE ACTIVITIES OF COOPERATIVE SOCIETIES AS IMPOSED UNDER COOPERATIVE SOCIETIES ACT, 1912?

ANSWER:

1. **RESTRICTIONS ON SHAREHOLDINGS (Sec. 5):** The maximum amount of shareholding that a single member can hold is twenty percent of the total number of shares or value of Rs. 1,000/- whichever is lower.
2. **RESTRICTIONS ON LOANS (Sec. 29):**
   a. Society shall not make a loan to any person other than a member.
   b. However, with the special sanction of the Registrar, a registered society may make a loan to another registered society.
3. **RESTRICTIONS ON BORROWINGS (Sec. 30):** A society shall not accept loans and deposits from persons who are not members unless otherwise provided by the byelaws of the society.
4. **INVESTMENT OF FUNDS (Sec. 32):** A society may invest its funds in any one or more of the following
   a. In the Central or State Co-operative Bank.
   b. In any bank, other than a Central or State co-operative bank, as approved by the Registrar on specified terms and conditions.
   c. In any of the securities specified in section 20 of the Indian Trusts Act. 1882.
   d. In the shares, securities, bonds, or debentures of any other society with limited liability.
   e. In any other moneys permitted by the Central or State Government.
5. **APPROPRIATION OF PROFITS TO RESERVE FUND (Sec. 33):** Every society shall transfer twenty-five percentage of the profits to Reserve Fund, before distribution as dividends or bonus to members.

6. **CONTRIBUTIONS TO CHARITABLE PURPOSES (Sec. 34):** A society may. with the sanction of the Registrar, contribute an amount not exceeding 10% of the net profits remaining after the compulsory transfer to the reserve fund for any charitable purpose.
7. **CONTRIBUTION TO EDUCATION FUND:** Some of the State Acts provide that every society shall contribute annually towards the Education Fund of the State Federal Society, at the prescribed rates.
8. **ANY OTHER APPROPRIATIONS:** Apart from statutory provisions relating to Reserve Fund, the auditor may have regard to the provisions in byelaws and Rules and Regulations of the society.
9. **INVESTMENT OF RESERVE FUND OUTSIDE THE BUSINESS OR UTILISATION AS WORKING CAPITAL:** Some of the State Acts provide that a society may use the Reserve Fund:
   a. In the business of a society, as working capital (subject to the rules made in this behalf).
   b. May invest as per provisions of the Act.
   c. May be used for some public purposes likely to promote the object of the society. The auditor should ensure strict compliance with the State Act and Rules in this regard.

Q.NO.4 WRITE ABOUT APPOINTMNET OF AUDITOR OF A COOPERATIVE SOCIETY?

ANSWER:

1. **ELIGIBILITY TO GET APPOINTED AS AUDITOR:**
   a. Chartered accountants having valid Certificate of Practice issued by ICAI
   b. Any other person having qualification required by respective state Acts like persons holding a government diploma in co-operative accounts or in co-operation and accountancy and also a person who has served as an auditor in the co-operative department of a government to act as an auditor etc.

2. **AUTHORITY FOR APPOINTMENT OF THE AUDITOR:** Registrar of Co-operative Societies and the auditor so appointed conduct the audit on behalf of the Registrar and submits his report to him and to the society. The audit fees are paid by the society on the basis of statutory scale of fees prescribed by the Registrar, according to the category of the society audited.

TEST YOUR KNOWLEDGE:

1. **Mr. A, has served as an auditor in the Co-operative Department of a Government, is appointed as a statutory auditor by a Co-operative Society that has receipts over Rs.3 crores during the financial year. He is not a Chartered Accountant. Mr.B, Chartered Accountant is appointed to conduct tax audit of the society under section 44AB of the Income Tax Act, 1961. Comment.**

Answer:

Mr. M can be appointed as a statutory auditor of cooperative society, but the appointment has to be made by Registrar of Cooperative societies. Mr. D's appointment as tax auditor is also valid.

Q.NO.5 WHAT ARE SPECIAL POINTS IN AN AUDIT OF COOPERATIVE SOCIETY?

ANSWER:

1. **EXAMINATION OF OVERDUE DEBTS:** Overdue debts have far impact on the working of a credit society and affect its working capital position.
   a. **Classification:** Overdue debts for a period from 6 months to 5 years and more than 5 years must be classified and shall have to be reported by an auditor.
   b. **Assessing the recovery:** A further analysis of these overdue debts from the viewpoint of chances of recovery must be made, and they must be classified as good or bad.
   c. **Ensuring making of provisions:** The auditor must ascertain whether proper provisions for doubtful debts are made and whether the same is satisfactory.

2. **OVERDUE INTEREST:**
   a. **Meaning:** Overdue interest is interest accrued or accruing in accounts, the amount of which the principal is overdue.
   b. **Accounting Treatment:**
      i. Overdue interest should be excluded from Recognition of Interest Income while calculating profit.
      ii. Such interest will be credited to overdue interest reserve and transferred to profit and loss a/c when realised.

3. **CERTIFICATION OF BAD DEBTS:** Check the authority for writing off the bad debts.
   a. **Authorisation by auditor:** Some state acts may require that the Bad debts can be written off only when they are certified as bad by the auditor. For example, Maharashtra State Co-operative Rules, 1961.
   b. **Authorisation by the managing committee:** Where no such requirement exists, the managing committee of the society must authorise the write-off.

4. **VALUATION OF ASSETS AND LIABILITIES:**
   a. **Assets:**
      i. Ascertain existence, ownership, and valuation of assets.
      ii. Fixed assets should be valued at cost less adequate provision for depreciation.
      iii. The incidental expenses incurred in the acquisition and the installation expenses of assets should be properly capitalised.
      iv. The current assets should be valued at cost or market price, whichever is lower.

   b. **Liabilities:** The auditor should see that all the known liabilities are brought into the account, and the contingent liabilities are stated by way of a note.

5. **ADHERENCE TO CO-OPERATIVE PRINCIPLES:**
   a. **Ensure the Functioning of society towards achieving objectives:** The auditor must ascertain how far the objectives, for which the co-operative organisation is set up. have been achieved in the course of its working.

b. **Criteria for assessment:** The assessment is not necessarily in terms of profits, but in terms of extending of benefits to members who have formed the society.
c. **Principle of Propriety:** While auditing the expenses, the auditor should see that they are economically incurred and there is no wastage of funds. Middlemen commissions are, as far as possible, avoided and the purchases are made by the committee members directly from the wholesalers. The principles of propriety audit should be followed for the purpose.

6. **ENSURING COMPLIANCE WITH THE PROVISIQNS QF THE ACT AND RULES:** An auditor of a co-operative society is required to identify the non-compliance with the provisions of Co-operative Societies Act and Rules and byelaws.

7. **VERIFICATION OF MEMBER'S REGISTER AND EXAMINATION OF THEIR PASS BOOKS:** Examination of entries in members pass books regarding the loan given and its repayments, and confirmation of loan balances in person. Specifically in the rural and agricultural credit societies, members are not literate and as such this is a good safeguard on their part.

8. **SPECIAL REPORT TO THE REGISTRAR:** During the course of audit, if the auditor notices the following serious irregularities in the working of the society, then he may report these special matters to the Registrar, drawing his specific attention to the points.
   a. Personal profiteering by members of managing committee in transactions of the society, which are ultimately detrimental to the interest of the society.
   b. Detection of fraud relating to expenses, purchases, property, and stores of the society.
   c. Specific examples of mismanagement. Eg: Decisions of management against co- operative principles.
   d. In the case of urban co-operative banks, disproportionate advances to vested interest groups, such as relatives of management, and deliberate negligence about the recovery, Cases of reckless advance, where the management is negligent about taking adequate security and proper safeguards for judging the credit worthiness of the party.

9. **AUDIT CLASSIFICATION OF SOCIETY:** After a judgement of an overall performance of the society, the auditor must award a class to the society. This judgement is to be based on the criteria specified by the Registrar. It may be noted here that if the management of the society is not satisfied about the award of audit class, it can make an appeal to the Registrar, and the Registrar may direct to review the audit classification The auditor should be very careful, while making a decision about the class of society.

10. **DISCUSSION OF DRAFT AUDIT REPORT WITH MANAGING COMMITTEE:** On conclusion of the audit, the auditor should ask the Secretary of the society to convene the managing committee meeting to discuss the audit draft report. The audit report should never be finalised without discussion with the managing committee.

Q.NO.6 WHAT ARE RIGHTS AND DUTIES OF AUDITOR OF A COOPERATIVE SOCIETY?

ANSWER:

1. **RIGHTS OF CO-OPERATIVE AUDITORS:**
    a. He shall at all times have access to all the books, accounts etc.
    b. He can inquire every officer of the society to furnish such information in regard to the transactions and working of the society
2. **DUTIES OF CO-OPERATIVE AUDITORS:** The auditor must state the following matters in his audit report:
    a. Whether he has obtained all the necessary information and explanations which were necessary for the purpose of audit.
    b. Whether in his opinion and to the best of his information and according to the explanations given to him, the said accounts give all the information required by the Act.
    c. Whether in his opinion, proper books of account as required by Act, the Rules and the byelaws of the society have been properly maintained.
    d. Whether the Profit and Loss Account and balance sheet of the society give a true and fair view of the Profit or Loss and state of affairs of the society and are in agreement with the books of account of the society.

    The auditor will have to give qualifying observations, if any of the answers to the above-mentioned matters are negative.

Q.NO.7 WRITE ABOUT SCHEDULES TO AUDIT REPORT OF A COOPERATIVE SOCIETY?

ANSWER:

The auditor will have to attach schedules to the report regarding the following information:

1. All transactions which appear to be contrary to the provisions of the Act, the rules and byelaws of the society.
2. All sums, which ought to have been, but have not been brought into account by the society (i.e., Omissions).
3. Any material, or property belonging to society which appears to the auditor to be bad or doubtful of recovery.
4. Any material irregularity or impropriety in expenditure or in the realisation or monies due to society.

In the case of Nil report in any of the above matters, the auditor will have to give a Nil report.

Q.NO.8 WRITE ABOUT PROVISIONS RELATED TO APPOINTMENT OF AUDITOR OF MULTI STATE COOPERATIVE SOCIETY?

ANSWER:

1. **QUALIFICATION OF AUDITORS:** Section 72 of the Multi-State Co-operative Societies Act, 2002 states that a person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949 can only be appointed as auditor of multi-State co-operative society.

2. **DISQUALIFICATION OF AUDITORS:** The following persons are not eligible for appointment as auditors of a multi-State co-operative society:
   a. A body corporate.
   b. An officer or employee of the multi-State co-operative society.
   c. A person who is a member or who is in the employment, of an officer or employee of the multi-State co-operative society.
   d. A person who:
      i. Is indebted to the multi-State co-operative society or
      ii. Has given any guarantee or
      iii. Has provided any security in connection with the indebtedness of any third person to the multi- State co-operative society for an amount exceeding Rs.1000.

3. **VACATION OF OFFICE:** If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be deemed to have vacated his office as such.

4. **APPOINTMENT OF FIRST AUDITORS (SEC. 70):**
   a. **Authority to appoint:** By the board within one month of the date of registration of such society.
      If the board fails to exercise its powers under this sub-section, the multi-State co-operative society in the general meeting may appoint the first auditor.
   b. **Tenure of first auditor:** Till the conclusion of the first annual general meeting.

5. **APPOINTMENT OF SUBSEQUENT AUDITORS (SEC. 70):**
   a. **Authority to appoint:** By the members of the multi-State co-operative society, at each annual general meeting.
   b. **Tenure of subsequent auditor:** from the conclusion of that meeting until the conclusion of the next annual general meeting.

Q.NO.9 WHAT ARE THE POWERS OF MULTI STATE COOPERATIVE SOCIETY AUDITOR?

ANSWER:

1. He shall have a right of access at all times to the book's accounts and vouchers of the Multi-State cooperative society, whether kept at the head office of the Multi-State co-operative society or elsewhere, and
2. He can inquire the officers or other employees of the multi-State co-operative society and require such information and explanation as the auditor may think necessary.

Q.NO.10 WHAT ARE THE DUTIES OF MULTI STATE COOPERATIVE SOCIETY AUDITOR?

ANSWER:

A. DUTIES U/S 73(2):

As per section 73(2), the auditor shall make following inquiries:

1. Whether loans and advances made by the Multi-State co-operative society
   a. on the basis of security have been properly secured and
   b. whether the terms on which they have been made are not prejudicial to the interests of the Multi State co- operative society or its members,
2. Whether transactions of the Multi-State co-operative society which are represented merely by book entries are not prejudicial to the interests of the Multi-State co-operative society,
3. Whether personal expenses have been charged to revenue account, and
4. Where it is Stated in the books and papers of the Multi-State co-operative society that any shares have been allotted for cash,
   a. whether cash has actually, been received in respect of such allotment, and
   b. if no cash has actually been so received, whether the position as stated in the account books and the balance sheet as correct regular and not misleading

B. DUTIES U/S 73(3):

1. The auditor shall make a report to the members of the Multi-State co-operative society on
   a. The accounts examined by him and
   b. Every balance-sheet and profit and loss account and on every other document required to be part of or annexed to the balance-sheet or profit and loss account, which are laid before the Multi-State co-operative society in general meeting.
2. In the report, he shall state whether, in his opinion and to the best of his information and according to the explanation given to him,
   a. The said account give the information required by this act in the manner so required, and
   b. Give a true and fair view:

C. DUTIES U/S 73(4): The auditor shall state:

a. Whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.
b. Whether, in his opinion, proper books of account have been kept by the Multi- State co-operative society so far as appears from his examination of these books and proper returns adequate for the purpose of his audit have been received from branches or offices of the Multi-State cooperative society not visited by him.
c. Whether the report on the accounts of any branch office audited by a person other than the Multi-State co-operative society's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.
d. Whether the Multi-State co-operative society's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and return.

Q.NO.11 EXPLAIN THE PROVISIONS RELATING TO THE POWERS OF CENTRAL GOVERNMNET TO ORDER SPECIAL AUDIT OF MULTI STATE COOPERATIVE SOCIETY?

ANSWER:

POWERS OF CENTRAL GOVERNMNET TO ORDER SPECIAL AUDIT OF MULTI STATE COOPERATIVE SOCIETY (SECTION 77):

1. **PASSING AN ORDER BY CG:** Circumstances necessitating the need for special audit:
   a. That the affairs of any multi-State co-operative society are not being managed in accordance with co-operative principles or prudent commercial practices or
   b. That any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry, or business to which it pertains; or
   c. That the financial position of any multi-State co-operative society is such as to endanger its solvency.

Condition for passing an order: However, Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such multi-State co-operative society.

2. **PROCEDURE FOR CONDUCTING SPECIAL AUDIT:**
   a. **Appointing special auditor:** The Central Government may direct that a special audit of the multi- State co-operative society's accounts shall be conducted and appoint either a chartered accountant or the multi-State co-operative society's auditor himself to conduct the special audit.
   b. **Remuneration of special auditor:** The expenses of, and incidental to, any special audit (including the remuneration of the special auditor) shall be determined by the Central Government which determination shall be final and paid by the Multi-State Co-operative society.
   c. **Powers of special auditor:** The special auditor shall have the same powers and duties in relation to the special audit as an auditor of a multi-State co-operative society has under section 73.
   d. **Reporting by special auditor:** The special auditor shall make the report to the Central Government. The report of the special auditor shall, include all the matters required to be included in the auditor's report under section 73 and any other matter as directed by the Central Government.
   e. **Action taken by CG:** On receipt of the report of the special auditor the Central Government may take such action on the report as it considers necessary in accordance with the provision of the Act or any law for the time being in force.
   f. **Situation where no action is taken by CG:** if the Central Government does not take any action on the report within four months from the date of its receipt,
      i. That Government shall send to the Multi-State Co- operative society, the report with its comments thereon and

ii. Require the Multi-State Co-operative society either to circulate that copy or those extracts to the members or to have such copy or extracts read before the Multi-State Co-operative society at its next general meeting.

TEST YOUR KNOWLEDGE:

1. **Central Govt. hold 55% of the paid-up share Capital in Kisan Credit Co-operative Society, which is incurring huge losses. Advise when the Central Government can direct Special Audit under Section 77 of the Multi State Co-operative Society Act.**

Answer: Write point 1 from above answer.

Q.NO.12 EXPLAIN THE POWERS OF CENTRAL REGISTRAR TO MAKE AN INQUIRY U/S 78 OF MULTI-STATE CO-OPERATIVE SOCIETIES ACT, 2002.

ANSWER:

1. **ELIGIBILITY TO MAKE AN APPLICATION FOR INQUIRY:**
    a. A creditor or
    b. Not less than one-third of the members of the board or
    c. Not less than one-fifth of the total number of members of a multi-state co-operative society
2. **AUTHORITY TO WHOM THE APPLICATION IS TO BE MADE:** The Central Registrar.
3. **INQUIRY BY WHOM:**
    a. Either by the registrar himself or
    b. Some other person authorized by him
4. **NOTICE TO THE SOCIETY:** However, before holding such inquiry fifteen days notice must be given to the multi-State co-operative society.
5. **POWERS OF THE PERSON MAKING THE INQUIRY:**
    a. **To Access to the books:** Right of access to the books, accounts, documents, and other properties belonging to and may require any person in possession or responsible for the custody of any such books, accounts, documents securities, cash or other properties to produce the same at any place specified by him.
    b. **To call general meeting:**
        i. He may require the officers of the society to call a general meeting of the society by giving notice of not less than seven days at such time and place at the headquarters of the society to consider such matters as may be directed to him, and
        ii. Where the officers of the society refuse or fail to call such a meeting, he shall have power to call it himself.
    c. **To issue summons:** He may summon any person who is reasonably believed bv him to have any knowledge of the affairs of the multi-State co-operative society to appear before him at any place at the headquarters of the society or any branch thereof and may examine such person on oath.

6. **SENDING THE INQUIRY REPORT BY CENTRAL REGISTRAR:** The Central Registrar shall, within a period of three months of the date of receipt of the report, communicate the report of inquiry
   a. To the Multi-State Co-operative society, and
   b. To the person or authority, if any at whose instance the inquiry is needed.

Q.NO.13 EXPLAIN THE POWERS OF CENTRAL REGISTRAR TO MAKE AN INSPECTION U/S 79 OF MULTI-STATE CO-OPERATIVE SOCIETIES ACT, 2002.

ANSWER:

1. **ELIGIBILITY TO MAKE AN APPLICATION FOR INSPECTION:**
   a. A creditor or,
   b. Not less than one-third of the members of the board or,
   c. Not less than one-fifth of the total number of members of a multi-state co-operative society.
2. **AUTHORITY TO WHOM THE APPLICATION IS TO BE MADE:** The Central Registrar.
3. **INSPECTION BY WHOM:**
   a. Either by the registrar himself or,
   b. Some other person authorized by him
4. **NOTICE TO THE SOCIETY:** However, before holding such inspection fifteen days notice must be given to the multi-State co-operative society.
5. **POWERS OF THE PERSON MAKING THE INSPECTION:**
   a. He shall at all times have access to all books, accounts, papers, vouchers, securities, stock and other property of that society and
   b. He may, in the event of serious irregularities discovered during inspection, take them into custody and shall have power to verify the cash balance of the society and
   c. He, with the prior approval of central registrar, has right to call a meeting of the society where such general meeting is, in his opinion necessary.
   d. Every officer or member of a Multi-State Co-operative society shall furnish such information with regard to the working of the society as the central registrar or the person making such inspection may require.
6. **SENDING THE INSPECTION REPORT BY REGISTRAR:** A copy of the report of inspection under this section shall be communicated to the Multi-State Co-operative society within a period of three months from the date of completion of such inspection.

TEST YOUR UNDERSTANDING

1. **A society has been formed by pan India employees of a public sector bank. The purpose of society is to promote savings habits of members and to grant loan to them up to a small specified amount. Small savings are promoted amongst members by way of compulsory contribution from monthly salary. Identify type of society and also discuss nature of books of accounts to be maintained by such a society.**

Answer:

The society is in nature of Multi-state cooperative society as it serves interests of members in more than one state. It accepts small savings from its members and grants loan to members. As per Multi-State Co-operative Society Rules 2002, every Multi- State Co-operative society shall keep books of account with respect to: -

a. all sum of money received and expended and matters in respect of which the receipt and expenditure take place
b. the assets and liabilities
c. sales and purchases

5.AUDIT DOCUMENTATION AND EVIDENCE

SA 500 – AUDIT EVIDENCE

Q.NO.1 EXPLAIN THE DIFFERENT TYPES OF AUDIT PROCEDURES?

ANSWER:

A. MEANING OF AUDIT PROCEDURES:

1. It is a broad framework of audit through which the audit is carried out to obtain sufficient appropriate evidence in order to express the opinion on financial statements.
2. The audit procedures are performed in two parts as below:
   a. Risk assessment procedures; and
   b. Further audit procedures which consist of:
      i. Compliance procedures, and
      ii. Substantive procedures which include analytical procedures and test of details.

B. RISK ASSESSMENT PROCEDURES: The audit procedures are performed

1. To obtain an understanding of the entity and its environment,
2. Including the Internal control system,

Purpose: To identify and assess the risks of material misstatements in financial statements.

C. COMPLIANCE PROCEDURES:

1. It deals with examination of internal controls to determine their effectiveness to determine the nature, timing, and extent of substantive procedures to be performed.
   E.g.: If the auditor obtains positive confirmations in compliance procedures, generally the timing and extent of substantive procedures will reduce.
2. These are also known as "Test of controls".

D. SUBSTANTIVE AUDIT PROCEDURES: It involves examination of accounting records including financial statements to determine the reliability of information therein. It can be performed by way of:

1. **Test of Details:**
   a. **Test of transactions:** It deals with vouching of transactions recorded in the accounting records.
   b. **Test of balances:** It deals with the verification of balances in the accounting records.
2. **Analytical Procedures:** Analytical procedures consist of evaluation of financial information by understanding the relationships among the financial and non-financial data.

E. CONCLUSION:

1. The Compliance Procedures and substantive procedures must complement each other. The auditor shall not ignore either of it. He must carry out both the audit procedures to make the audit more effective.

2. Further the fact that the controls are very effective does not mean the auditor can skip substantive procedures. He must carry out both.
3. The absence of misstatements (non-identification) in substantive procedures does not indicate that the controls are effective.
4. The presence of material misstatement strongly indicates that there is a significant deficiency in the internal controls.

Q.NO.2 DEFINE THE TERM AUDIT EVIDENCE. EXPLAIN IN DETAIL SUFFICIENCY AND APPROPRIATENESS OF AUDIT EVIDENCE?

ANSWER:

A. AUDIT EVIDENCE:

1. Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.
2. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.
3. Audit evidence is necessary to support the auditor's opinion and report.
4. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit.
5. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert.
6. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.
7. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.
8. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient and appropriate audit evidence.

B. MEANING OF ACCOUNTING RECORDS AND OTHER INFORMATION:

1. **Accounting records:** Information contained in the accounting records include the following:
   a. The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts
   b. The general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and
   c. Records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.
2. **Other information:** Other information includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc.

C. SUFFICEINCY OF AUDIT EVIDENCE: Sufficiency is the measure of the quantity of audit evidence. The following factors affect the auditors decisions regarding sufficiency of audit evidence:

1. Nature and Size of client
2. Risk of Material Misstatement (If the risk is high, the auditor requires more quantity of audit evidence)
3. Effectiveness of Internal controls (if the controls are effective, the auditor obtains less quantity of audit evidence)
4. Quality of such audit evidence (the higher the quality, the less may be required)
5. Materiality (Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand, if assertions are more material to the users of the financial statements, more evidence would be required.)
6. Size of the population
7. Characteristics of population (Less evidence would be required in case homogeneous population but on the other hand in case of heterogeneous populations, more evidence would be required.)

D. APPROPRIATENESS OF AUDIT EVIDENCE:

1. 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.
2. 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.
3. Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration.
   Example, If the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

TEST YOUR KNOWLEDGE:

1. The auditor of Fresh and Well Limited explained to the audit team members about the relationship between Audit Evidence and Opinion of Auditor. Explain what relationship exists between Audit Evidence and Opinion of Auditor.

Answer:

There exists a very important relationship between Audit Evidence and opinion of the Auditor. While conducting an audit of a company, the auditor obtains audit evidence and with the help of that audit evidence obtained, the auditor forms an audit opinion on the financial statements of that company.

2. There was a Partnership Firm of Chartered Accountants WT and Associates. Mr. W, one of the partners of WT and Associates, while explaining to his audit team members about importance of audit evidence informed them about sufficiency and appropriateness

of audit evidence. Mr. H, one of the members of audit team of WT and Associates was of the view that sufficiency of audit evidence means simplicity of audit evidence and appropriateness of audit evidence means ease of obtaining audit evidence. Explain whether sufficiency and appropriateness of audit evidence mean simplicity and ease of obtaining audit evidence.

Answer:

Sufficiency and Appropriateness of audit evidence does not mean simplicity and ease of obtaining audit evidence rather sufficiency of audit evidence is related to the quantity of audit evidence and appropriateness of audit evidence is related to quality of audit evidence.

3. **Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Explain.**

Answer: Write A point from above answer

4. **What is meant by sufficiency of Audit Evidence? Explain the factors affecting the auditor's judgement as to the sufficiency of audit evidence.**

Answer: Write C point from above answer

Q.NO.3 EXPLAIN THE TYPES OF AUDIT EVIDENCE.

ANSWER:

A. BASED ON FORM / NATURE:

1. **Documentary:** Evidence obtained in paper or electronic form. E.g.: Registration documents, title deeds, vouchers, and Bills etc.
2. **Oral:** Evidence which is obtained through inquiry. E.g.: Response to Inquiries made by auditor.
3. **Visual:** Evidence obtained by the auditor through actual observation. E.g.: Physical inspection of Fixed Assets, Cash, etc.

B. BASED ON SOURCE:

1. **Internal evidence:** Evidence which originates within the entity being audited is called internal evidence. E.g.: Sales invoice, GRN, Debit and Credit note, internal confirmations, etc.
2. **External evidence:** Evidence, which originates outside the entity being audited, is called external evidence. E.g.: Purchase invoice, Debit notes and Credit notes, Quotations, External confirmation, etc.

Q.NO.4 DISTINGUISH BETWEEN INTERNAL EVIDENCE AND EXTERNAL EVIDENCE.

ANSWER:

A. INTERNAL EVIDENCE:

1. **Meaning:** Internal evidence Is the evidence which originates from within the organization being audited. E.g.: Sales invoice, goods received notes, cash memo, etc.
2. **Availability:** The bulk of evidence that an auditor gets is internal in nature.
3. **Reliability:**
   a. Client's staff will have control on the internal evidence. So, the auditor should be careful in placing reliance on such evidence.
   b. It does not mean that all the internal evidence needs to be suspected every time. But the auditor shall be alert to the possibilities of manipulation, creation of false and misleading evidences.

B. EXTERNAL EVIDENCE:

1. **Meaning:** External evidence is the evidence that originates from outside the client's organization. E.g.: Purchase invoice, quotations, external confirmations, etc.
2. **Availability:** Substantial external evidence is also available to the auditor but lesser in comparison to internal audit evidence.
3. **Reliability:**
   a. It is generally considered to be more reliable as they come from third parties who are independent of the entity being audited.
   b. However, if the auditor has any reason to doubt the independence of any third party, then he should exercise greater care in that matter. E.g., Collusion of third party with the client.

Note: If audit evidence obtained from one source is inconsistent with that obtained from another, the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter.

Q.NO.5 EXPLAIN THE PRINCIPLES REGARDING RELIABILITY OF AUDIT EVIDENCE.

ANSWER:

1. External evidence is more reliable than internal evidence.
2. Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained through client.
3. Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally.
4. Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies.
5. Internal evidence is more reliable when the internal controls are strong.
6. Evidences are more reliable when they are consistent with each other.

Q.NO.6 EXPLAIN THE METHODS TO OBTAIN AUDIT EVIDENCE.

ANSWER:

1. **INSPECTION:**
    a. 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.
    Example:
    - Inspection of documents like bond/ fixed certificate for evidence related to existence of an asset.
    - 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.

    b. 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.
    c. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.
    d. *Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.*
    e. *Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.*

2. **INQUIRY:**
    a. Inquiry consists of seeking information from knowledgeable persons, both financial and non-financial, within the entity or outside the entity.
    b. Inquiry is used extensively throughout the audit in addition to other audit procedures.
    c. Inquiries may range from formal written inquiries to informal oral inquiries.
    d. Evaluation of responses to inquiries is an integral part of inquiry process.
    e. Through inquiry the auditor may obtain following three types of information:
        i. New information which auditor originally not aware of.
        ii. Information that differs significantly from other information that the auditor has obtained: and
        iii. Additional information in support for existing information which is corroborative in nature.
    f. The evidence often comes from inquires may not be persuasive as it is less reliable.

3. **OBSERVATION:**

a. Observation consists of looking at a process or procedure being performed by others. **Example,** The auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities.
b. 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.

4. **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.

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

6. **RE-PERFORMANCE:** It involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

7. **ANALYTICAL PROCEDURES:** Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non- financial data.

TEST YOUR KNOWLEDGE:

1. **While auditing the books of accounts of Extremely Distinct Limited for the financial year 2020-21, the auditor of the company used an audit procedure according to which complete documents and records of the company were checked in detail in order to obtain audit evidence. Explain the audit procedure used by the auditor of Extremely Distinct Limited**

Answer:

The audit procedure used by auditor of Extremely Distinct Limited is known as Inspection because inspection is an audit procedure in which complete documents and records of a company are checked in detail for the purpose of obtaining audit evidence.

Q.NO.7 WHAT ARE THE FACTORS TO BE CONSIDERED BY AN AUDITOR WHILE USING THE WORK OF MANAGEMENT EXPERT.

ANSWER:

1. When information to be used as audit evidence has been prepared using the work of a management's expert, the nature, timing and extent of audit procedures may be affected by such matters;
   a. The nature and complexity of the matter to which the management's expert relates.
   b. The risks of material misstatement in the matter.
   c. The availability of alternative sources of audit evidence.
   d. The nature, scope and objectives of the management's expert's work.

e. Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
f. The extent to which management can exercise control or influence over the work of the management's expert.
g. Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
h. The nature and extent of any controls within the entity over the management's expert's work.
i. The auditor's knowledge and experience of the management's expert's field of expertise.

2. When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances:
   a. Obtaining audit evidence about the accuracy and completeness of the information; and
   b. Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.

Q.NO.8 DEFINE THE TERM ASSERTION. ALSO GIVE EXAMPLES OF ASSERTIONS FOR VARIOUS ITEMS OF FINANCIAL STATEMENTS.

ANSWER:

A. MEANING: Assertions refer to representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

B. EXAMPLES OF ASSERTIONS:

1. **ACCOUNT BALANCES:** Assertions about account balances at the period end:
   a. **Existence**: Assets, liabilities, and equity interests exist.
   b. **Rights and obligations:** The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
   c. **Completeness:** All assets, liabilities and equity interests that should have been recorded have been recorded.
   d. **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.

2. **CLASS OF TRANSACTIONS:** Assertions about classes of transactions and events for the period under audit:
   a. **Occurrence:** Transactions and events that have been recorded have occurred and pertain to the entity.
   b. **Completeness:** All transactions and events that should have been recorded have been recorded.

c. **Measurement:** Amounts and other data relating to recorded transactions and events have been recorded appropriately.
d. **Cut-off:** Transactions and events have been recorded in the correct accounting period.
e. **Classification:** Transactions and events have been recorded in the proper accounts.

3. **DISCLOSURES:** Assertions about presentation and disclosure:
   a. **Occurrence and rights and obligations:** Disclosed events, transactions, and other matters have occurred and pertain to the entity.
   b. **Completeness:** All disclosures that should have been included in the financial statements have been included.
   c. **Classification and understandability:** Financial information is appropriately presented and described, and disclosures are clearly expressed.
   d. **Measurement and valuation:** Financial and other information are disclosed fairly and at appropriate amounts.

C. **NEGATIVE ASSERTION:** Negative assertions are also encountered in the financial statements and the same may be express or implied.
For example, if it is stated that there is no contingent liability it would be an expressed negative assertion; on the other hand, if in the balance sheet there is no item as "building", it would be an implied negative assertion that the entity did not own any building on the balance sheet date.

TEST YOUR KNOWLEDGE:

1. State the assertions for the following item in the balance sheet:

Plant and Machinery (at cost)			**2,00,000**
Less: Depreciation till the end of previous year	**70,000**		
Depreciation for the year	**13,000**	**83,000**	
		1,17,000	

Answer:

The assertions are as follows:
a. the firm owns the plant and machinery;
b. the historical cost of plant and machinery is Rs. 2 lacs;
c. the plant and machinery physically exist;
d. the asset is being utilised in the business of the company productively;
e. total charge of depreciation on this asset is Rs. 83,000 to date on which Rs. 13,000 relates to the year in respect of which the accounts are drawn up; and
f. the amount of depreciation has been calculated on recognised basis and the calculation is correct.

2. When we find in the balance sheet, an item under current assets reading as "cash in hand – Rs. 8,000," what are the obvious assertions that would strike the mind?

Answer:

When we find in the balance sheet, an item under current assets reading as "cash in hand – Rs. 8,000" the obvious assertions that would strike the mind are the following:

a. The firm concerned had Rs. 8,000 in hand in valid notes and coins on the balance sheet day;
b. That the cash was free and available for expenditure to the firm; and
c. That the books of account show a cash balance of identical amount at the end of the day on which the balance sheet is drawn up.

3. Name the assertions for the following audit procedures:

a. Yearend inventory verification

b. Depreciation has been properly charged on all assets

c. The title deeds of the land disclosed in the balance sheet are held in the name of the company.

d. All liabilities are properly recorded

e. Related party transactions are shown properly.

Answer:

a. Existence
b. Valuation and measurement
c. Rights and Obligations
d. Completeness
e. Presentation and Disclosure

Q.NO.9 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. ANALYSE AND EXPLAIN.

ANSWER:

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.

1. This requirement reflects the facts that:
   a. the auditor's assessment of risk is judgemental and so may not identify all risks of material misstatement; and
   b. there are inherent limitations to internal control, including management override.

2. Depending on the circumstances, the auditor may determine that:
   a. Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
   b. Only tests of details are appropriate.

c. A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

SA 230 – AUDIT DOCUMENTATION

Q.NO.10 DEFINE THE TERM AUDIT DOCUMENTATION. ALSO STATE ITS PURPOSE AND CONTENTS.

ANSWER:

A. MEANING: Audit Documentation refers to the record of

1. Audit procedures performed,
2. Relevant audit evidence obtained, and
3. Conclusions the auditor reached.

It is also known as **"Working papers"** or **"Work papers"** or **"Audit file"**.

B. OBJECTIVE OF AUDIT DOCUMENTATION: Audit documentation provides:

1. Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and
2. Evidence that the audit was planned and performed in accordance with SAs and applicable legal and regulatory requirements.

C. PURPOSE OF AUDIT DOCUMENTATION: The following are the purpose of Audit documentation:

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

D. CONTENTS OF AUDIT DOCUMENTATION: Audit Documentation include

1. Audit programmes
2. Analyses
3. Issues memoranda
4. Summaries of significant matters
5. Letters of confirmation and representation
6. Checklists
7. Correspondence (including e-mail) concerning significant matters.
8. Who performed the audit work and the date such work was completed; and
9. Who reviewed the audit work performed and the date and extent of such review.

Q.NO.11 EXPLAIN THE FACTORS WHICH EFFECT THE FORM, TIMING AND EXTENT OF AUDIT DOCUMENTATION.

ANSWER:

A. FORM OF AUDIT DOCUMENTATION: The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

1. The nature, timing and extent of the audit procedures performed.
2. The results of the audit procedures performed and the audit evidence obtained and
3. Significant matters arising during the audit and the conclusions reached thereon and significant professional judgements made in reaching those conclusions.

B. FACTORS WHICH EFFECT THE FORM AND CONTENT OF AUDIT DOCUMENTATION: The form, content and extent of audit documentation depend on factors such as:

1. The size and complexity of the entity.
2. The nature of the audit procedures to be performed.
3. The identified risks of material misstatement.
4. The significance of the audit evidence obtained.
5. The nature and extent of exceptions identified.
6. The audit methodology and tools used.

C. TIMELY PREPARATION OF AUDIT DOCUMENTATION:

1. The auditor shall prepare audit documentation on a timely basis.
2. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalised.
3. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

Q.NO.12 WRITE ABOUT ASSEMBLY OF AUDIT FILE, ITS OWNERSHIP AND RETENTION.

ANSWER:

A. MEANING: Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

Audit file is maintained under two categories:

1. Permanent Audit File
2. Current Audit File

B. ASSEMBLY OF FINAL AUDIT FILE:

1. The auditor shall assemble the audit documentation 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.
2. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report (as per SQC-1).
3. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions.
4. Changes may, however, be made to the audit documentation during the final assembly process, if they are administrative in nature. **For example,**
   a. Deleting or discarding superseded documentation.
   b. Sorting, collating and cross-referencing working papers.
   c. Signing off on completion checklists relating to the file assembly process.
5. After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period.

C. RETENTION PERIOD: 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 (as per SQC-1).

D. OWNERSHIP:

1. Audit documentation is the property of the auditor.
2. He may at his discretion, make portions of, or extracts from, audit documentation available to clients or others.

TEST YOUR KNOWLEDGE:

1. While auditing the books of accounts of Very Careful Limited for the financial year 2020-21, a team member of the auditors of Very Careful Limited was of the view that with regard to audit of the company, no relation exists between Audit File and Audit Documentation. Explain the relationship between Audit File and Audit Documentation.

Answer:

Audit file may be defined as one or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement. The auditor shall assemble the audit documentation 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.

2. The Principal auditor can demand the working papers of Branch auditor. (or)
The branch auditor shall make the copies of audit documentation available to principal auditor. True/False.

Answer:

False.

The branch audit documentation is the property of branch auditor. The branch auditor is at his discretion to make available the copies of audit documentation to principal auditor. There is no obligation on branch auditor.

Q.NO.13 WHAT IS AUDITNOTE BOOK? ALSO STATE ITS CONTENTS.

ANSWER:

A. MEANING:

1. An audit notebook is usually a bound book in which a large variety of matters observed during the course of audit are recorded.
2. It forms part of audit working papers (generally current audit file).
3. For each year a fresh audit notebook is maintained.

B. PURPOSE:

1. It helps in tracking the links of work when the concerned assistant is away, or the work is stopped temporarily.
2. It is also used for recording various queries raised in the course of the work and their state of disposal.
   a. In respect of disposed queries, explanation obtained, and evidence seen would be recorded in the said book.
   b. While queries remaining undisposed of would be noted for follow up.

Q.NO.14 WHAT IS AUDIT COMPLETION MEMORANDUM OR AUDIT DOCUMETATION SUMMARY.

ANSWER:

1. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-
   a. the significant matters identified during the audit and
   b. how they were addressed.
2. It is particularly maintained for large and complex audits.
3. Further, the preparation of such a summary may assist auditor's consideration of the significant matters.
4. It may also help the auditor to consider whether the objectives of all relevant SA's are complied with.

Q.NO.15 WRITE A SHORT NOTE ON DOCUMENTATION OF SIGNIFICANT MATTERS.

ANSWER:

1. Significant matters arising during the course of audit are required to be included in audit documentation.
2. Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples are as follows:
    a. Results of audit procedures indicating
        i. that the financial statements could be materially misstated, or
        ii. a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
    b. Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
    c. Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter Paragraph in the auditor's report.

Q.NO.16 EXPLAIN THE CONCEPT OF TRUE AND FAIR VIEW AND ITS RELEVANCE IN AUDITING.

ANSWER:

1. The concept of true and fair is a fundamental concept in auditing.
2. 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.
3. What constitutes a 'true and fair' view is a matter of an auditor's judgement in the particular circumstances of a case.
4. In more specific terms, to ensure true and fair view, an auditor has to see:
    a. That the assets are neither undervalued or overvalued, according to the applicable accounting principles,
    b. No material asset is omitted;
    c. The charge, if any, on assets are disclosed;
    d. Material liabilities should not be omitted;
    e. The profit and loss account and balance sheet discloses all the matters required to be disclosed;
    f. Accounting policies have been followed consistently; and
    g. All unusual, exceptional or non-recurring items have been disclosed separately.

Q.NO.17 EXPLAIN THE MEANING OF AUDIT TRAIL.

ANSWER:

A. MEANING OF AUDIT TRAIL:
1. An audit trail is a documented flow of a transaction.
2. It is used to investigate how a source document was translated into an account entry and from there it was inserted into financial statement of an entity.
3. It is used as audit evidence to establish authentication and integrity of a transaction.

B. ADVANTAGES OF AUDIT TRAIL:

1. Audit trails help in maintaining record of system and user activity.
   For example, in case of banks, there is an audit trail keeping track of log-on activity detailing record of log-on attempts and device used.
2. It is a step-by-step record by which accounting, trade details, or other financial data can be traced to their source.
3. Audit trails help to enhance internal controls and data security.
4. Audit trails can help in fixing responsibility, rebuilding events and in thorough analysis of problem areas.
5. Audit trail analysis can specify reason of the problem.
6. It can also help in ensuring operation of system as intended.
7. In this way, audit trails can help entities in their regular system operations.

C. COSTS INVOLVED IN AUDIT TRAIL:

1. However, audit trails involve costs. The cost is not only in terms of system expenditure but also in terms of time involved in analysing data made available by audit trails.

D. USE OF AUTOMATED TOOLS FOR AUDIT TRAIL AND BENEFITS TO AUDITOR:

1. However, use of automated tools can be made to analyse large volume of data thrown up by audit trails.
2. Systems which have a feature of audit trail inspires confidence in auditors.
3. It helps auditors in verifying whether controls devised by the management were operating effectively or not.
4. It aids in verification whether a transaction was indeed performed by a person authorised to do it.
5. Since audit trails also enhance data security, these can be used by auditor while performing audit procedures thus increasing reliability of audit evidence obtained.

Q.NO.18 WRITE ABOUT SELECTING ITEMS FOR TESTING TO OBTAIN AUDIT EVIDENCE.

ANSWER:

When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure.

The means available to the auditor for selecting items for testing are:

(a) Selecting all items (100% examination);
(b) Selecting specific items; and
(c) Audit sampling.

1. **Selecting All Items:**
   a. The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population).

b. 100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details.

c. 100% examination may be appropriate when, For example:
    - The population constitutes a small number of large value items;
    - There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
    - The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

2. **Selecting Specific Items:**
    a. The auditor may decide to select specific items from a population.
    b. In making this decision, factors that may be relevant include the
        - auditor's understanding of the entity,
        - the assessed risks of material misstatement, and
        - the characteristics of the population being tested.
    c. The judgmental selection of specific items is subject to non-sampling risk.
    d. Specific items selected may include:
        - High value or key items.
        - The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic.
        - All items over a certain amount.
        - The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
        - Items to obtain information. The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

3. **Audit Sampling:** Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it. Audit sampling is discussed in subsequent paragraphs.

Q.NO.19 WRITE ABOUT INCONSISTENCY IN OR DOUBTS OVER RELIABILITY OF AUDIT EVIDENCE.

ANSWER:

1. If:
    a. audit evidence obtained from one source is inconsistent with that obtained from another; or
    b. the auditor has doubts over the reliability of information to be used as audit evidence,

    the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit.

2. SA 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter.

TEST YOUR UNDERSTANDING

1. **On perusal of financial statements of a company, auditor of company finds that notes to accounts contain aging of trade payables in accordance with requirements of Schedule III of Companies Act, 2013. The accountant of company is responsible for ensuring proper aging of trade payables included in notes to accounts. The auditor wants to verify whether aging of trade payables made in financial statements is proper or not. Identify what he is trying to do.**

Answer:

The auditor is verifying aging of trade payables. He is "reperforming" the control which was mandated by the management.

2. **CA Sooryagaythri is conducting audit of an entity. During the course of audit, she has made oral inquiries from head accountant regarding preparing of bank reconciliations every month as has been laid down by the management. Discuss, whether inquiries as stated above would provide satisfaction to her that controls in respect of preparing bank reconciliations statements have operated effectively.**

Answer:

Inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls. Mere inquiry does not lead to obtaining of sufficient appropriate audit evidence. In the instant case, CA Sooryagaythri should verify whether proper bank reconciliations have been carried out monthly as stipulated by management. Only then, she can be satisfied about operating effectiveness of controls in this regard.

3. **A company has stipulated a control that reconciliations of its records showing quantitative details of its property, plant and equipment are carried out at regular intervals with physical verification of such items. The auditor has found that such reconciliations are being carried out as stipulated. Discuss, whether above factor, increases reliability of other internally generated evidence within the company relating to existence of such items.**

Answer:

The management is carrying out reconciliations of items contained in Property, Plant and Equipment records with physical verification of such items at regular intervals. It means that controls in this regard have operated effectively. 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.

4. **During the course of audit of a company, an issue arose relating to treatment of interest costs of company on its restructured loans taken from a bank. This important matter was discussed with CFO of the company and was properly resolved. Is it necessary for the auditor to include in its working papers?**

Answer:

The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

In the instant case, an important matter regarding treatment of interest costs of company on its restructured loans taken from a bank directly impacting profits of the company was discussed. Although issue was resolved, it is necessary to document the same by including detail of the person with whom discussions took place along with date.

5. **CA Sonali Morarka has completed audit of a listed company. The audit report dated 15th July, 2022 has been issued. However, audit working papers including record of discussions with management, details of audit procedures performed to obtain audit evidence and conclusions reached by her have not been properly assembled. More than six months have elapsed after issue of audit report. Subsequently, she has received a letter from regulator in connection with audit of the company requesting her to share copy of audit file.**
   The letter has woken up her from deep slumber. She hurriedly assembled audit file and inserted some more papers which were necessary. However, she put current date on these inserted papers and the copy of audit file was sent to regulator. Discuss, the issues involved, in context of "audit documentation".

Answer:

An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.

Further, preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

In the given case, even after passage of more than six months, she has not assembled audit file. Besides, she has put in some papers with current date which is not permissible at all. It shows that part of audit documentation has been prepared afterwards putting a question mark on quality of audit.

6. RISK ASSESSMENT AND INTERNAL CONTROL

Q.NO.1 DEFINE THE TERM AUDIT RISK. ALSO STATE ITS COMPONENTS AND INTER-RELATIONSHIP BETWEEN THEM.

ANSWER:

A. MEANING:

1. Audit risk means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated.
2. In simple terms, if the auditor expresses unmodified opinion when modified opinion is appropriate would be considered as Audit Risk.
3. **Excludes:** However, audit risk does not include:
   a. Risk of expressing a modified opinion when financial statements are not materially misstated.
   b. Business risk faced by auditor. Example: Loss of clients or reputation is not considered as audit risk.

B. COMPONENTS OF AUDIT RISK: It is made up of two components, which are, Risk of Material Misstatement and Detection risk.

Audit Risk = Risk of Material Misstatement x Detection Risk

1. **RISK OF MMS:** The risk that the financial statements are materially misstated prior to audit. This consists of two components namely inherent risk and control risk. Further the Risk of MMS is an entity's risk and will exist irrespective of audit of financial statements.

   a. **Inherent Risk:**
      i. The risk of that a transaction or balance could be materially misstated before considering the related internal control system.
      ii. Absence of related control is also termed as inherent risk.
      iii. Inherent risk is generally unavoidable and inherent in the system.

      Examples:
      - *An accounting standard provides guidance on some complex issue which might not be understood by the management. Therefore, recording of this issue in financial statements carries inherent risk of being misstated.*
      - *There are large number of business failures in an industry. Therefore, assertions in financial statements of an entity operating in such an industry carry an inherent risk of being misstated*

   b. **Control Risk:**

i. The risk that the internal control system, fails to prevent, detect or correct a misstatement on a timely basis.
ii. Control Risk is a risk that internal control existing and operating in an entity would not be efficient enough to stop from happening, or find and then rectify in an appropriate time, any material misstatement relating the financial statements of that entity.
iii. This risk is also termed as control weakness or control deficiency.
iv. There exists an inverse relation between Control Risk and Efficiency of Internal Control of an Entity.

Examples:

- *A company has devised control that cash and cheque books should be kept in a locked safe and access is granted to authorized personnel only. There is risk that control is not being followed.*
- *An entity has devised a control that fire extinguishers and smoke detectors are in place and are in working condition at all times to reduce the risk of damage to inventories caused by fire. There is a risk that fire extinguishers in place are expired and are not being refilled. Similarly, there is a possibility that smoke detectors are not working.*
- *A company has devised a control relating to petty cash that items of expenditure of only less than ₹ 10000 should be routed through imprest system of petty cash. There is a risk that control is not being followed.*

2. **DETECTION RISK:** 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

C. INTERRELATIONSHIP BETWEEN COMPONENTS:

1. There exists an INVERSE RELATIONSHIP between Risk of MMS and Detection risk.
2. For Example: If the Risk of MMS is high, the auditor will conduct an in-depth audit, resultantly he can detect MMS.

TEST YOUR KNOWLEDGE:

1. XYZ Ltd is engaged in the business and running several stores dealing in variety of items such as readymade garments for all seasons, shoes, gift items, watches etc. There are security tags on each and every item. Moreover, inventory records are physically verified on monthly basis. Discuss the types of inherent, control and detection risks as perceived by the auditor.

Answer:

Inherent Risk: Because items may have been misappropriated by employees, therefore, risk to the auditor is that inventory records would be inaccurate.

Control Risk: There is a security tag on each item displayed. Moreover, inventory records are physically verified on monthly basis. Despite various controls being implemented at the stores, still collusion among employees may be there and risk to auditor would again be that inventory records would be inaccurate.

Detection Risk: Auditor checks the efficiency and effectiveness of various control systems in place. He would do that by making observation, inspection, enquiry, etc. In addition to these, the auditor would also employ sampling techniques to check few sales transactions from beginning to end. However, despite all these procedures, the auditor may not detect the items which have been stolen or misappropriated.

2. Risk of material misstatement consists of two components" Explain clearly defining risk of material misstatement.

Answer: Write Point B(1)

3. "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." Explain

Answer: Write Point B(1)

Q.NO.2 EXPLAIN IN DETAIL RISK ASSESSMENT PROCEDURES IN LIGHT OF SA 315. ALSO, STATE WHAT IS INCLUDED IN RISK ASSESSMENT PROCEDURES.

ANSWER:

SA 315 - IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT:

A. RISK ASSESSMENT PROCEDURE:

1. The objective of auditor is:
   a. To identify the risk of MMS at two levels-
      i. **ROMM at overall financial statement level:** Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.
      ii. **ROMM at assertion level:** Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.
   b. To assess (Analyse) the risk of MMS for determining its significance.
   c. To minimize the audit risk to an acceptably low level by properly planning and performing audit (audit procedures) based on risk assessment process.
2. The risk is identified and assessed by understanding the entity and its environment including entity's internal controls.
3. Evaluate whether the risks identified are impacting financial statements at a pervasive level and affect many assertions potentially.
4. Assess What Can Go Wrong (WCGR) by considering related controls at assertion level.
5. Remember the risk may arise either from Fraud (Intentional) or error (Unintentional).

6. Also, the risk assessment procedure by own do not provide sufficient appropriate audit evidence. The auditor shall carryout substantive procedures to obtain sufficient appropriate audit evidence.
7. The assessment of risk is a matter of professional judgment rather than a matter capable of precise measurements. Further risk assessment is based on information obtained through risk audit procedures.

B. RISK ASSESSMENT PROCEDURES INCLUDES:

1. **INQUIRIES OF MANAGEMENT AND OTHERS WITHIN THE ENTITY:** Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, auditor may inquire others within the entity like:
   a. Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
   b. Inquiries directed toward internal audit personnel may provide information about the design and effectiveness of the entity's internal control.
   c. Inquiries of employees may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
   d. Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations etc.
   e. Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends.
   f. Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
   g. Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system- related risks.

2. **ANALYTICAL PROCEDURES:**
   a. Analytical procedures performed as risk assessment procedures may help the auditor identify aspects of the entity may assist in assessing the risks of material misstatement.
   b. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information.
   c. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

3. **OBSERVATION AND INSPECTION:**
   a. The auditor shall inspect the documents such as business plans and strategies, records, and internal control manuals.
   b. The auditor may inspect the reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of director's meetings).
   c. The auditor shall observe the entity's premises and plant facilities.

TEST YOUR KNOWLEDGE:

1. **Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. Explain with the help of examples.**

Answer: Write Point B(1)

2. **CA L is in the process of finalizing his Risk Assessment Procedures of Effluent Limited which include observation and inspection that may support inquiries of management and others. Discuss few examples of audit procedures which include observation or inspection of the entity's operations.**

Answer: Write Point B(3)

3. **Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Explain in detail.**

Answer: Write Point B(2)

4. **The auditor shall identify and assess the risks of material misstatement at both levels to provide a basis for designing and performing further audit procedures. For the purpose of Identifying and assessing the risks of material misstatement the auditor shall Identify risks, assess the identified risks, relate the identified risks and consider the likelihood of misstatement. Explain the above in detail.**

Answer: Write Point A

Q.NO.3 UNDERSTANDING OF THE ENTITY- A CONTINUOUS PROCESS. EXPLAIN.

ANSWER:

Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analysing information throughout the audit.

The understanding helps the auditor in the following ways:

1. Assessing risks of material misstatement of the financial statements;
2. Determining materiality in accordance with SA 320;
3. Considering the appropriateness of the selection and application of accounting policies;

4. Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
5. Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

TEST YOUR KNOWLEDGE:

1. **The auditor of ABC Textiles Ltd chalks out an audit plan without understanding the entity's business. Since he has carried out many audits of textile companies, there is no need to understand the nature of business of ABC Ltd. Advise the auditor how he should proceed.**

Answer: Write the above answer.

2. **While auditing the books of accounts of Heavy Material Limited for the financial year 2020-21, a team member of the auditor of Heavy Material Limited showed no inclination towards understanding the business and the business environment of the above mentioned company. Is the approach of team member of the auditor of Heavy Material Limited correct or incorrect? Also give reason for your answer.**

Answer:

Write the above answer and then write the below conclusion.

The approach of team member of the auditor of Heavy Material Limited is incorrect because understanding the business and the business environment of company whose audit is to be conducted is very important, as it helps in planning the audit and identifying areas requiring special attention during the course of audit of that company.

Q.NO.4 WRITE ABOUT DOCUMENTATION OF RISK.

ANSWER:

The auditor shall document:
1. The discussion among the engagement team and the significant decisions reached;
2. Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and of each of the internal control components, the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
3. The identified and assessed risks of material misstatement at the financial statement level and at the assertion level ; and
4. The risks identified, and related controls about which the auditor has obtained an understanding.

TEST YOUR KNOWLEDGE:

1. **Mr. N, one of the team members of the auditors of Reasonably Cheerful Limited was of the view that risks that were identified during the course of audit were not required to be documented. Explain with a reason whether the viewpoint of Mr. N is justified.**

Answer: Write above answer

Q.NO.5 DEFINE THE TERM INTERNAL CONTROL. STATE ITS OBJECTIVES/PURPOSE.

ANSWER:

1. **MEANING:** As per SA-315, , the internal control may be defined as "the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives.

2. **OBJECTIVES OF INTERNAL CONTROL:** Internal controls are implemented to achieve the following objectives:
   a. The reliability of the entity's financial reporting;
   b. The effectiveness and efficiency of its operations;
   c. Its compliance with applicable laws and regulations; and
   d. Safeguarding of assets.

TEST YOUR KNOWLEDGE:

1. **Internal control over safeguarding of assets against unauthorised acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. Explain stating clearly the objectives of Internal Control.**

Answer: Write above answer

Q.NO.6 WHAT ARE INHERENT LIMITATIONS OF INTERNAL CONTROL?

ANSWER:

Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control. The following are the inherent limitations of internal controls:

1. **HUMAN JUDGMENT IN DECISION-MAKING:** Human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.
   Example: There may be an error in the design of, or in the change to, a control.

2. **LACK OF UNDERSTANDING THE PURPOSE:**
   a. Those people who are required to monitor and implement the internal controls may not understand the purpose of controls.
   b. This will lead to ineffective utilisation of exception reports.

3. **COLLUSION AMONG PEOPLE:**
   a. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control.
   b. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition.

4. **COST EXCEEDING BENEFITS:** Further, in designing and implementing controls, management may make judgments to not implement internal controls, as the cost of implementing controls can be higher than the benefits derived from them.

5. **LIMITATIONS IN CASE OF SMALL ENTITIES:**
   1. Smaller entities often have fewer employees due to which segregation of duties is not practicable.
   2. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity.
   3. This oversight may limit the opportunities for segregation of duties.
   4. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured.
   5. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

TEST YOUR KNOWLEDGE:

1. **Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control. Explain those limitations.**

Answer: Write above answer.

2. **Inappropriate management can override internal controls of any organization. Correct/Incorrect.**

Answer:

Correct

Controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

Q.NO.7 WRITE A SHORT NOTE ON CONTROLS RELEVANT TO AUDIT?

ANSWER:

1. All internal controls implemented in the organisation may not be relevant for auditors.
2. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:
   a. Materiality.
   b. The significance of the related risk.
   c. The size of the entity.
   d. The nature of the entity's business, including its organisation and ownership characteristics.
   e. The diversity and complexity of the entity's operations.
   f. Applicable legal and regulatory requirements.
   g. The circumstances and the applicable component of internal control.
   h. The nature and complexity of the systems that are part of the entity's internal control, including the use of service organisations.
3. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an airline's system of automated controls to maintain flight schedules, but these controls ordinarily would not be relevant to the audit.

Q.NO.8 WHAT ARE THE VARIOUS METHODS FOR EVALUATION OF INTERNAL CONTROLS?

ANSWER:

1. **NARRATIVE RECORD:**
   a. This is a complete and exhaustive description of the system as found in operation by the auditor.
   b. Actual testing and observation are necessary before such a record can be developed.
   c. It may be recommended in cases where no formal control system is in operation and would be more suited to small business.
   d. The basic disadvantages of narrative records is its difficulty in identifying weaknesses or gaps in the system.

2. **CHECK LIST:**
   a. This is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer.
   b. The instructions/questions are framed having regard to the desirable elements of control.
   c. When he completes instruction, he initials the space against the instruction.
   d. Answers to the check list instructions are usually '**Yes**', **'No'** or **'Not Applicable'.**
   e. An example of checklist for purchases
      i. Are tenders called before placing orders?
      ii. Are the purchases made on the basis of a written order?

iii. Is the purchase order form standardised?
iv. Are purchase order forms pre-numbered?
v. Are the inventory control accounts maintained by persons who have nothing to do with custody of work, receipt of inventory, inspection of inventory and purchase of inventory?

3. **INTERNAL CONTROL QUESTIONNAIRE (ICQ):**

a. It refers to a complete series of questions in a logical and sequential order prepared by the auditor concerning internal control.
b. Answers to the questions are usually **Yes, No or Not Applicable** along with Remarks column for an explanation or further details of 'No' answers.
c. In ICQ, the questions are generally so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. In respect of questions not relevant to the business. 'Not Applicable' reply is given.
d. The questionnaire is usually issued to the client and the answers to the questions are filled by clients employees.
e. After examination of answers, if any inconsistencies or weaknesses are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture.
f. Then the auditor prepares a report of deficiencies (i.e. Letter of weaknesses) observed by him through ICQ and sends it to management along with recommendations for improvement.
g. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections
f. An example of Questionnaire for purchases
   i. Are tenders called before placing orders?
   ii. Are the purchases made on the basis of a written order?
   iii. Is the purchase order form standardised?
   iv. Are purchase order forms pre-numbered?
   v. Are the inventory control accounts maintained by persons who have nothing to do with custody of work, receipt of inventory, inspection of inventory and purchase of inventory?

4. **FLOWCHART:**

a. It is a graphic presentation of each part of the company's system of internal control.
b. A flow chart is considered to be the most concise way of recording the auditor's review of the system.
c. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form.
d. It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested
e. This will help auditor to understand and evaluate the internal controls in the correct perspective.

Q.NO.9 WRITE ABOUT UNDERSTANDING OF INTERNAL CONTRLOLS. ALSO EXPLAIN THE BENEFITS OF UNDERSTANDING OF INTERNAL CONTROLS.

ANSWER:

A. UNDERSTANDING OF INTERNAL CONTROLS:

1. The auditor shall understand the internal controls and accounting system to determine the nature, timing and extent of audit procedures. The audit programmed is substantially influenced by internal control system found in operation.
2. Further the evaluation enables the auditor to priorities the audit areas depending upon the weaknesses identified in the system.
3. If he does not care to study this aspect, it is very likely that his audit programmed may become unwieldy (Uncontrollable) and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers.
4. The information about the controls can be obtained from reading company manuals, studying organization charts and by making suitable enquiries from the officers and employees.
5. Existence of satisfactory internal control is not an absolute deterrent to fraud. Even though controls are highly effective the misstatements keep exist.
6. Also Existence of Misstatement strongly indicates that there is a significant deficiency in related controls.
7. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit.
8. In other words, all the controls relevant to financial reporting may or may not be relevant to audit of financial statements.

B. BENEFITS OF EVALUATION OF INTERNAL CONTROL TO THE AUDITOR: The review of internal controls will enable the auditor to know:

1. Whether an adequate internal control system is in use and operating as planned by the management.
2. Whether an effective internal auditing department is operating.
3. Whether the controls adequately safeguard the assets.
4. How management is discharging its function for correct recording of transactions.
5. How reliable the reports, records and the certificates to the management can be.
6. The extent and the depth of the examination that he needs to carry out in the different areas of accounting.
7. What would be appropriate audit technique and the audit procedure in the given circumstances.
8. What are the areas where control is weak: and
9. Whether any suggestions can be given to improve the control system to management by auditor.

TEST YOUR KNOWLEDGE:

1. **Auditor GR and Associates, appointed for audit of PNG Ltd, a manufacturing company engaged in manufacturing of various food items. While planning an audit, the auditor does not think that it would be necessary to understand internal controls. Advise the auditor in this regard.**

Answer: Write Point A from above answer

2. **The team member of the auditor of Simple and Easy Limited was of the view that understanding the internal control of the company would not help them in any manner in relation to audit procedures to be applied while conducting the audit.**

Answer: Write Point A from above answer

Q.NO.10 WHAT IS THE PURPOSE OF TEST OF CONTROLS? ALSO EXPLAIN WHAT IT INCLUDES.

ANSWER:

A. PUROPSE: Tests of control are performed to obtain audit evidence about the effectiveness of:

1. Design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements or not; and
2. Operation of the internal controls throughout the period.
3. The testing is being carried out on selective basis and will cover all important areas that are relevant to financial statements.

B. TESTS OF CONTROL MAY INCLUDE:

1. 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 authorized.
2. Inquiries about internal controls and observation of internal controls. For example, determining. For example, who actually performs each function and not merely who is supposed to perform it.
3. Re-performance of internal controls. For example, reconciliation of bank accounts, to ensure that they were correctly performed by the entity.
4. Testing of internal control operating on specific computerized applications or over the overall information technology function. For example, access or program change controls.

TEST YOUR KNOWLWDGE:

1. **Explain the nature and extent of test of test of controls.**

Answer: Write above answer

Q.NO.11 IT HAS BEEN SUGGESTED THAT ACTUAL OPERATION OF THE INTERNAL CONTROL SHOULD BE TESTED BY THE APPLICATION OF PROCEDURAL TESTS AND EXAMINATION IN DEPTH. EXPLAIN WITH THE HELP OF EXAMPLE IN RESPECT OF THE PROCEDURE FOR SALES.

ANSWER:

1. It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth.
2. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorisation, recording and documentation of transaction at each stage through which it flows.
3. For example, the procedure for sales requires the follows:
   a. Before acceptance of any order the position of inventory of the relevant article should be known to ascertain whether the order can be executed in time.
   b. An advice under the authorisation of the sales manager should be sent to the party placing the order. This advice should be prepared on a standardised form and copy thereof should be forwarded to inventory section to enable it to prepare for the execution of the order in time.
   c. The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.
   d. The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.
   e. Before deciding upon the credit period, a reference should be made to the credit section to know the creditworthiness of the party and particularly whether the party has honored its commitments in the past.

Q.NO.12 WHAT ARE THE FACTORS TO BE CONSIDERD BY AN AUDITOR IN DETERMINING WHETHER IT IS APPROPRIATE TO USE AUDIT EVIDENCE ABOUT THE OPERATING EFFECTIVENESS OF CONTROLS OBTAINED IN PREVIOUS AUDITS?

ANSWER:

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

1. The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process.
2. The risks arising from the characteristics of the control, including whether it is manual or automated.
3. The effectiveness of general IT-controls.
4. The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control.
5. Whether the lack of a change in a particular control poses a risk due to changing circumstances.
6. The risks of material misstatement and the extent of reliance on the control.

Note: If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit.

Q.NO.13 STATE THE SPECIFIC INQUIRIES TO BE MADE BY AUDITOR WHEN DEVIATION FROM CONTROLS ARE DETECTED.

ANSWER:

When deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether:

1. The test of controls that have been performed provide an appropriate basis for reliance on the controls;
2. Additional test of controls are necessary; or
3. The potential risks of misstatement need to be addressed using substantive procedures.

Q.NO.14 WHEN THE AUDITOR SHALL DESIGN AND PERFORM TESTS OF CONTROLS TO OBTAIN SUFFICIENT APPROPRIATE AUDIT EVIDENCE AS TO THE OPERATING EFFECTIVENESS OF RELEVANT CONTROLS?

ANSWER:

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

1. 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
2. Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.
3. A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

TEST YOUR KNOWLEDGE:

1. **A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls. Explain and also state when will the auditor design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls.**

Answer: Write above answer

Q.NO.15 WHEN AUDITOR IDENTIFIES DEFICIENCIES ON INTERNAL CONTROLS EXPLAIN THE IMPACT ON CONTROL RISK ASSESSMENT AND STRATEGY FOR THE AUDIT OF THE FINANCIAL STATEMENTS?

ANSWER:

CONTROL RISK ASSESSMENT WHEN CONTROL DEFICIENCIES ARE IDENTIFIED:

1. When auditor identifies deficiencies and report on internal controls, he determines the significant financial statement assertions that are affected by the ineffective controls in order to evaluate the effect on control risk assessments and strategy for the audit of the financial statements.
2. When auditor identifies control deficiencies in more than one control for each relevant assertion, he evaluates control risk considering all of the controls he has tested.
3. If auditor determines that the controls relevant to particular assertion are operating effectively, he may conclude that **RELY ON CONTROLS** is appropriate, (i.e. reliance on internal controls can be placed when determining nature, timing and extent of audit procedures)
4. Otherwise, we change our control risk assessment to **'NOT RELY ON CONTROLS.'**
5. When a deficiency relates to an ineffective control that is the only control identified for an assertion, he revises risk assessment to **'NOT RELY ON CONTROLS'** for associated assertions, as no other controls have been identified that mitigate the risk related to the assertion.
6. If the deficiency relates to one WCGW (what can go wrong) out of several WCGWs (deficiency relates to one control out of so many controls), he can **'RELY ON CONTROLS'** but performs additional substantive procedures to adequately address the risks related to the deficiency.

Q.NO.16 WHAT ARE INTERNAL FINANCIAL CONTROLS? EXPLAIN THE REPORTING REQUIREMENTS REGARDING THE SAME?

ANSWER:

A. OBJECTIVE AND PURPOSE OF INTERNAL FINANCIAL CONTROLS: Internal financial controls are the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies,

1. The safeguarding of its assets.
2. The prevention and detection of frauds and errors.
3. The accuracy and completeness of the accounting records.
4. The timely preparation of reliable financial information.
5. Compliance with applicable laws and regulations.

B. AUDITORS' RESPONSIBILITY: SEC. 143(3)(I):

1. The auditor shall express an opinion on effectiveness of internal financial controls with reference to Financial statements.

2. Further this reporting responsibility is applicable <u>only in respect of Audit of Annual financial statements</u> and not applicable for Interim or Quarterly financial statements.

C. SOME PROVISIONS OF THE COMPANIES ACT REGARDING INTERNAL FINANCIAL CONTROL:

1. **Section 134 (5)(e):** In case of listed Companies, the Directors' responsibility statement shall state that the Directors had laid down Internal financial controls to be followed by the company and that such Internal financial controls are adequate and were operating effectively.
2. **Section 177(4)(vii) of the Act:** Every audit Committee shall act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, include - evaluation of internal financial controls and risk management systems.
3. **As per Section 149(8) of the Act:** The company and independent directors shall abide by the provisions specified in Schedule IV which lays down the Code for independent Directors. As per this code, the role and functions of independent directors include that they shall satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible.

TEST YOUR KNOWLEDGE:

1. Mr. T, one of the directors of Over Careful Limited was of the view that internal financial controls have nothing to do with accounting records of a company. Comment on the views of Mr T.

<u>Answer:</u>

Clause (e) of Sub-section 5 of Section 134 explains the meaning of internal financial controls as, "the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information."

In view of above, viewpoint of Mr. T is incorrect.

Q.NO.17 WHAT ARE THE COMPONENTS OF INTERNAL CONTROLS?

<u>ANSWER:</u>

1. The control Environment (Governance, management structure and Culture of honesty).
2. Entity's risk assessment process (Identification of risk to design a control to mitigate it).
3. Information system, including related business process, relevant to financial reporting.
4. Control activities (Review of policies to be implemented).
5. Monitoring of controls (Testing of controls to update them).

Q.NO.18 WRITE ABOUT CONTROL ENVIRONMENT AS A COMPONENT OF INTERNAL CONTROL?

ANSWER:

1. **THE AUDITOR SHALL EVALUATE WHETHER:**
   a. Management has created and maintained a culture of honesty and ethical behavior;
   b. Control environment provides appropriate foundation for other components

2. **ELEMENTS OF CONTROL ENVIRONMENT:**
   a. **Communication and enforcement** of integrity and ethical values
   b. **Commitment to competence:** How the management decides the competence levels for particular jobs.
   c. **Participation by those charged with governance:** Evaluate the roles of those charged with governance such as:
      i. Their independence from management
      ii. Their experience
      iii. Extent of their involvement and scrutiny of activities
      iv. Appropriateness of their actions and degree to which questions are raised with management
   d. **Management's philosophy and operating style:** Characteristics such as management's
      i. Approach to taking and managing business risks
      ii. Attitudes and actions toward financial reporting
      iii. Attitudes toward information processing and accounting functions and personnel
   e. **Organizational structure:** Framework within which an entity operates.
   f. **Assignment of authority and responsibility:** How operating activities are assigned, and authorization hierarchies are established.

TEST YOUR KNOWLEDGE:

1. **The auditor of MARUT Ltd, engaged in manufacturing of Smart Motor Bikes, obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:**
   a. **Management has created and maintained a culture of honesty and ethical behavior.**
   b. **The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.**
   c. **Advise what is included in control environment. Also explain the elements of control environment.**

Answer: Write above answer

Q.NO.19 WRITE ABOUT AUDITORS UNDERSTANDING REGARDING THE ENTITY's RISK ASSESSMENT PROCESS.

ANSWER:

The auditor shall obtain an understanding of whether the entity has a process for:

1. Identifying business risks relevant to financial reporting objectives;
2. Estimating the significance of the risks;
3. Assessing the likelihood of their occurrence; and
4. Deciding about actions to address those risks.

Note: Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

Q.NO.20 WHAT ARE THE FACTORS THE AUDITOR SHALL CONSIDER IN EXERCISING JUDGEMENT AS TO WHICH RISKS AS TO SIGNIFICANT RISKS?

ANSWER:

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

2. Whether the risk is a risk of fraud;
3. Whether the risk is related to recent significant economic, accounting, or other developments like changes in regulatory environment, etc., and, therefore, requires specific attention;
4. The complexity of transactions;
5. Whether the risk involves significant transactions with related parties;
6. 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
7. Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

Q.NO.21 RISK OF MATERIAL STATEMENT IS GREATER FOR SIGNIFICANT NON-ROUTINE TRANSACTIONS. GIVE EXAMPLES.

ANSWER:

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

1. Greater management intervention to specify the accounting treatment.
2. Greater manual intervention for data collection and processing.
3. Complex calculations or accounting principles.
4. The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

Q.NO.22 WRITE ABOUT MONITORING OF CONTROLS AS A COMPONENT OF INTERNAL CONTROL.

ANSWER:

1. **DEFINITION:** Monitoring of controls is a process to assess the effectiveness of internal control performance over time.
2. **ASSESSING THE EFFECTIVENESS OF CONTROLS ON A TIMELY BASIS:** It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.
3. **MANAGEMENT ACCOMPLISHES THROUGH ON-GOING ACTIVITIES OR SEPARATE EVALUATIONS:** Management accomplishes monitoring of controls through on-going activities, separate evaluations, or a combination of the two. On-going monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.
4. **MANAGEMENT'S MONITORING ACTIVITIES INCLUDE:** Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.
5. **IN CASE OF SMALL ENTITIES:** Management s monitoring of control is often accomplished by managements or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.
6. **MONITORING OF CONTROLS- IF THE ENTITY HAS AN INTERNAL AUDIT FUNCTION:** If the entity has an internal audit function, the auditor shall obtain an understanding of the following:
   a. The internal audit function's responsibilities and how the internal audit function fits in the entity's organisational structure; and
   b. The activities performed, or to be performed, by the internal audit function.

TEST YOUR KNOWLEDGE:

1. **"The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting" Explain.**

Answer: Write above answer

Q.NO.23 EXPLAIN THE FUNCTIONS OF THE INTERNAL AUDITOR WITH REGARD TO INTERNAL CONTROLS.

ANSWER:

The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the Activities Relating to Internal Control:

1. **EVALUATION OF INTERNAL CONTROL:**
   a. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto
   b. In doing so, the internal audit function provides assurance on the control.

c. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

2. **EXAMINATION OF FINANCIAL AND OPERATING INFORMATION:** The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make transactions, balances and procedures.
3. **REVIEW OF OPERATING ACTIVITIES:** The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including nonfinancial activities of an entity.
4. **REVIEW OF COMPLIANCE WITH LAWS AND REGULATIONS:** The internal audit function may be assigned to review compliance with laws, regulations and other external requirements. and with management policies and directives and other internal requirements.

TEST YOUR KNOWLEDGE:

1. ***One of the directors of Stability Establishment Limited was of the view that Internal Audit has no relation with Internal Control of a company. Comment***

Answer: Write above answer

Q.NO.24 WRITE ABOUT INTERNAL FINANCIAL CONTROLS (IFC) AND INTERNAL FINANCIAL CONTROL OVER FINANCIAL REPORTING (IFC-FR).

ANSWER:

A. INTERNAL FINANCIAL CONTROLS (IFC): As per Section 134(5)(e) of Companies Act, 2013, the term 'internal financial controls' means the policies and procedures adopted by the company for ensuring the

a. orderly and efficient conduct of its business,
b. including adherence to company's policies,
c. the safeguarding of its assets,
d. the prevention and detection of frauds and errors,
e. the accuracy and completeness of the accounting records, and
f. the timely preparation of reliable financial information.

B. INTERNAL FINANCIAL CONTROL OVER FINANCIAL REPORTING (IFC-FR): As per the Guidance Note, Audit of Internal Financial Controls Over Financial Reporting, issued by Institute of Chartered Accountants of India, IFC-FR shall mean, "A process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles."

Thus IFC-FR = Maintenance of Financial records + Authorization of transactions in accordance with GAAP + Safeguarding of assets of the company.

C. **IFC vs. IFC-FR:**

a. Internal Financial Control over Financial Reporting (IFC-FR) covers those controls which are elements of Financial Reporting i.e., of balance sheet, profit and loss accounts. They cover those risks which are having a direct or indirect reporting on financial statements.
b. Internal Financial Control (IFC), in addition to ICFR, covers controls which ensure efficient and effective functions of business, controls which safeguard assets and ensure compliance of policies.
c. To put it differently, IFC as a concept is much wider in scope when compared to IFC-FR.
d. In fact, **IFC = IFC-FR + Operational Controls + Anti-fraud Controls**

Thus, it can be said that IFC-FR is a concept which is more intended towards users/readers of financial statement whereas IFC is more intended towards functions and management of the business.

Q.NO.25 WRITE ABOUT INFORMATION SYSTEM, INCLUDING THE RELATED BUSINESS PROCESSES, RELEVANT TO FINANCIAL REPORTING AND COMMUNICATION AS A COMPONENT OF INTERNAL CONTROL.

ANSWER:

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas: -

a. The classes of transactions in the entity's operations that are significant to the financial statements
b. The procedures by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements
c. The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions
d. How the information system captures events and conditions that are significant to the financial statements
e. The financial reporting process used to prepare the entity's financial statements
f. Controls surrounding journal entries.

Q.NO.26 WRITE ABOUT CONTROL ACTIVITIES AS A COMPONENT OF INTERNAL CONTROL.

ANSWER:

1. The auditor shall obtain an understanding of control activities relevant to the audit, which the auditor considers necessary to assess the risks of material misstatement.
2. An audit requires an understanding of only those control activities related to significant class of transactions, account balance, and disclosure in the financial statements and the assertions which the auditor finds relevant in his risk assessment process.
3. Control activities are the policies and procedures that help ensure that management directives are carried out.

4. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.
5. Control activities relevant to audit generally include policies and procedures relating to
   a. performance reviews (reviews of actual performance with budgets),
   b. information processing (for example controls over checking arithmetical accuracy of records, program change controls etc),
   c. physical controls(like controls over physical security of assets) and
   d. segregation of duties (controls over ensuring that different people are assigned the responsibilities of authorising transactions, recording transactions and maintaining custody of assets)

FEW ILLUSTRATIVE EXAMPLES OF INTERNAL CONTROL QUESTIONNAIRE IN DIFFERENT AREAS OF AN ENTITY ARE GIVEN AS UNDER:

A. PURCHASES

4. Are purchases centralised in the Purchase Department?
5. Are purchases made only from approved suppliers?
6. Is a list of approved suppliers maintained for this purpose?
7. Does the master list contain more than one source of supply for all important materials?
8. Are the purchase orders based on valid purchase requisitions duly signed by authorised persons in this behalf?
9. Are purchases based on competitive quotations from two or more suppliers?
10. Are purchase orders pre-numbered?
11. Are purchase orders signed only by employees authorized in this behalf?
12. Are all materials received only in the Receiving Department?
13. Are persons connected with receipt of materials and the keeping of receiving records denied authority to issue purchase orders or to approve invoices?
14. Are materials inspected and counted, weighed or measured in the Receiving Department?
15. Are receipt of materials evidenced by pre-numbered Goods Received Note?

B. ***CREDITORS***

1. Are suppliers' invoices routed direct to the Accounts Department?
2. Are they entered in a Bill register before submitting them to other departments for check and/or approval?
3. Are advance and partial payments entered on the invoices before they are submitted to other departments?
4. Does the system ensure that all invoices are duly processed?
5. In respect of raw material and supplies, are reconciliations made of quantities and/or values received as shown by purchase invoices with receipt into stock records?
6. Does the Accounts Department match the invoices of supplies with Goods Received Notes and purchase orders?
7. Do all invoices bear evidence of being checked for prices, freight, terms etc.?
8. Are all advance payments duly authorized by persons competent to authorize such payments?

9. *Are duplicate invoices marked immediately on receipt to avoid payment against them?*
10. *Are all supplier's statements compared with ledger accounts?*
11. *Is there any follow-up action to investigate difference, if any, between the suppliers' statements and the ledger accounts?*
12. *Is a list of unpaid creditors prepared and reconciled periodically?*

C. ***INVENTORIES***

1. *Are stocks stored in assigned areas?*
2. *Are stocks insured comprehensively against different risks? If some risk is not insured, whether it is due to specific decision taken by a senior official?*
3. *Is a record maintained for the insurance policies?*
4. *Is the record reviewed periodically?*
5. *Is there an official who decides on the value for which stocks are to be insured?*
6. *Is the adequacy of insurance cover reviewed periodically?*
7. *Are perpetual stock records kept for raw materials, work-in-progress, finished goods and stores?*
8. *Are stock records periodically reconciled with accounting records?*
9. *Where there is a system of perpetual inventory count:*
   a. *Is there a periodical report of shortages/excess?*
   b. *If so, are these differences investigated?*
   c. *Are these differences adjusted in the stock records and in the financial accounts?*
   d. *Is written approval obtained from a responsible official to adjust these differences?*
10. *Are there norms for stock levels to be held?*

D. ***FIXED ASSETS***

1. *Are budgets for capital expenditure approved?*
2. *Is the authority to incur capital expenditure restricted to specified officials?*
3. *Are purchases of capital expenditure subject to same controls as applicable to purchases of raw materials, stores etc.?*
4. *Is there proper check to see that amounts expended do not exceed the amount authorized?*
5. *Are fixed assets verified periodically?*
6. *Is there a written procedure for such verification?*
7. *Are reports prepared on such verification?*
8. *Do such reports indicate damaged/obsolete items of fixed assets?*
9. *Are discrepancies disclosed by such reports investigated?*
10. *Are the records and financial accounts corrected with appropriate authority?*

TEST YOUR UNDERSTANDING

1. **Wear & Tear Private Limited is a "start-up" engaged in providing holistic solutions to problem of paddy stubble burning mainly catering to needs of farmers of North western India. Due to importance given by governments to this issue, companies have entered in the market in past few years. Many of these companies have not been successful and have gone bust. As an**

auditor of the company, can you spot the component of risks of material misstatement involved in above?

Answer:

It has been stated that many companies engaged in providing holistic solutions to problem of stubble burning have not been successful. It shows that line of activity is inherently risky. Therefore, there is a greater possibility of misstatements. The component of risks of material misstatement involved is "inherent risk."

2. **A company has devised a control that its inventory of perishable goods is stored in appropriate conditions- in a controlled environment to prevent any damages to inventory. Responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. Identify the component of risks of material misstatement involved as an auditor of the company.**

Answer:

The company has devised a control that its inventory of perishable goods is stored in appropriate conditions and responsibility is fixed on two persons to monitor environment using sensors and to report on deviations. There is a possibility that persons given responsibility do not perform their work and report deviations. The component of risks of material misstatement is "control risk".

3. **Shree Foods Private Limited is engaged in manufacturing of garlic bread. The auditors of company have planned audit procedures in respect of recognition of revenues of the company. Despite that, there is a possibility that misstatements in revenue recognition are not identified by planned audit procedures. Which risk is being alluded to?**

Answer:

There is a possibility that planned audit procedures may not achieve desired result and fail to detect misstatements in revenue recognition. The risk alluded to it is "detection risk"

4. **Jo Jo Limited is planning to list on Bombay Stock Exchange next year. As an auditor of Jo Jo Limited, identify any one reason of increased audit risk due to listing of the company next year.**

Answer:

Jo Jo Limited is planning to list on Bombay Stock Exchange next year. There is a greater chance of misstatements in the financial statements due to planned listing next year. There could be a possibility of intentional manipulation of financial statements so that good response is received to proposed issue. Therefore, there is increased audit risk i.e., risk of expressing inappropriate opinion by the auditor when financial statements are materially misstated.

5. **On perusing financial statements of Jo Jo Limited put up for audit, it is observed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year).**

Identify what kind of risk assessment procedures are being performed by auditor? Has it any relation with listing of the company next year on Bombay Stock Exchange?

Answer:

It is noticed by the auditor that current ratio has improved from 1.20:1 (in preceding year) to 1.75:1 (in current year). The auditor is using "analytical procedures" as risk assessment procedures. Current ratio has improved from previous year. There could be a possibility of misstatement in current assets and current liabilities. It is possible that improvement in current ratio is artificial due to misstatements and has been done to secure good response to the proposed issue of company next year.

6. **CA Smriti is auditor of a company. As part of audit, she is going through company policies and practices regarding employee recruitment, training, orientation and related matters. She seems to be very much interested in finding out whether company hires best candidates from applicant pool. Identify what she is trying to do? How gaining knowledge about this aspect is useful to her as an auditor?**

Answer:

The study of company policies and practices regarding employee recruitment, training, orientation and related matters including hiring of best candidates is part of understanding HR function of the company. It, in turn, helps in understanding control environment of the company. By gaining such a knowledge, she can better understand internal control of the company.

7. **During the audit of same company, CA Smriti is keen to find out whether there exists a proper system of segregation of duties in the company. She wants to be sure that a person responsible for recording a transaction is different from the person authorising it. Discuss what she is trying to do and how its understanding is significant to her as an auditor.**

Answer:

She is keen to find out whether there exists a proper system of segregation of duties in the company. She is gaining an understanding of internal control of the company. In particular, she is understanding "control activities". When a person recording a transaction is different from one authorizing it, she gains confidence that there exists a system for preventing misstatements. It helps her in gaining insight into the internal control system of the company.

8. **Zomba Products Private limited is a small company. The control systems in the company are rudimentary. How, you as an auditor of the company, would proceed to evaluate internal control of the company?**

Answer:

In a small company, control systems are basic and not formalized. Therefore, auditor should proceed to evaluate internal control using narrative record.

9. A Chartered accountant during course of audit of a company finds that cash is not deposited into bank frequently although concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. Discuss what does it represent from auditor's perspective.

Answer:

Cash is not deposited into bank frequently, although, concerned staff of company was required to do so. Further, the official responsible for ensuring performance of above function, has also not paid any attention to it. It means that control is not working as planned. It would not be able to prevent misstatement and very purpose of control is defeated. It represents a "control deficiency"

10. A company has stipulated a control through its automated software that interest @ 12% p.a. is charged in case of those customers who fail to make payment within a month of a sales transaction. The internal auditor of the company finds that during a certain period, software has failed to charge interest due to certain technical glitches. Does reporting of above situation fall in domain of internal auditor's work?

Answer:

One of the functions of internal auditor includes responsibility for reviewing controls, evaluating their operation, and recommending improvements thereto. In the given case, internal auditor has found that controls relating to levying of interest have not operated. The system has not levied stipulated interest in respect of a certain period. It can result in loss of income for the company and improper financial reporting. Such a matter, definitely, falls in the domain of reporting by internal auditor.

7.STANDARDS ON AUDITING

LIST OF STANDARDS APPLICABLE FOR CA INTER

A. STANDARDS THAT WILL BE COVERED AS A PART OF OTHER CHAPTERS:

S.No	SA	TITLE	COVERED IN CHAPTER
1	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	Nature, Objective and Scope of Audit
2	SA 210	Agreeing the Terms of Audit Engagements	Nature, Objective and Scope of Audit
3	SA 230	Audit Documentation	Audit Documentation and Evidence
4	SA 299	Joint Audit of Financial Statements	Company Audit
5	SA 300	Planning an Audit of Financial Statements	Audit Strategy, Planning and Programme
6	SA 315	Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment	Risk Assessment and Internal Control
7	SA 320	Materiality in Planning and Performing an Audit	Audit Strategy, Planning and Programme
8	SA 500	Audit Evidence	Audit Documentation and Evidence
9	SA 520	Analytical Procedures	Analytical Procedures
10	SA 530	Audit Sampling	Audit Sampling
11	SA 600	Using the Work of Another Auditor	Company Audit
12	SA 610	Using the Work of Internal Auditors	Audit Reporting
13	SA 700	Forming an Opinion and Reporting on Financial Statements	Audit Reporting
14	SA 701	Communicating Key Audit Matters in the Independent Auditor's Report	Audit Reporting
15	SA 705	Modifications to the Opinion in the Independent Auditor's Report	Audit Reporting
16	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	Audit Reporting

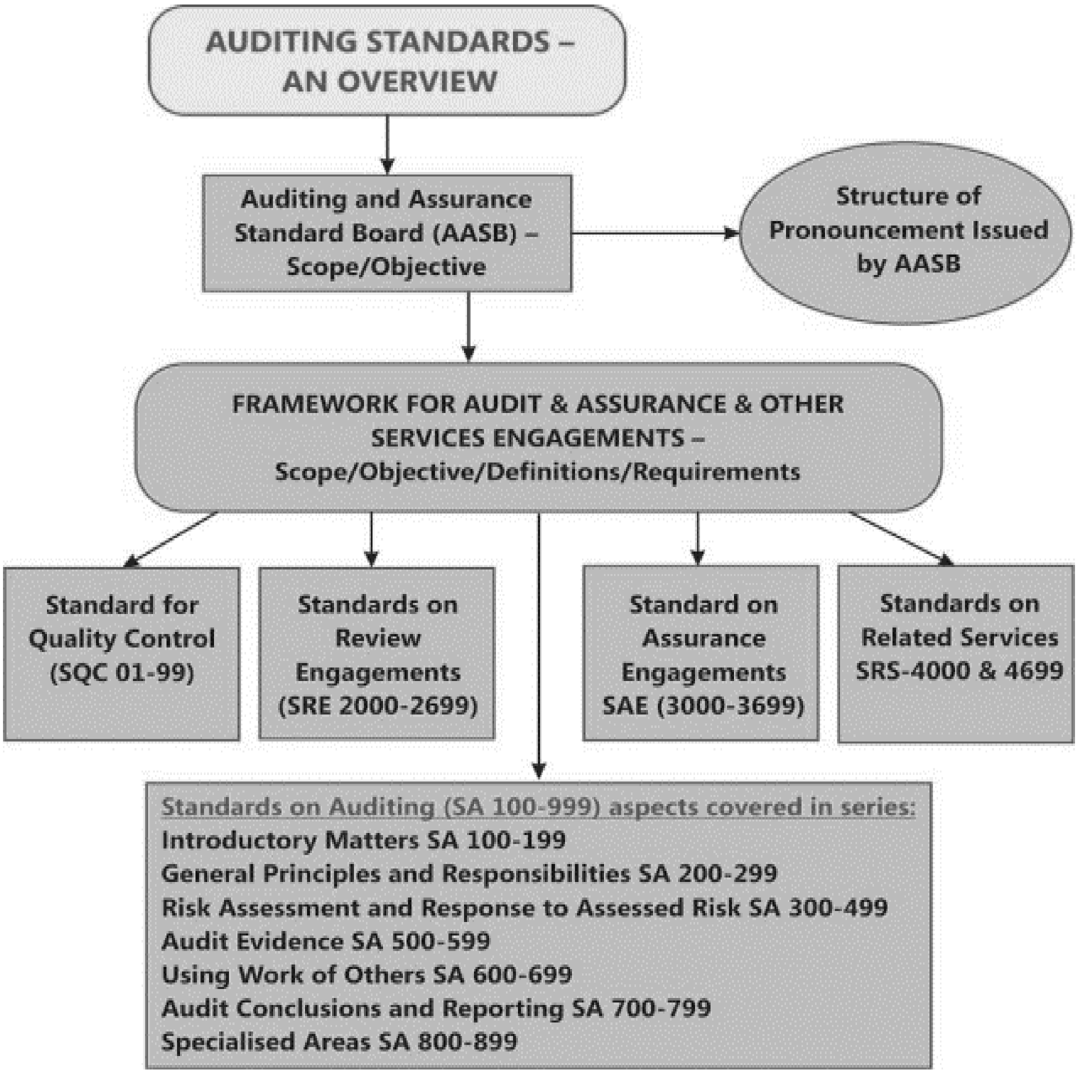
B. STANDARDS THAT WILL BE EXCLUSIVELY COVERED IN THIS CHAPTER:

S.No	SA	TITLE
1	SA 220	Quality Control for an Audit of Financial Statements
2	SA 260	Communication with Those Charged With Governance
3	SA 265	Communicating deficiencies in internal controls to Those charged with governance and Management
4	SA 450	Evaluation of Misstatements identified during the audit
5	SA 501	Audit Evidence-Specific Considerations for Selected Items
6	SA 505	External Confirmations
7	SA 510	Initial Audit Engagements – Opening Balances
8	SA 550	Related Parties
9	SA 560	Subsequent Events
10	SA 570	Going Concern
11	SA 580	Written Representations
12	SA 710	Comparative Information—Corresponding Figures and Comparative Financial Statements
13	SQC 1	Quality control for firms that perform audits and reviews of historical financial information, and other assurance and related services engagements

INTRODUCTION

A. WHY ARE STANDARDS NEEDED?

1. Standards ensure carrying out of audit against established benchmarks at par with global practices.
2. Standards improve quality of financial reporting thereby helping users to make diligent decisions.
3. Standards promote uniformity as audit of financial statements is carried out following these Standards.
4. Standards equip professional accountants with professional knowledge and skill.
5. Standards ensure audit quality.



B. STANDARDS ON AUDITING (SA) VS STANDARDS ON REVIEW ENGAGEMENTS (SRE):

1. Standards on Auditing (SAs) apply in "audit of historical financial information" whereas Standards on Review Engagements (SREs) apply in "review of historical financial information."
2. "Audit" of historical financial information which is a reasonable assurance engagement whereas "Review" of historical financial information which is a limited assurance engagement only.

3. "Historical financial information means" information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.
4. Some examples of Standards on Auditing are
   a. SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing
   b. SA 230 Audit Documentation
   c. SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
   d. SA 500 Audit Evidence
5. Examples of Standards on Review engagements are
   a. SRE 2400 (Revised) Engagements to Review Historical Financial Statements
   b. SRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity
6. **Reasonable assurance engagement vs. Limited assurance engagement**

Reasonable assurance engagement	Limited assurance engagement
Reasonable assurance engagement provides high level of assurance.	Limited assurance engagement provides lower level of assurance than reasonable assurance engagement.
It performs elaborate and extensive procedures to obtain sufficient appropriate evidence.	It performs fewer procedures as compared to reasonable assurance engagement.
It draws reasonable conclusions on the basis of sufficient appropriate evidence.	It involves obtaining sufficient appropriate evidence to draw limited conclusions.
Example of reasonable assurance engagement is an audit engagement.	Example of limited assurance engagement is review engagement.

C. STANDARDS ON ASSURANCE ENGAGEMENT (SAE):

1. These standards apply in assurance engagements dealing with subject matters other than historical financial information.
2. Such assurance engagements do not include "audit" or "review" of historical financial information.
3. For example, an assurance engagement relating to examination of prospective financial information.
4. Prospective financial information means financial information based on assumptions about events that may occur in the future and possible actions by an entity.
5. Historical financial information is rooted in past events which have already occurred whereas prospective financial information is related to future events.
6. Examples of Standards on Assurance Engagements are: -
   a. SAE 3400 The Examination of Prospective Financial Information

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

D. STANDARDS ON RELATED SERVICES (SRS):

1. These standards apply in engagements to perform agreed-upon procedures regarding financial information.
2. For example, an engagement to perform agreed-upon procedures may require the auditor to perform certain procedures concerning individual items of financial data, say, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity etc.
3. Examples of Standards on related services are: -
   a. SRS 4400 Engagements to perform agreed-upon procedures regarding financial information
   b. SRS 4410 (Revised) Compilation engagements

Note: All the above standards i.e., Standards on Auditing (SAs), Standards on Review Engagements (SREs), Standards on Assurance Engagements (SAEs) and Standards on related services (SRSs) are collectively known as the Engagement Standards.

E. STANDARDS ON QUALITY CONTROL (SQC): These standards are to be applied for all services covered by Engagement Standards.

F. DUTIES IN RELATION TO ENGAGEMENT AND QUALITY CONTROL STANDARDS:

1. It is the duty of professional accountants to see that Standards are followed in engagements undertaken by them.
2. Ordinarily, these are to be followed by professional accountants.
3. However, a situation may arise when a specific procedure as required in Standards would be ineffective in a particular engagement. In such a case, he is required to document how alternative procedures performed achieve the purpose of required procedure.
4. Also, reason for departure has also to be documented unless it is clear.
5. Further, his report should draw attention to such departures.
6. It is also to be noted that a mere disclosure in the report does not absolve a professional accountant from complying with applicable Standards.

SA 220 - QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS

A. OBJECTIVE: The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

1. The audit complies with professional standards and regulatory and legal requirements; and
2. The auditor's report issued is appropriate in the circumstances.

B. DEFINITIONS:

1. **ENGAGEMENT PARTNER:** The partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

2. **ENGAGEMENT QUALITY CONTROL REVIEW**: A process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

3. **ENGAGEMENT TEAM:** All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.

C. ELEMENTS OF SYSTEM OF QUALITY CONTROL: The firm's system of quality control should include policies and procedures addressing each of the following elements:

1. LEADERSHIP RESPONSIBILITIES FOR QUALITY WITHIN THE FIRM:

a. As per SA 220, the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

b. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasise the importance of:

   i. Performing work that complies with professional standards and regulatory and legal requirements;

   ii. Complying with the firm's quality control policies and procedures as applicable;

   iii. Issuing auditor's reports that are appropriate in the circumstances; and

   iv. The engagement team's ability to raise concerns without fear of reprisals; and

   v. The fact that quality is essential in performing audit engagements.

2. ETHICAL REQUIREMENTS RELATING TO AN AUDIT OF FINANCIAL STATEMENTS: The responsibilities of an engagement partner in relation to ethical requirements in an audit engagement are as under: -

a. Identifying a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level.

b. Reporting by engagement partner to the relevant persons within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is legally permitted.

3. ACCEPTANCE AND CONTINUANCE OF CLIENT RELATIONSHIPS AND AUDIT ENGAGEMENTS: Already covered in Chapter – **Nature, Objective and Scope of audit.**

4. HUMAN RESOURCES:

a. The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to
   i. Perform its engagements in accordance with professional standards and regulatory and legal requirements, and
   ii. To enable the firm or engagement partners to issue reports that are appropriate in the circumstances.
b. Such policies and procedures address the following personnel issues:
   i. Recruitment
   ii. Performance evaluation
   iii. Capabilities
   iv. Competence
   v. Career development
   vi. Promotion
   vii. Compensation; and
   viii. Estimation of personnel needs

c. The firm's recruitment processes include procedures that help the firm select individuals of integrity as well as the capacity to develop the capabilities and competence necessary to perform the firm's work.

5. ENGAGEMENT PERFORMANCE:

a. The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances.
b. Matters addressed include the following:
   i. How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
   ii. Processes for complying with applicable engagement standards.
   iii. Processes of engagement supervision, staff training and coaching.
   iv. Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
   v. Appropriate documentation of the work performed and of the timing and extent of the review.
   vi. Processes to keep all policies and procedures current.
c. 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:
   i. Determine that an engagement quality control reviewer has been appointed.
   ii. Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer.

iii. Not date the auditor's report until the completion of the engagement quality control review.

d. 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.

6. MONITORING:

a. An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively.

b. 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.

c. The engagement partner should document following matters pertaining to an audit engagement: -

i. Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.

ii. Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.

iii. Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.

iv. The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement.

TEST YOUR KNOWLEDGE

1. The firm's system of quality control should include policies and procedures addressing each and every element of system of quality control. State those elements.

Answer:

1. Leadership responsibility of quality within the audit firm
2. Ethical requirements relating to audit of financial statements
3. Acceptance and continuance of client relationships
4. Human resources
5. Engagement performance
6. Monitoring of quality control policies and procedures

2. XYZ & Co, a firm of chartered accountants has been appointed as an auditor of CHARAN LTD. Mr X, engagement partner argues that audit manager shall take the responsibility

for the overall quality on each audit engagement to which he is assigned. **Correct/Incorrect.**

Answer:

Incorrect.

As per SA 220, Engagement partner shall take the leadership responsibility for overall quality on each audit engagement to which he has been assigned. In the given case, Mr.X, engagement partner shall take the leadership responsibility on overall quality of audit engagement.

3. **The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an on-going consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements. Explain the purpose of monitoring compliance with quality control policies and procedures.**

Answer: Write Point C(6)

4. **As per SA 220 "Quality Control for an Audit of Financial Statements", the engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. Explain clearly stating the meaning of engagement partner and also the actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement.**

Answer: Write Point C(1)

5. **The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles. Discuss the personnel issues addressed by such policies and procedures. Also explain how addressing the personnel issues would empower the firm.**

Answer: Write Point C(4)

6. **The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances. Explain that policies to be implemented in the element of engagement performance.**

Answer: Write Point C(5)

SA 260 – COMMUNICATION WITH THOSE CHARGED WITH GOVERNANACE

A. OBJECTIVES: The objectives of the auditor are: -

1. To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
2. To obtain from those charged with governance information relevant to the audit;
3. To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process and
4. To promote effective two-way communication between the auditor and those charged with governance.

B. WHO ARE THOSE CHARGED WITH GOVERNANCE (TCWG): The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process.

For example, in most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager.

C. DETERMINING APPROPRIATE PERSONS WITH WHOM TO COMMUNICATE: The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate.

D. MATTERS TO BE COMMUNICATED BY AUDITOR: Following matters are required to be communicated by auditor with those charged with governance: -

1. **The auditor's responsibilities in relation to the financial statement audit:** The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:
   a. The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance and
   b. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.
2. **Planned scope and timing of the audit:** The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor.
3. **Significant findings from the audit:** The auditor shall communicate with those charged with governance: -

a. The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.
b. 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
c. Significant difficulties, if any, encountered during the audit;
d. Unless all of those charged with governance are involved in managing the entity: -
   i. Significant matters arising during the audit that were discussed, or subject to correspondence, with management;
   ii. Written representations the auditor is requesting
e. Circumstances that affect the form and content of the auditor's report, if any and
f. Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

E. COMMUNICATION OF AUDITOR'S INDEPENDENCE IN CASE OF LISTED ENTITIES: In the case of listed entities, the auditor shall communicate with those charged with governance: -

1. A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence and
2. All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include
   a. Total fees charged during the period covered by the financial statements for audit.
   b. Non-audit services provided by the firm and network firms to the entity and components controlled by the entity.
   c. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor and
3. The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

F. THE COMMUNICATION PROCESS:

1. The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate.
2. Written communications need not include all matters that arose during the course of the audit.
3. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required in case of listed entities.
4. The auditor shall communicate with those charged with governance on a timely basis.

G. **DOCUMENTATION:** Where matters required by SA 260 to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.

Test your knowledge:

1. **In what ways an effective two-way communication between auditor and those charged with governance is important?**

Answer: Write Point A from SA 260

SA 265 - COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT

A. **OBJECTIVES:** The objective of the auditor is to communicate appropriately to those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

B. **MEANING OF "DEFICIENCY IN INTERNAL CONTROL" AND "SIGNIFICANT DEFICIENCY IN INTERNAL CONTROL":**

1. **Deficiency in internal control –** This exists when:
   a. A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or
   b. A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.
2. **Significant deficiency in internal control –**
   a. A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.
   b. The significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement.
   c. Significant deficiencies may, therefore, exist even though the auditor has not identified misstatements during the audit.

C. **EXAMPLES OF MATTERS THAT THE AUDITOR MAY CONSIDER IN DETERMINING WHETHER A DEFICIENCY OR COMBINATION OF DEFICIENCIES IN INTERNAL CONTROL CONSTITUTES A SIGNIFICANT DEFICIENCY**
   a. The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.

b. The susceptibility to loss or fraud of the related asset or liability.
c. The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
d. The financial statement amounts exposed to the deficiencies.
e. The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.

D. EXAMPLES OF INDICATORS OF SIGNIFICANT DEFICIENCIES IN INTERNAL CONTROL:

1. Evidence of ineffective aspects of the control environment, such as:
    a. Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.
    b. Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.
    c. Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.
2. Absence of a risk assessment process within the entity.
3. Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.
4. Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).
5. Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.
6. Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss.
7. Evidence of management's inability to oversee the preparation of the financial statements.

E. DETERMINATION OF SIGNIFICANT DEFICIENCIES IN INTERNAL CONTROL:

1. The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control.
2. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.

F. COMMUNICATION OF SIGNIFICANT DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE:

1. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.
2. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: -
    a. In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and

b. Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

3. The auditor shall include in the written communication of significant deficiencies in internal control: -
   a. A description of the deficiencies and an explanation of their potential effects; and
   b. Sufficient information to enable those charged with governance and management to understand the context of the communication.
4. In particular, the auditor shall explain that: -
   a. The purpose of the audit was for the auditor to express an opinion on the financial statements;
   b. The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
   c. The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

Test Your Knowledge:

1. List out some matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency."

Answer: Write Point C from SA 265

SA 450 - EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

A. OBJECTIVE: The objective of the auditor is to evaluate: -

1. The effect of identified misstatements on the audit and
2. The effect of uncorrected misstatements, if any, on the financial statements

B. ACCUMULATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT:

1. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial.
2. A misstatement may arise from a variety of factors.
   For example,
   - *An inaccuracy in gathering or processing data from which financial statements are prepared or an omission of an amount or disclosure can result into a misstatement.*
   - *An entity has wrongly capitalized machinery repair expenses amounting to Rs.5 lacs resulting in overstatement of profits.*

C. CONSIDERATION OF IDENTIFIED MISSTATEMENTS AS THE AUDIT PROGRESSES:

1. The auditor shall determine whether the overall audit strategy and audit plan need to be revised if: -
    a. The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material or
    b. The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SA 320.
2. The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements.
3. If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain.

D. COMMUNICATION AND CORRECTION OF MISSTATEMENTS:

1. The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation.
2. The auditor shall request management to correct those misstatements.
3. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the items are misstatements, inform the auditor if it disagrees and take action as necessary.
4. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.
5. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement.

E. EVALUATING THE EFFECT OF UNCORRECTED MISSTATEMENTS:

1. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results.
2. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate.
3. In making this determination, the auditor shall consider: -

a. The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence and
b. The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

F. COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE:

1. The auditor shall communicate with those charged with governance regarding uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation.
2. The auditor's communication shall identify material uncorrected misstatements individually.
3. The auditor shall request that uncorrected misstatements be corrected.
4. The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

G. WRITTEN REPRESENTATION FROM MANAGEMENT REGARDING EFFECTS OF UNCORRECTED STATEMENTS: The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

H. DOCUMENTATION REGARDING MISSTATEMENTS IDENTIFIED DURING AUDIT: The audit documentation shall include: -

1. The amount below which misstatements would be regarded as clearly trivial;
2. All misstatements accumulated during the audit and whether they have been corrected; and
3. The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion.

SA 501 - AUDIT EVIDENCE-SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS

A. OBJECTIVE: As per SA 501, The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the:

1. Existence and condition of inventory;
2. Completeness of litigation and claims involving the entity; and
3. Presentation and disclosure of segment information in accordance with the applicable financial reporting framework.

B. EXISTENCE AND CONDITION OF INVENTORY:

1. When inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:
   a. **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.
   b. Verify final inventory records to determine whether they match with quantity of the physical stock.

2. **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 required 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.

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

4. **Matters relevant in planning attendance at physical inventory counting:**
   a. Nature of inventory
   b. Stages of completion of work in progress.
   c. The risks of material misstatement related to inventory.
   d. The nature of the internal control related to inventory.
   e. Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
   f. The timing of physical inventory counting.
   g. Whether the entity maintains a perpetual inventory system.
   h. The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate
   i. Whether the assistance of an auditor's expert is needed.

5. **Attendance at physical inventory counting is impracticable:**
   a. 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.
   b. For example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting.
   c. If the auditor is unable to obtain evidence by performing alternative audit procedures, then auditor shall consider modifying his opinion as per SA 705.

d. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. The difficulty of time or cost involved in itself not a valid basis for physical inspection impracticability.

6. **Inventory lying in the custody of third party:**
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:
a. Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.
b. Perform inspection or other audit procedures appropriate in the circumstances like:
i. Attending the third-party premises and verifying the stock.
ii. Arranging another auditor for verifying stock help with third party.
iii. Checking the appropriate documentation.

C. COMPLETENESS OF LITIGATIONS AND CLAIMS:

1. The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including: (a)
a. Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
b. Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
c. Reviewing legal expense accounts.

2. **If the Auditor Assesses a Risk of Material Misstatement regarding Litigation or Claims:**
a. If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.
b. The auditor shall do so through a letter of inquiry, prepared by management and sent by auditor, requesting the entity's external legal counsel to communicate directly with the auditor.
c. If the management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel, or the entity's external legal counsel refuses to respond appropriately to the letter of inquiry, or law, regulation, or the respective legal professional body prohibits the entity's external legal counsel from communicating directly with the auditor, the auditor shall perform alternative audit procedures.
d. If the auditor is unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.
e. If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example if the professional body to which

the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

i. A list of litigation and claims;
ii. Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
iii. A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

f. In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:

iv. The auditor determines that the matter is a significant risk.
v. The matter is complex.
vi. There is disagreement between management and the entity's external legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

g. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements:

i. have been disclosed to the auditor and appropriately accounted for and
ii. disclosed in accordance with the applicable financial reporting framework.

D. SEGMENT INFORMATION:

1. The auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by:

a. Obtaining an understanding of the methods used by management in determining segment information. Further,

i. Evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
ii. Where appropriate, testing the application of such methods; and

b. Performing analytical procedures or other audit procedures appropriate in the circumstances

2. **Understanding of the Methods Used by Management:** Example of matters that may be relevant when obtaining an understanding of the methods used by management:

a. Sales, transfers and charges between segments, and elimination of intersegment amounts.
b. Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.

c. The allocation of assets and costs among segments.
d. Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

TEST YOUR KNOWLEDGE:

1. **XYZ Ltd is engaged in manufacturing of different type of yarns. On-going through its financial statements for the past years, it is observed that inventory is material to the financial statements. You as an auditor of the company wanted to obtain sufficient appropriate audit evidence regarding the existence and condition of the inventory as appearing in the financial statements. Discuss, how would you proceed as an auditor?**

Answer: Refer Point B

2. **Paramount Exports Ltd is a manufacturer exporter having its own production capacity and also gets the job work done through various job workers. The auditor of Paramount Exports Ltd. Considers that inventory held with job workers is material to the financial statements. Suggest the audit procedures in the given case.**

Answer: Refer Point B(6)

3. **Pride India Ltd is a manufacturer of various FMCG (fast moving consumable goods) range of products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims resulting to risk of material misstatements.**

Answer: Refer Write C(1)

4. **SPR Ltd has been into the media business since 1990. During the F.Y 2021 -2022 many notices were received by the company for hurting public sentiments and financial claims were filed against the company. As an auditor of the company, you requested the management for arranging the meeting with company's external legal counsel. Management is of the view that such meetings are necessary in some certain circumstances only. Can you list down those certain circumstances?**

Answer: Refer Point C(2)(e)

5. **Pachranga International Ltd is manufacturer of pickles, ginger garlic paste, jams etc having its plant at Jaipur. Being in food industry, the company is facing many litigations in various courts across India. Auditors SPV & Co. wants to identify such litigations and claims involving the company which may give rise to risk of material misstatement. Guide the auditor as to how they should proceed for the purpose.**

Answer: Refer Write C(1)

6. **The matter of difficulty, time, or cost involved is in itself a valid basis for impracticability of physical verification of inventory. Correct/Incorrect.**

Answer:

Incorrect

The matter of difficulty, time, or cost involved is in itself not a valid basis for impracticability of physical verification of inventory.

7. **If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry, prepared and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor. Correct/Incorrect.**

Answer:

Incorrect

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry, prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor.

8. **Explain clearly the examples of matters relevant in planning attendance at physical inventory counting.**

Answer: Write Point B(4)

9. **GPS & Co, Chartered Accountants, conducting the audit of Pratibha Ltd., a listed company for the year ended 31.03.2022 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GPS & Co wanted to ensure that methods adopted by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework Guide GPS & Co with 'Examples of Matters' that may be relevant when obtaining an understanding of the methods used by the management with reference to the relevant Standards on Auditing.**

Answer: Refer Point D(2)

SA 505 - EXTERNAL CONFIRMATIONS

A. DEFINITIONS:

1. **EXTERNAL CONFIRMATION:** External confirmation may be defined as 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.

2. **POSITIVE CONFIRMATION REQUEST:** A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.
3. **NEGATIVE CONFIRMATION REQUEST:** A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
4. **NON-RESPONSE:** A failure of the confirming party to respond, or fully respond, to a positive confirmation request, or a confirmation request returned undelivered.
5. **EXCEPTION:** A response that indicates a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

B. OBJECTIVE: The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

C. EXTERNAL CONFIRMATION PROCEDURES: When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

1. DETERMINING THE INFORMATION TO BE CONFIRMED OR REQUESTED:

a. External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements.
   For example: Bank balances, Accounts receivables balances, Accounts payable balances, inventory balances etc.
b. However, the use of external confirmations is not just restricted to, account balances (amounts and balances).
c. It can also be used for other qualitative aspects like:
   i. to confirm terms of agreements and contracts
   ii. transactions between an entity and other parties
   iii. confirm the absence of certain conditions, such as a "side agreement"
   iv. property deeds given as security to the banker.

2. SELECTING THE APPROPRIATE CONFIRMING PARTY:

a. Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed.
b. For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

3. DESIGNING CONFIRMATION REQUESTS:

a. The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.
b. Factors to consider when designing confirmation requests include:

i. Specific identified risks of material misstatement, including fraud risks.
ii. The layout and presentation of the confirmation request.
iii. Prior experience on the audit or similar engagements.
iv. The assertions being addressed.
v. The method of communication [for example, in paper form, or by electronic mode (like e-mail) or other medium].
vi. Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
vii. The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

4. **FOLLOW-UP ON CONFIRMATION REQUESTS:** The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time.

D. USAGE OF NEGATIVE CONFIRMATIONS:

1. Negative confirmations provide less persuasive audit evidence than positive confirmations.
2. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level.
3. The auditor shall use negative confirmation request as sole substantive audit procedure when all of the following conditions are present:
   a. The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
   b. The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous, account balances, transactions or conditions;
   c. A very low exception rate is expected; and
   d. The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

E. MANAGEMENT'S REFUSAL TO ALLOW THE AUDITOR TO SEND A CONFIRMATION REQUEST:

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

1. Inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness;
2. Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures; and
3. Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.
4. If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable, or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures,

a. the auditor shall communicate with those charged with governance in accordance with SA 260.
b. The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with SA 705.

5. Examples of alternative audit procedures the auditor may perform include:
   a. For accounts receivable balances – examining specific subsequent cash receipts, shipping documentation, and sales near the period-end.
   b. For accounts payable balances – examining subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes.

F. RESPONSES TO EXTERNAL CONFIRMATIONS ARE NOT RELIABLE:

1. If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain further audit evidence to resolve those doubts.
2. 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.

G. EVALUATING THE EVIDENCE OBTAINED:

1. The auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether performing further audit procedures is necessary.
2. When evaluating the results of individual external confirmation requests, the auditor may categorise such results as follows:
   a. A response by the appropriate confirming party indicating agreement with the information provided in the confirmation request, or providing requested information without exception;
   b. A response deemed unreliable;
   c. A non-response; or
   d. A response indicating an exception.
3. The auditor's evaluation, when taken into account with other audit procedures the auditor may have performed, may assist the auditor in concluding whether sufficient appropriate audit evidence has been obtained or whether performing further audit procedures is necessary, as required by SA 330.

TEST YOUR KNOWLEDGE:

1. When using external confirmation procedures, the auditor shall maintain control over external confirmation requests including sending the requests, including follow-up requests when applicable, to the confirming party. Explain the other points as to when using external confirmation procedures, the auditor would be required to maintain control over external confirmation requests.

Answer:

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

a. Determining the information to be confirmed or requested
b. Selecting the appropriate confirming party
c. Designing the confirmation request
d. Sending the request and follow up requests.

2. **During the financial year 2020-21, the auditor of Delicious and Healthy Limited asked a Trade Receivable to respond directly to the auditor whether the amount they were required to pay to Delicious and Healthy Limited was Rs. 79,000. That trade receivable confirmed to the auditor of Delicious and Healthy Limited, that they were required to pay an amount of Rs. 79,000 to Delicious and Healthy Limited. State and explain the type of Confirmation Request as required by the auditor.**

Answer: Write definition of positive confirmation request.

In the given case the request sent by the auditor is positive confirmation request.

3. **While conducting the audit of Rocky Ltd, the auditor X of XYZ and Associates, Chartered Accountants observes that there are large number of Trade payables and receivables standing in the books of accounts as on 31st March. The auditor wanted to send confirmation request to few trade receivables, but the management refused the auditor to send confirmation request. How would the auditor proceed?**

Answer: Write Point E

4. **External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements but need not be restricted to these items. Discuss.**

Answer: Refer Point C(1)

5. **CA Satish, is appointed as an auditor of Rex Ltd.; he wants to design a suitable Confirmation request letter fora few debtors of Rex Ltd. As a senior auditor of the firm, explain to him with reference to SA 505 "External Confirmation" all the conditions that should be present to use Negative Confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level.**

Answer: Write Point D

6. **The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses. What are the factors that are required to be considered while designing confirmation requests?**

Answer: Refer Point C(3)

SA 510 - INITIAL AUDIT ENGAGEMENTS – OPENING BALANCES

A. DEFINITIONS:

1. **INITIAL AUDIT ENGAGEMENT:** An engagement in which either:
   a. The financial statements for the prior period were not audited; or
   b. The financial statements for the prior period were audited by a predecessor auditor.
2. **OPENING BALANCES:**
   a. Those account balances that exist at the beginning of the period.
   b. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period.
   c. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.
3. **PREDECESSOR AUDITOR:** The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

B. OBJECTIVE: In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

1. Opening balances contain misstatements that materially affect the current period's financial statements; and
2. Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

C. AUDIT PROCEDURES REGARDING OPENING BALANCES:

1. The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.
2. The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:
   a. Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
   b. Determining whether the opening balances reflect the application of appropriate accounting policies; and
   c. Performing one or more of the following:

i. Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
ii. Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
iii. Performing specific audit procedures to obtain evidence regarding the opening balances.

3. **Nature and extent of Audit Procedures:** The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as:
   a. The accounting policies followed by the entity.
   b. The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements.
   c. The significance of the opening balances relative to the current period's financial statements.
   d. Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified.
4. **Audit Procedures regarding current assets and liabilities:**
   a. For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures.
   b. In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:
      - Observing a current physical inventory count and reconciling it to the opening inventory quantities.
      - Performing audit procedures on the valuation of the opening inventory items.
      - Performing audit procedures on gross profit and cut-off.
5. **For non-current assets and liabilities:** For non-current assets and liabilities,
   a. such as property plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances.
   b. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties.

D. AUDIT PROCEDURES REGARDING ACCOUNTING POLICIES:

1. The auditor shall obtain sufficient appropriate audit evidence about
   a. whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and
   b. whether changes in the accounting policies have been properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

E. AUDIT CONCLUSIONS AND REPORTING IN RELATION TO OPENING BALANCES:

1. If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705.
2. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate, in accordance with SA 705.

F. AUDIT CONCLUSIONS AND REPORTING IN CONSISTENCY OF ACCOUNTING POLICIES:

If the auditor concludes that:

1. The current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or
2. A change in accounting policies is not properly accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,

the auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with SA 705(Revised).

G. MODIFICATION TO THE OPINION IN THE PREDECESSOR AUDITOR'S REPORT: If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements in accordance with SA 705.

TEST YOUR KNOWLEDGE:

1. The newly appointed auditor of BTN Limited wants to obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements. What audit procedures should he perform for this purpose?

Answer: Write Point C

2. M/s Pankaj & Associates, Chartered Accountants, have been appointed as an auditor of ABC Limited. CA Pankaj did not apply any audit procedures regarding opening balances. He argued that since financial statements were audited by the predecessor auditor therefore, he is not required to verify them. Is CA Pankaj correct in his approach?

Answer: Write Definition of initial audit engagement and Objectives of SA 510.

Conclusion: In the given case CA Pankaj shall obtain sufficient and appropriate audit evidence regarding opening balances as per the requirements of SA 510.

3. M/s PQR and associates are the statutory auditors of TUV Ltd. for the FY 2020-21. They have been appointed as statutory auditors of TUV Ltd. for the first time. What is the objective of the engagement partner in terms of SA 510?

Answer: Write Point B

4. **Auditors of M/s Govardhan India (P) Ltd. were changed for the accounting year 2020-21. The closing inventory of the company as on 31.03.2020 amounting to Rs.100 lakhs continued as it is and became closing inventory as on 31.03.2021. The auditors of the company propose to exclude from their audit programme the audit of closing inventory of Rs.100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor.**

Answer:

First write objective of SA 510.

a. General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the Balance Sheet date.
b. 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.
c. Moreover, it is also quite likely that the inventory lying might have deteriorated and the same need to be examined.
d. Therefore, the auditor is advised not to exclude the audit of closing inventory from his audit programme.

5. **Mr. Tom. a practicing-chartered accountant has been appointed as an auditor of Cruise Ltd. Mr. Tom performed the audit procedures to obtain sufficient and appropriate audit evidence regarding opening balances. Advice what are the reporting requirements of the auditor regarding the findings of the opening balances.**

Answer: Write Point E

SA 550 - RELATED PARTIES

A. MEANING OF RELATED PARTY: A party that is either:

1. A related party as defined in the applicable financial reporting framework; or
2. Where the applicable financial reporting framework establishes minimal or no related party requirements:
   a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
   b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
   c. Another entity that is under common control with the reporting entity through having:
      i. Common controlling ownership;
      ii. Owners who are close family members; or
      iii. Common key management.

Note: However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another.

B. NATURE OF RELATED PARTY RELATIONSHIPS AND TRANSACTIONS:

1. Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties.
2. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. Examples are as follows:
    a. Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
    b. Information systems may be ineffective at identifying or summarising transactions and outstanding balances between an entity and its related parties.
    c. Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

C. RESPONSIBILITIES OF THE AUDITOR:

1. **Obtaining audit evidence about accounting and disclosure requirements:**
    a. There are specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and effects on the financial statements.
    b. The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions or balances.
    c. The auditor needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:
        i. Achieve a true and fair presentation; or
        ii. Are not misleading.

2. **Identifying Fraud risk factors:** Further, understanding about related party relationships and transactions, helps the auditor in identifying the fraud risk factors. Because the fraud can be easily committed through related parties.

3. **Inherent limitations arising out of Related party transactions:**
    a. However, because of inherent limitations of audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

b. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:
   i. Management may be unaware of the existence of all related party relationships.
   ii. Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

4. **Maintaining Professional Skepticism:** Planning and performing the audit with professional skepticism as required by SA 200 is therefore particularly important to reduce the audit risk to an acceptably low level.

D. HOW THE AUDITOR CAN VERIFY THE EXISTENCE OF RELATED PARTIES: The auditor may inspect the following records or documents that may provide information about related party relationships and transactions, for example:

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

TEST YOUR KNOWLEDGE:

1. P Ltd. is a company from a business group "ABCD" and is engaged in trading of garments. The promoters of the company are promoters and directors of some other group companies also. You have been appointed as an auditor of P Ltd. P Ltd has entered into various intercompany transactions (within group companies) during the year which are outside its normal course of business. What will be your duties as an auditor in relation to those transactions?

Answer: Refer Point C

2. Explain how the auditor can verify the existence of related party transactions?

Answer: Refer Point D

3. Write a short note on related party relationships and transactions.

Answer: Refer Point B

SA 560 - SUBSEQUENT EVENTS

A. DEFINITIONS:

1. **SUBSEQUENT EVENTS:** 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.
2. **DATE OF FINANCIAL STATEMENTS:** The date of the end of the latest period covered by the financial statements.
3. **DATE OF APPROVAL OF FINANCIAL STATEMENTS:** The date on which all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognised authority have asserted that they have taken responsibility for those financial statements.
4. **DATE OF THE AUDITOR'S REPORT:** The date the auditor dated the report on the financial statements in accordance with SA 700.
5. **DATE THE FINANCIAL STATEMENTS ARE ISSUED:** The date that the auditor's report and audited financial statements are made available to third parties.
6. **SUBSEQUENT EVENTS AS PER FINANCIAL REPORTING FRAMEWORK:** Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Such financial reporting frameworks ordinarily identify two types of events:
   b. Those that provide evidence of conditions that existed at the date of the financial statements; and
   c. Those that provide evidence of conditions that arose after the date of the financial statement.

B. OBJECTIVE: The objectives of the auditor are to:

a. Obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements; and
b. Respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

C. AUDIT PROCEDURES REGARDING SUBSEQUENT EVENTS: The auditor shall perform the below mentioned audit procedures to ensure that all the subsequent events are identified:

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

3. Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
4. Reading the entity's latest subsequent interim financial statements, if any.
5. The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation that all events occurring subsequent to the date of the financial statements which requires adjustment or disclosure have been adjusted or disclosed.

D. AUDITORS RESPONSIBILITIES REGARDING SUBSEQUENT EVENTS:

1. **FACTS WHICH BECOME KNOWN TO THE AUDITOR AFTER THE DATE OF THE AUDITOR'S REPORT BUT BEFORE THE DATE THE FINANCIAL STATEMENTS ARE ISSUED:**
   a. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report.
   b. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
      i. Discuss the matter with management and, where appropriate, those charged with governance.
      ii. Determine whether the financial statements need amendment and, if so,
      iii. Inquire how management intends to address the matter in the financial statements.
   c. ***If Management Amends the Financial Statements:*** *the auditor shall:*
      i. Carry out the audit procedures necessary in the circumstances on the amendment.
      ii. Obtain sufficient and appropriate evidence regarding the amendment such subsequent events.
   d. ***If management does not amend the financial statements:***
      i. Where the auditor concludes that the financial statements are not amended and if the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by SA 705 and then provide the auditor's report; or
      ii. If the auditor's report has already been provided to the entity, the auditor shall notify management and those charged with governance not to issue the financial statements to third parties before the necessary amendments have been made.
      iii. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action, to seek to prevent reliance on the auditor's report.

2. **FACTS WHICH BECOME KNOWN TO THE AUDITOR AFTER THE FINANCIAL STATEMENTS ARE ISSUED:**
   a. After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements.

b. However, when, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
   i. Discuss the matter with management and, where appropriate, those charged with governance.
   ii. Determine whether the financial statements need amendment and, if so,
   iii. Inquire how management intends to address the matter in the financial statements.

c. ***If the management amends the financial statements:*** *The auditor shall:*
   i. *Carry out the audit procedures necessary in the circumstances on the amendment.*
   ii. *Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.*
   iii. *Provide a new auditor's report on the amended financial statements. The report shall include an emphasis of matter or other matter paragraph describing the effect of amendment of financial statements on the earlier issued F/S and earlier issued audit report.*

d. ***If management does not take necessary steps:*** *The auditor shall take appropriate action to seek prevent reliance on the audit report and financial statements that are already issued to third parties.*

TEST YOUR KNOWLEDGE:

1. The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. Explain.

Answer: Refer Point C

2. As per SA 560, Subsequent Events are the events occurring between the date of the financial statements and the date of the approval of financial statements, and facts that become known to the auditor after the date of the auditor's report. Correct/Incorrect.

Answer:

Incorrect

As per SA 560, Subsequent Events are the events occurring between the date of the financial statements and the date of auditors report, and facts that become known to the auditor after the date of the auditor's report.

3. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of

the auditor's report, may have caused the auditor to amend the auditor's report. Explain the auditor's obligation in the above situation.

Answer: Refer D(1)

4. **After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, when, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report. Explain the auditor's obligation in the above situation.**

Answer: Refer Point D(2)

5. **SA 560, "Subsequent Events" deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events. Explain those events and also define subsequent events.**

Answer: Write Point A(1) and A(6)

SA 570 – GOING CONCERN

A. OBJECTIVE: The objectives of the auditor are:

1. To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;
2. To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
3. To report in accordance with this SA.

B. USE OF GOING CONCERN ASSUMPTION:

1. Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future.
2. General purpose financial statements are prepared using the going concern basis of accounting, unless management either
   a. Intends to liquidate the entity or to cease operations, or
   b. Has no realistic alternative but to do so.
3. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

C. MANAGEMENT'S ASSESSMENT OF THE ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN:

1. The management is primarily responsible for making an assessment regarding entity's ability to continue as a going concern.
2. The management shall consider the following factors, while making an assessment regarding entities ability to continue as going concern.
   a. The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs.
   b. The size and complexity of the entity
   c. The nature and condition of its business a
   d. The degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.

D. AUDIT PROCEDURES: The audit procedures to be performed by the auditor are as follows:

1. **RISK ASSESSMENT PROCEDURES:**
   a. When performing risk assessment procedures as required by SA 315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern.
   b. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:
      i. **If such an assessment has been performed,** the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them; or
      ii. **If such an assessment has not yet been performed,** the auditor shall discuss with management the basis for the intended use of the going concern basis of accounting, and inquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

2. **FURTHER AUDIT PROCEDURES:** If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence, through performing the following additional audit procedures:
   a. Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
   b. Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.

c. Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions:
   i. Evaluating the reliability of the underlying data generated to prepare the forecast; and
   ii. Determining whether there is adequate support for the assumptions underlying the forecast.
d. Considering whether any additional facts or information have become available since the date on which management made its assessment.
e. Requesting written representations from management regarding their future action plans and the feasibility of these plans.
f. Audit procedures that are relevant to the requirement as stated above may include the following:
   i. Analyzing and discussing cash flow, profit and other relevant forecasts with management.
   ii. Analyzing and discussing the entity's latest available interim financial statements.
   iii. Reading the terms of debentures and loan agreements and determining whether any have been breached.
   iv. Reading minutes of the meetings of shareholders, TCWG for reference to financing difficulties.
   v. Inquiring of the entity's legal counsel regarding the existence of litigation and claims
   vi. Confirming the existence of arrangements with banks and other third parties to provide financial support.

E. EVENTS OR CONDITIONS THAT MAY CAST SIGNIFICANT DOUBT ON THE ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN: The following are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

1. FINANCIAL INDICATORS

a. Net liability or net current liability position.
b. Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment
c. Excessive reliance on short-term borrowings to finance long-term assets.
d. Indications of withdrawal of financial support by creditors.
e. Negative operating cash flows indicated by historical or prospective financial statements.
f. Adverse key financial ratios.

2. OPERATING INDICATORS:

a. Management intentions to liquidate the entity or to cease operations.
b. Loss of key management without replacement.
c. Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
d. Labour difficulties.
e. Shortages of important supplies.

f. Emergence of a highly successful competitor.

3. **OTHER INDICATORS**:
   a. Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions.
   b. 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.
   c. Changes in law or regulation or government policy expected to adversely affect the entity.
   d. Uninsured or underinsured catastrophes when they occur.

F. IMPACT ON AUDITORS' OPINION WHEN GOING CONCERN ASSUMPTION IS INAPPROPRIATE:

1. **ADEQUATE DISCLOSURE MADE BY MANAGEMENT:** If the auditor concludes that the going concern assumption is inappropriate, and the management has made adequate disclosure in the financial statements (i.e., liquidation basis), then the auditor shall:
   a. Express an **unmodified opinion** and
   b. May consider it appropriate or necessary to include an **Emphasis of Matter paragraph** in the auditor's report to draw the user's attention to that alternative basis of accounting and the reasons for its use.

2. **NO ADEQUATE DISCLOSURE GIVEN BY MANAGEMENT:** If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgement, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an **adverse opinion.**

G. IMPACT ON AUDITORS OPINION IF USE OF THE GOING CONCERN BASIS OF ACCOUNTING IS APPROPRIATE BUT A MATERIAL UNCERTAINTY EXISTS:

1. **ADEQUATE DISCLOSURE OF A MATERIAL UNCERTAINTY IS MADE IN THE FINANCIAL STATEMENTS:** If adequate disclosure about the material uncertainty is made in the financial statements,
   a. the auditor shall express an **unmodified opinion** and
   b. the auditor's report shall include a separate section under the heading **"Material Uncertainty Related to Going Concern."**

2. **ADEQUATE DISCLOSURE OF A MATERIAL UNCERTAINTY IS NOT MADE IN THE FINANCIAL STATEMENTS:** If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall:
   a. Express a **qualified opinion or adverse opinion**, as appropriate, in accordance with SA 705 and
   b. In the **Basis for Qualified (Adverse) Opinion** section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to

continue as a going concern and that the financial statements do not adequately disclose this matter.

H. IMPACT ON AUDITORS OPINION IF MANAGEMENT IS UNWILLING TO MAKE OR EXTEND ITS ASSESSMENT: If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall consider issuing, a **qualified opinion or a disclaimer of opinion** in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding management's use of the going concern basis of accounting in the preparation of the financial statements.

TEST YOUR KNOWEDGE:

1. **The objectives of the auditor are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements. Explain the procedures the auditor is expected to perform when he identifies any circumstances that cast significant doubt on entity's going concern.**

Answer: Write Point D(2)

2. **M/s Arjun & Associates has been appointed as the statutory auditors of DJ Ltd. The company has been suffering losses due to the emergence of highly successful competitor, thereby leading to negative net worth. Also, the sales head, key management personnel, of the company left the company due to health issues. When CA Arjun, the engagement partner discussed the scenario with the management of the company, he did not get any satisfactory reply from the management. What is the responsibility of M/s Arjun & Associates with regard to SA 570?**

Answer:

a. As per SA 570, one of the objectives of the auditor regarding going concern is to obtain sufficient and appropriate audit evidence regarding the same and to conclude on the appropriateness of the management's use of the going concern basis of accounting in the preparation of the financial statements.
b. Further it also contains the list of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern which are:
   i. Financial indicator- Negative net worth
   ii. Operating indicator- Loss of key management and emergence of highly successful competitor.
c. In the present case, MNO Ltd. has negative net worth on account of emergence of highly successful competitor and the sales head of the company has also left the company.
d. Also, CA Amar did not get any satisfactory reply when he discussed the going concern matter with the management. Thus, from the above facts, it appears that MNO Ltd. is not having going concern.

3. **Management's assessment of the entity's ability to continue as a going concern involves making a judgement about inherently uncertain future outcomes of events or conditions. What are relevant factors to that judgement?**

Answer: Write point C

4. **If the financial statements have not been prepared using the going concern basis of accounting and, in the auditors judgment, management's use of the going concern basis of accounting for the preparation of F/S is appropriate the auditor shall express an adverse opinion. Correct/Incorrect.**

Answer:

Incorrect

If the financial statements have been prepared using the going concern basis of accounting and, in the auditors judgment, management's use of the going concern basis of accounting for the preparation of F/S is inappropriate the auditor shall express an adverse opinion.

5. **Mr Raju has been appointed as an auditor of Real Ltd for the financial year 2020-21. While conducting the audit the auditor found sufficient and appropriate audit evidence that there is material uncertainty regarding the entity's ability to continue as a going concern. Explain the reporting requirements in the given case.**

Answer: Write Point G

6. **Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future. Give examples of operating indicators that could cast a significant doubt on entity's ability to continue as a going concern.**

Answer: Refer Point E(2)

7. **While doing audit of ABC Pvt Ltd, on the basis of sufficient and appropriate evidence, auditor comes to a conclusion that use of the Going Concern Basis of Accounting is appropriate, but a material uncertainty exists. Discuss the implications for auditor's report if:**
   i. **Adequate Disclosure of a Material Uncertainty is Made in the Financial Statements**
   ii. **Adequate Disclosure of a Material Uncertainty is Not Made in the Financial Statements**

Answer: Refer Point E(2)

SA 580 – WRITTEN REPRESENTATIONS

A. **DEFINITION:** Written representations may be defined as a <u>written statement by management</u> provided to the auditor to confirm certain matters or to <u>support other audit evidence.</u> Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

B. WRITTEN REPRESENTATION AS AUDIT EVIDENCE:

1. Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements.
2. Accordingly, similar to responses to inquiries, written representations are audit evidence. Written representations are requested from those responsible for the preparation and presentation of the financial statements.
3. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

C. OBJECTIVE: The objectives of the auditor are:

1. To obtain written representations that management believes that it has fulfilled its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
2. To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations; and
3. To respond appropriately to written representations provided by management or if management does not provide the written representations requested by the auditor.

D. MANAGEMENT FROM WHOM WRITTEN REPRESENTATIONS REQUESTED:

1. The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.
2. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation.
3. Since management is responsible for preparations of financial statements and conduct of business, they would be expected to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations.
4. In some cases, however, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include:
   a. An actuary responsible for actuarially determined accounting measurements.
   b. Staff engineers who may have responsibility for and specialized knowledge about environmental liability measurements.
   c. Internal counsel who may provide information essential to provisions for legal claims.

E. **WRITTEN REPRESENTATION FROM MANAGEMENT TO RECONFIRM ITS RESPONSIBILITIES:** The auditor may also ask management to reconfirm its acknowledgement and understanding of those responsibilities in written representations. This is particularly appropriate when:

1. Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
2. The terms of the audit engagement were prepared in a previous year;
3. There is any indication that management misunderstands those responsibilities; or
4. Changes in circumstances make it appropriate to do so.

F. **OTHER WRITTEN REPRESENTATIONS:**

1. In addition to the written representation about management's responsibilities regarding preparation of financial statements, the auditor may consider it necessary to request other written representations about the financial statements.
2. Such written representations may supplement, but do not form part of, the written representation relating to management's responsibilities regarding preparation of financial statements. They may include representations about the following:
   a. Whether the selection and application of accounting policies are appropriate; and
   b. Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed in accordance with that framework: -
      - Plans or intentions that may affect the carrying value or classification of assets and liabilities;
      - Liabilities, both actual and contingent;
      - Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral;
      - Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

G. **WRITTEN REPRESENTATIONS ABOUT SPECIFIC ASSERTIONS:** When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:

a. The entity's past history in carrying out its stated intentions.
b. The entity's reasons for choosing a particular course of action.
c. The entity's ability to pursue a specific course of action.
d. The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.

H. **DATE AND PERIOD COVERED BY WRITTEN REPRESENTATIONS:**

1. The date of the written representations shall be as near as practicable to but not after, the date of the auditor's report on the financial statements.
2. Because written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations.

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

I. FORM OF WRITTEN REPRESENTATION:

1. The written representations shall be in the form of a representation letter addressed to the auditor.
2. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required, the relevant matters covered by such statements need not be included in the representation letter.

J. DOUBT AS TO THE RELIABILITY OF WRITTEN REPRESENTATIONS:

1. If the auditor has concerns about the competence, integrity, ethical values or diligence of management, the auditor shall determine the effect that such concerns may have on the reliability of representations and audit evidence in general.
2. In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter.
3. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705.

K. REQUESTED WRITTEN REPRESENTATIONS NOT PROVIDED: If management does not provide one or more of the requested written representations, the auditor shall:

1. Discuss the matter with management;
2. Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations and audit evidence in general; and
3. Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705.

L. DISCLAIMER OF OPINION IN CASE OF NON-RELIABILITY OF WRITTEN REPRESENTATIONS ABOUT MANAGEMENT'S RESPONSIBILITIES OR FAILURE TO PROVIDE SUCH WRITTEN REPRESENTATIONS: The auditor shall disclaim an opinion on the financial statements in accordance with SA 705 if:

1. The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations about management fulfilling its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions are not reliable; or
2. Management does not provide the written representations relating to fulfilling its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions

TEST YOUR KNOWLEDGE:

1. **"Although written representations provide necessary audit evidence yet they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal." Discuss.**

Answer: Refer Point A and B

2. **The auditor X of XYZ and Co., a firm of Chartered Accountants is conducting audit of MN Industries Ltd. The auditor requests management to provide Banker's certificate in support of Fixed deposits whereas management provides only written representation on the matter. Analyse how would you deal as an auditor.**

Answer: Write point A and B

In he given case cannot rely only on written representation for expressing an opinion on financial statements.

3. **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. Explain stating clearly objectives of the auditor regarding written representation.**

Answer: Write Point A and C

4. **The Partner of M&M, Chartered Accountants, asked the management to provide statements from the creditors as part of audit evidence and also required written representation from the management but the management did not provide the requested written representations. Discuss how the auditor would proceed.**

Answer: Write Point A and I

5. **In some cases, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Explain in the context of SA 580.**

Answer: Write Point D

6. **State the circumstances in which it will be appropriate for the auditor to request written representations from the management to reconfirm its responsibilities.**

Answer: Write Point E

SA 710 – COMPARATIVE INFORMATION: CORRESPONDING FIGURES AND COMPARATIVE FINANCIAL STATEMENTS

A. **DEFINITIONS:**

1. **COMPARATIVE INFORMATION:** The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.
2. **CORRESPONDING FIGURES:**
   a. Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures").
   b. The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.
3. **COMPARATIVE FINANCIAL STATEMENTS:** Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period

B. **OBJECTIVE:** As per SA 710, the objectives of the auditor are:

1. To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and
2. To report in accordance with the auditor's reporting responsibilities.

C. **AUDIT PROCEDURES REGARDING COMPARATIVE INFORMATION**

1. The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework.
2. The auditor shall evaluate whether:
   a. The comparative information agrees with the amounts and other disclosures presented in the prior period; and
   b. The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.
3. 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.
4. As required by SA 580, the auditor shall request written representations regarding the comparative information.

D. **AUDIT REPORTING REGARDING CORRESPONDING FIGURES:** When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the following circumstances:

1. If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved,
   a. The auditor shall modify the auditor's opinion on the current period's financial statements.
   b. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:
      i. Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
      ii. In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures (if not material).
2. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued,
   a. the auditor shall verify whether the misstatement has been dealt with as required under the applicable financial reporting framework and,
   b. if that is not the case, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements.
3. **Prior Period Financial Statements Not Audited:** If the prior period financial statements were not audited, the audit or shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

E. **AUDIT REPORTING REGARDING COMPARATIVE FINANCIAL STATEMENTS:** In case of comparative financial statements,

1. **Auditor's opinion- to refer each period:** When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed.
2. When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall **disclose the substantive reasons for the different opinion in an Other Matter paragraph** in accordance with SA 706.
3. **Prior Period Financial Statements Audited by a Predecessor Auditor:** If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:
   a. That the financial statements of the prior period were audited by a predecessor auditor;

   b. The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefor; and
   c. The date of that report.
4. **Prior Period Financial Statements Not Audited:** If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

F. NATURE OF THE COMPARATIVE INFORMATION:

1. The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework.
2. The essential audit reporting differences between the approaches are:
   a. **For corresponding figures,** the auditor's opinion on the financial statements refers to the current period only; whereas
   b. **For comparative financial statements,** the auditor's opinion refers to each period for which financial statements are presented.

TEST YOUR KNOWLEDGE:

1. Define the term Comparative Information. Explain the audit procedures regarding comparative information.

Answer: Write point A(1) and C

2. The senior member of the firm Kaur & Associates, Chartered Accountants, informed to its auditing staff that, when corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in specified circumstances. What are those exceptional circumstances?

Answer: Write point D

3. Define the term Corresponding figures and Comparative Financial Statements. Also explain the reporting differences between the two.

Answer: Write A(2,3) and Point F

4. Explain the reporting requirements of the auditor regarding comparative financial statements.

Answer: Write Point E

SQC 1 – QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION, AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS

A. AUDIT QUALITY:

1. The purpose of an independent audit is to provide confidence to users of audited financial statements.
2. Therefore, high audit quality is essential to maintain confidence in the independent assurance provided by the auditors. It is the responsibility of auditor to maintain high audit quality.
3. SQC 1 and SA 220 both deal with quality control.
4. Whereas SQC 1 deals with all engagements including audits, reviews and other assurance and related service engagements, SA 220 applies to audit engagements only.
5. Further, SQC 1 applies to entire firm. However, SA 220 applies to a particular audit engagement.

B. ELEMENTS OF SYSTEM OF QUALITY CONTROL: The firm's system of quality control should include policies and procedures addressing each of the following elements: -

1. Leadership responsibilities for quality within the firm
2. Ethical requirements
3. Acceptance and continuance of client relationships and specific engagements
4. Human resources
5. Engagement performance
6. Monitoring

C. LEADERSHIP RESPONSIBILITIES FOR QUALITY WITHIN THE FIRM :

1. SQC 1 requires firms to establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements.
2. Such policies and procedures should require the firm's chief executive officer or the firm's managing partners to assume ultimate responsibility for the firm's system of quality control.
3. The example set by firm's leadership encourages an inner culture that recognizes high quality audit work.
4. Further, persons assigned operational responsibilities for the firm's quality control system by the firm's chief executive officer or managing partners should have sufficient and appropriate experience, ability and the necessary authority to assume that responsibility.

D. ETHICAL REQUIREMENTS:

1. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements contained in the Code of ethics issued by ICAI.
2. The Code establishes the fundamental principles of professional ethics which include integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.
3. Observance of "Independence" in all engagements is the basic requirement. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and (including experts contracted by the firm and network firm personnel) maintain independence where required by the Code. Such policies and procedures should enable the firm to: -

a. <u>Communicate</u> its independence requirements to its personnel
b. <u>Identify and evaluate</u> circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, <u>to withdraw from the engagement.</u>

4. There should exist a mechanism in the firm by which engagement partners provide the firm with relevant information about client engagements and personnel of firm promptly notify firm of circumstances and relationships that create a threat to independence.
5. <u>All breaches of independence should be promptly notified</u> to firm for appropriate action. Its objective is to ensure that independence requirements are satisfied.
6. At least annually, <u>the firm should obtain written confirmation</u> of compliance with its policies and procedures on independence from all firm personnel required to be independent in terms of the requirements of the Code.

E. ACCEPTANCE AND CONTINUANCE OF CLIENT RELATIONSHIPS AND SPECIFIC ENGAGEMENTS:

1. **Factors to consider before acceptance and continuation of client relationships:** A firm before accepting an engagement should acquire vital information about the client. Such an information should help firm to decide about: -
   a. Integrity of Client
   b. Competence (including capabilities, time and resources) to perform engagement
   c. Compliance with ethical requirements
2. **Matters that the firm considers regarding integrity of the client:** With regard to the integrity of a client, matters that the firm considers include, for example:
   a. The <u>identity and business reputation</u> of the client's principal owners, key management, related parties and those charged with its governance.
   b. The <u>nature of the client's operations</u>, including its business practices.
   c. Information concerning the <u>attitude of the client's principal owners</u>, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
   d. Whether the <u>client is aggressively concerned with maintaining the firm's fees</u> as low as possible.
   e. Indications of an <u>inappropriate limitation</u> in the scope of work.
   f. Indications that the client might be <u>involved in money laundering or other criminal activities</u>.
   g. The <u>reasons for the proposed appointment</u> of the firm and non-reappointment of the previous firm.
3. **Conflict between the firm and the client:**
   a. If there is any conflict of interest between the firm and client, it should be <u>properly resolved before accepting the engagement</u>.
   b. Where the <u>firm obtains information that would have caused it to decline an engagement</u> if that information had been obtainable earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of:

i. The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities and
ii. The possibility of withdrawing from the engagement or from both the engagement and the client relationship.

F. HUMAN RESOURCES: The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances. Such policies and procedures should address relevant HR issues including

1. recruitment,
2. compensation,
3. training,
4. career development,
5. performance evaluation etc.

There should be emphasis on the continuing professional development of firm's personnel.

G. ENGAGEMENT PERFORMANCE:

1. Consistency in quality of engagement performance is achieved through
   a. briefing of engagement teams of their objectives,
   b. processes for complying with engagement standards,
   c. processes of engagement supervision and training,
   d. methods of reviewing performance of work,
   e. appropriate documentation of work performed.
2. Consultation should take place in difficult or contentious matters pertaining to an engagement. Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have specialized expertise, to resolve a difficult or contentious matter.
3. A firm needing to consult externally, for example, a firm without appropriate internal resources, may take advantage of advisory services provided by other firms or professional and regulatory bodies.
4. Significant judgments made in an engagement should be reviewed by an engagement quality control reviewer for taking an objective view before the report is issued. The extent of the review depends on the complexity of the engagement and the risk that the report might not be appropriate in the circumstances.
5. The review does not reduce the responsibilities of the engagement partner.
6. Engagement quality control review is mandatory for all audits of financial statements of listed entities. In respect of other engagements, firm should devise criteria to determine cases requiring performance of engagement quality control review.
7. There might be difference of opinion within engagement team, with those consulted and between engagement partner and engagement quality control reviewer. The report should only be issued after resolution of such differences.

8. In case, recommendations of engagement quality control reviewer are not accepted by engagement partner and matter is not resolved to reviewer's satisfaction, the matter should be resolved by following established procedures of firm like by consulting with another practitioner or firm, or a professional or regulatory body.
9. Besides, the firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized. The assembly of engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements and in other cases within the limits appropriate to engagements.
10. Policies and procedures should be designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation. Unless otherwise specified by law or regulation, engagement documentation is the property of the firm.
11. The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel.
12. Engagement documentation has to be retained for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.
13. In the specific case of audit engagements, the retention period 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.

H. MONITORING: The firm should ensure that policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.

TEST YOUR UNDERSTANDING:

1. **The audit procedures performed so far by auditor of a company indicate that there is a possibility that company has not disclosed all material litigation cases involving the company. Does such a situation warrant direct communication by auditor with external lawyer of the company?**

Answer:

As per requirements of SA-501, If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, seek direct communication with the entity's external legal counsel. The above situation warrants direct communication with company's standing external lawyer.

2. **CA Jignesh Desai is in midst of audit of a company. The company is fairly large one and has a well -functioning internal audit department. While considering sending out external**

confirmation requests to trade receivables outstanding as on date of financial statements, he has delegated the process of choosing trade receivables, designing requests and receiving responses from customers to internal audit department. The responses are also received on the mail id of internal audit department. Is approach of CA Jignesh Desai proper?

Answer:

When using external confirmation procedures, the auditor shall maintain control over external confirmation requests, including:

1. Determining the information to be confirmed or requested;
2. Selecting the appropriate confirming party;
3. Designing the confirmation requests, including determining that requests are properly addressed and contain return information for responses to be sent directly to the auditor; and
4. Sending the requests, including follow-up requests when applicable, to the confirming party.

In the given case, it appears that external auditor has delegated entire work of sending out external confirmation requests to internal audit department over which he has no control. Further, responses to external confirmation requests are received on mail id of internal audit department. All these acts are not in line with requirements under SA 505.

3. **On reviewing schedule of trade receivables of a company, CA Mary finds that in respect of one outstanding balance, the CFO of the company is not willing to allow her to send external confirmation request due to the reason that sending out such request could spoil precariously placed business relations with the customer. On further inquiry, she finds out that there is a dispute going on with the company relating to some quality issues of goods sent to the customer and matter is sub judice. Efforts are also being made by the company for out of court settlement. Reviewing correspondence with the customer, she finds that issue is near resolution and no fraud risk factors exist. Is unwillingness of CFO justifiable?**

Answer:

In terms of requirements of SA 505, if management refuses to allow the auditor to send a confirmation request, the auditor shall inquire as to management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness.

A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. Further, fraud risk factors do not exist. Keeping in view, unwillingness of CFO is justifiable.

4. **CA PK Jacob is conducting audit of a company for year 2021-22. The company is engaged in export of ethnic rugs to buyers in Europe. The audit is nearing completion in month of July 2022. However, it becomes known to the auditor that one of overseas buyers has made a legal claim against the company on 1st June 2022 for injury caused to a customer of one European buyer due to sub-standard dyes used in rugs of one lot of order shipped in August, 2021. The management of company has decided to agree to an out of court settlement of Rs.5 crore to protect its reputation. The financial statements of the company are silent on this issue.**

Discuss, how, CA PK Jacob should proceed to deal with above issue.

Answer:

In the given case, the auditor has come to know of legal claim against the company before issue of audit report. It has also come to his knowledge that management of company has agreed to an out of court settlement of Rs.5 crore. It is an example of subsequent event between the date of the financial statements and the date of the auditor’s report. It provides evidence of conditions that existed at the date of the financial statements and requires adjustment in financial statements.

He should ask company management to make necessary adjustment to the financial statements. If adjustment is not made by management, he should consider impact on auditor’s report.

5. **CA Chandni Khanna is going to complete audit of a company within next few days. She has performed necessary audit procedures like inquiry of management personnel, reading minutes of meetings held after date of financial statements, going through books of accounts after date of financial statements to make sure that all subsequent events before signing audit report have been considered by her. Still, she wants to be certain that no such events have been left out. What she should do in such a situation? Also, discuss the rationale of doing so.**

Answer: Refer SA 560 Para Audit Procedures

6. **During course of audit of a company, CA. Varun Aggarwal notices that company is facing significant skilled labour shortages resulting in hampering of operations of company. The company’s manufacturing is dependent upon skilled labour coming from villages in certain districts of Eastern UP. However, due to job opportunities available near villages now, many are not interested in going out from their native villages. Such a situation has led to company not being able to keep its commitments, losing out on orders and fall in its revenues. Fixed costs of the company remain at a high level. As a result, company is facing a liquidity crunch and is not able to pay its creditors on time. The bankers of company are also not willing to help the company to tide over liquidity crisis. The auditor is having doubts over going concern status of the company. How should management of the company try to address auditor’s concerns? What audit procedures may be performed by auditor in such a situation?**

Answer:

Significant shortage of skilled labour, inability to pay creditors on time and overall liquidity crisis faced by the company are examples of events or conditions that, individually or collectively, may cast significant doubt on the entity’s ability to continue as a going concern.

In such a situation, management should try to address auditor’s concerns by preparing its future plan of action including preparation of cash flow forecast showing inflow and outflow of cash. Such a cash flow forecast should address auditor’s concerns regarding liquidity crisis being faced by the company.

The auditor should perform audit procedures to evaluate the reliability of the underlying data to prepare the forecast and determining whether there is adequate support for the assumptions underlying the forecast. The auditor should also consider whether any additional facts or information have become available since the date on which management made its assessment.

7. **You are nearing completion of audit of a company. On going through your working papers, it is noticed that finished goods inventory was overvalued by Rs. 2 crore. It has also been noticed that freight of Rs.10 lacs paid on import of machinery was charged to statement of profit and loss. Discuss, how you should, proceed and communicate in above situation before signing audit report.**

Answer:

The instances highlighted in above situation are examples of misstatements identified during the audit. Over valuation of inventory of finished goods by Rs. 2 crore and wrongly charging freight of Rs. 10 lacs paid on machinery to statement of profit and loss instead of capitalizing are examples of misstatements.

The auditor should communicate above identified misstatements to those charged with governance and request for correction of these misstatements. In case, these are not corrected, understand the reasons for not making the corrections and reassess materiality. It should also be considered whether uncorrected statements are material individually or in aggregate. Effect of uncorrected misstatements on the opinion in auditor's report should be communicated to those charged with governance.

8. **CA R Gurumurthy is about to complete audit of a company. Before completion, he asks management to provide him a written representation confirming that management has fulfilled its responsibilities regarding preparation of financial statements. He also wants management to confirm in writing about providing of all the necessary information and completeness of transactions to him. The management feels that auditor is seeking irrelevant documents near the completion of audit. Why view of management is not proper? What possible implications it may lead to?**

Answer:

The view of management is not proper. Audit evidence obtained during the audit that management has fulfilled its responsibilities regarding preparation of financial statements and about information provided and completeness of transactions is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities.

In case of refusal of management to provide such a confirmation, it may lead to disclaimer of opinion by the auditor.

9. **On reviewing internal control over inventories as part of statutory audit of a company, auditor finds that physical verification is not being conducted at regular intervals as stipulated by the management. The auditor finds it to be significant deficiency in internal control over inventories. He points it out to the management in a one-liner as under: -**

"Physical verification of inventories is not being conducted at regular intervals as stipulated by management." Is above communication by auditor proper? Ignore statutory reporting requirements, if any in this regard.

Answer:

While pointing out significant deficiencies in internal control, auditor has not only to communicate significant deficiencies giving their description but also explain the potential effects and sufficient information to those charged with governance and management to understand context of communication.

Therefore, the above communication is not proper. Not only significant deficiency has to be communicated, it should also be explained to management the potential effects of not carrying out physical verification of inventories at regular intervals as stipulated by management. It should explain that such a significant deficiency can lead to misstatement of inventories impacting profits of the company. Highlighting importance of such a control, it should be stated that responsibility be fixed for concerned persons for adhering to such an important control.

10. The management of Exotic Tours and Travels Limited requests its auditor Raja & Co.to provide an assurance report on the financial information for first quarter of a year by skipping required detailed procedures. Can Raja & Co. provide such a report? What would be nature of such a report? Would it be necessary for them to obtain sufficient appropriate evidence in such a case?

Answer:

Such report would be in nature of "review". However, auditors would have to obtain sufficient appropriate evidence.

11. CA. P Babu is conducting audit of financial statements of Quick Buy Private Limited. He was not able to obtain external confirmations from certain debtors due to practical difficulties and peculiar circumstances. However, such a procedure is mandated under one of Standards on Auditing. Unable to obtain external confirmations from these debtors, he relied upon sale details to these parties, e-invoices, e-way bills and also traced payments from these parties in bank accounts of the company. He was reasonably satisfied with audit evidence obtained. Is there any other reporting duty cast upon him relating to not following a mandated procedure in one of Standards on Auditing?

Answer:

He is required to document how alternative procedures performed achieve the purpose of required procedure. Reason for departure has to be documented unless it is clear. His report should draw attention to such departure.

8. AUDIT IN AN AUTOMATED ENVIRONMENT

Q.NO.1 DEFINE THE TERM AUTOMATED ENVIRONMENT. ALSO STATE THE FEATURES OF AUTOMATED ENVIRONMENT.

ANSWER:

A. **MEANING:** An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems also known as Information Systems (IS) or Information Technology (IT) systems.

Nowadays, it is very common to see computer systems being used in almost every type of business.

For example, think about how banking transactions are carried out using ATMs (Automated Teller Machines), or how tickets can be purchased using "apps" on mobile phones, etc. In these examples, you can see how these computer systems enable us to transact business at any time and any day.

B. **FEATURES OF AN AUTOMATED ENVIRONMENT:** The following are the features of automated environment:

1. Enables faster business operations
2. Accuracy in data processing and computation
3. Ability to process large volumes of data
4. Integration between business operations
5. Better security and controls
6. Less prone to human errors
7. Provides latest information

TEST YOUR KNOWLEDGE:

1. **An automated environment basically refers to a business environment where the processes, operations, accounting except the decisions are carried out by using computer systems. Correct/Incorrect.**

Answer:

Incorrect. An automated environment basically refers to a business environment where the processes, operations, accounting and even decisions are carried out by using computer systems

Q.NO.2 EXPLAIN RELEVANCE OF IT IN AUDIT.

ANSWER:

A. AUTOMATION OF ACTIVITIES: When a business operates in a more automated environment it is likely that we will see several business functions and activities happening within the systems. For example:

1. **Computation and Calculations** are automatically carried out (for example, bank interest computation and inventory valuation).
2. **Accounting entries** are posted automatically (for example, sub-ledger to GL postings are automatic).
3. **Business policies and procedures**, including internal controls, are applied automatically (for example, delegation of authority for journal approvals, customer credit limit checks are performed automatically).
4. **Reports used in business are produced from systems**. Management and other stakeholders rely on these reports and information produced (for example, debtors ageing report).
5. **User access and security** are controlled by assigning system roles to users (for example, segregation of duties can be enforced effectively).

B. RELEVANCE OF IT IN AUDIT:

1. Companies derive benefit from the use of IT systems as an enabler to support various business operations and activities.
2. Auditors need to understand the relevance of these IT systems to an audit of financial statements.
3. Auditors are required to understand, assess and respond to such risks that arise from the use of IT systems.
4. Even SA 315 requires the auditor to obtain an understanding of clients automated environment.
5. Given below are some situations in which IT will be relevant to an audit,
   a. Increased use of Systems and Application software in Business (for example, use of ERPs)
   b. Complexity of transactions has increased (multiple systems, network of systems)
   c. Hi-tech nature of business (Telecom, e-Commerce).
   d. Volume of transactions are high (Insurance, Banking, Railways ticketing).
   e. Regulatory requirements - Companies Act 2013, IT Act 2008.
   f. Required by Indian and International Standards - ISO, PCI-DSS, SA 315, SOC, ISAE.
   g. Increases efficiency and effectiveness of audit.

TEST YOUR KNOWLEDGE:

1. All automated environments are complex. Correct/Incorrect.

Answer:

Incorrect. The complexity of an automated environment depends on various factors including the nature of business, level of automation, volume of transactions, use of ERP and so on. There could be environment where dependence on IT and automation is relatively less or minimal and hence, considered less complex or even non-complex.

2. **Briefly mention three reasons why IT should be considered relevant to an audit of financial statements.**

Answer: Write Point B

3. **When the company is working in an automated environment, it is not necessary for its auditor to understand its automated environment and depends upon the professional judgement of the auditor as to whether gaining knowledge of company's IT systems is required or not. Do you agree with this statement?**

Answer: Refer above answer

Q.NO.3 WHAT ARE THE POINTS THAT AN AUDITOR SHOULD CONSIDER WHILE OBTAINING AN UNDERSTANDING OF COMPANY'S AUTOMATED ENVIRONMENT?

ANSWER:

Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.

Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment:

1. Information systems being used (one or more application systems and what they are).
2. Their purpose (financial and non-financial).
3. Location of IT systems - local vs global.
4. Architecture (desktop based, client-server, web application, cloud based).
5. Version (functions and risks could vary in different versions of same application).
6. Interfaces within systems (in case multiple systems exist).
7. In-house vs Packaged.
8. Outsourced activities (IT maintenance and support).
9. Key persons (CIO, CISO, Administrators).

Note: The understanding of a company's IT environment that is obtained should be documented [As per SA 230] using any standard format or template. An example of such template could be as below:

Information system being used	Version	Purpose	Location	Architecture	Interfaces within system	Inhouse vs Packaged	Outsourced activities	Key Persons	In scope
SAP	ECC 6.0, EHPS	Accounting, Supply chain, Production	Texas, USA	Client/Server, Unix AIX 5.3, MS-SQL Server 2008	Paymaster	Packaged	CIO,	Administrators	Yes

PayMaster	5.3	Payroll	Gurgaon, India	Web-based, Windows, Apache, Oracle 11g	SAP, Accent	Package d	Payroll processe d at ADP		Yes

Q.NO.4 WHAT ARE THE RISKS ARISING FROM THE USE OF AUTOMATED ENVIRONMENT?

ANSWER:

A. RISKS ARISING FROM THE USE OF IT: Having obtained an understanding of the IT systems and the automated environment of a company, the auditor should now understand the risks that arise from the use of IT systems. Given below are some such risks that should be considered:

1. Inaccurate processing of data, processing inaccurate data, or both.
2. Unauthorized access to data.
3. Direct data changes (backend changes).
4. Excessive access / Privileged access (super users).
5. Lack of adequate segregation of duties.
6. Unauthorized changes to systems or programs.
7. Failure to make necessary changes to systems or programs.
8. Loss of data.

B. IMPACT OF IT RELATED RISKS: The above risks, if not mitigated, could have an impact on audit in different ways.

1. **Impact on Substantive audit procedures:** The auditor cannot rely on the data obtained from systems. The system data and reports should be tested substantively for completeness and accuracy, hence more audit evidence is needed.
2. **Impact on Compliance procedures:** The auditor cannot rely on automated controls, system calculations and accounting procedures built into applications. System data and reports should be tested substantively for completeness and accuracy. Hence, more substantive audit work is needed.
3. **Impact on Reporting:** The auditor may be required to communicate to those charged with governance and also issue modified reports.

TEST YOUR KNOWLEDGE

1. In an audit of financial statements, the auditor should plan response to all IT risks. Correct/Incorrect.

Answer:

Incorrect. The auditor should plan response to those IT risks that are relevant to financial reporting and not "all" IT risks.

2. Describe how risks in IT systems, if not mitigated, could have an impact on audit.

Answer: Write Point B

Q.NO.5 WRITE ABOUT TESTING METHODS IN AUTOMATED ENVIRONMENT?

ANSWER:

A. **TESTING METHODS IN AUTOMATED ENVIRONMENT:** There are basically four types of audit tests that should be used. They are
   1. Inquiry
   2. Inspection
   3. Observation
   4. Reperformance

B. **WHICH METHOD AUDITOR SHALL USE?**
   1. inquiry is the most efficient audit test but it also gives the least audit evidence. Hence, inquiry should always be used in combination with any one of the other audit testing methods. Inquiry alone is not sufficient.
   2. Reperformance is most effective as an audit test and gives the best audit evidence. However, testing by reperformance could be very time consuming and least efficient most of the time.
   3. Generally, applying inquiry in combination with inspection gives the most effective and efficient audit evidence.
   4. However, which audit test to use, when and in what combination is a matter of professional judgement and will vary depending on several factors *(for example, risk assessment, control environment, desired level of evidence required, history of errors/misstatements, complexity of business, assertions being addressed, etc).*
   5. When testing in an automated environment, some of the more common methods are as follows:
      a. Obtain an understanding of how an automated transaction is processed by doing a walkthrough of one end-to-end transaction using a combination of inquiry, observation and inspection.
      b. Observe how a user processes transactions under different scenarios.
      c. Inspect the configuration defined in an application.
      d. Inspect the system logs to determine any changes made since last audit testing and technical manual / user manual of systems and applications.
      e. Carry out a test check (negative testing) and observe the error message displayed by the application.

Q.NO.6 WHAT IS DATA ANALYTICS? ALSO STATE ITS USES IN AUDIT.

ANSWER:

A. **MEANING:**

1. The combination of processes, tools and techniques that are used to tap vast amounts of electronic data to obtain meaningful information is called **Data analytics**.
2. Companies can benefit immensely from the use of data analytics in terms of increased profitability, better customer service, gaining competitive advantage, more efficient operations, etc.,
3. Even auditors can make use of similar tools and techniques in the audit process and obtain good results.
4. The tools and techniques that auditors use in applying the principles of data analytics are known as **Computer Assisted Auditing Techniques or CAATs** in short.

B. USE OF DATA ANALYTICS IN AUDIT: Data analytics can be used in testing of electronic records and data residing in IT systems using spreadsheets and specialised audit tools viz., IDEA and ACL to perform the following:

1. Check **completeness of data and population** that is used in either test of controls or substantive audit tests.
2. **Selection of audit samples** – random sampling, systematic sampling.
3. **Re-computation** of balances – reconstruction of trial balance from transaction data.
4. **Reperformance** of mathematical calculations – depreciation, bank interest calculation.
5. **Analysis of journal entries** as required by SA 240.
6. **Fraud investigation.**
7. Evaluating impact of **control deficiencies**.

TEST YOUR KNOWLEDGE

1. Specialised audit tools like IDEA, ACL are required to perform data analytics. Correct/Incorrect.

Answer:

Incorrect. Even though specialised audit tools are very useful, such tools are not always required or necessary to carry out data analytics. More commonly available spreadsheet applications like MS-Excel can also be effectively used for carrying out data analytics.

Q.NO.7 HOW THE AUDITOR SHALL ASSESS AND REPORT AUDIT FINDINDS IN AUTOMATED ENVIRONMENT?

ANSWER:

1. At the conclusion of each audit, it is possible that there will be certain findings or exceptions in IT environment and IT controls of the company that need to be assessed and reported to relevant stakeholders including management and those charged with governance viz., Board of directors, Audit committee.
2. Some points to consider are as follows:
   a. Are there any weaknesses in IT controls?
   b. What is the impact of these weaknesses on overall audit?
   c. Report deficiencies to management – Internal Controls Memo or Management Letter.

   d. Communicate in writing any significant deficiencies to Those Charged With Governance.
3. A deficiency in internal control exits if a control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or the control is missing.

TEST YOUR KNOWLEDGE:

1. **The Auditor of HK Limited completed the audit of the company in an automated environment Management of the company requested the auditor to give an idea about any exceptions observed in IT environment that need to be assessed. How the auditor should consider this request and report in light of an audit perspective?**

Answer: Write above answer

Q.NO.8 WRITE ABOUT DIGITAL AUDIT.

ANSWER:

1. Entities are embracing digitization as part of their operations to keep pace with changing times.
2. New technologies are helping companies revamp their operations and rethink the way business is conducted.
3. Companies are restructuring their business models driven by technology.
4. Automation is key to digitization. In such a business environment, use of digital technology is being made by auditors right from planning to expression of final opinion.
5. Auditors are making use of artificial intelligence, data analytics and other latest technologies to help understand business processes in a better way.
6. By using such tools, auditors can conduct audit in a better way and devote more attention to areas requiring greater focus.
7. Digital audit is helping auditors to better identify risks making use of technology.

Q.NO.9 WRITE ABOUT MANUAL ELEMENTS VS AUTOMATED ELEMENTS IN ENTITY'S INTERNAL CONTROLS.

ANSWER:

1. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:
   a. Large, unusual or non-recurring transactions.
   b. Circumstances where errors are difficult to define, anticipate or predict.
   c. In changing circumstances that require a control response outside the scope of an existing automated control.
   d. In monitoring the effectiveness of automated controls.

2. Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes.
3. Consistency of application of a manual control element cannot therefore be assumed.
4. Manual control elements may be less suitable for the following circumstances:
   a. High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
   b. Control activities where the specific ways to perform the control can be adequately designed and automated.

Q.NO.10 EXPLAIN DIFFERENT TYPES OF CONTROLS IN AN AUTOMATED ENVIRONMENT.

ANSWER:

A. GENERAL IT CONTROLS: "General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments.

General IT-controls that maintain the integrity of information and security of data commonly include controls over the following:

1. **Data center and network operations**
   a. **Objective:** To ensure that production systems are processed to meet financial reporting objectives.
   b. **Activities:**
      i. Overall Management of Computer Operations Activities
      ii. Batch jobs – preparing, scheduling and executing
      iii. Backups – monitoring, storage & retention
      iv. Performance Monitoring – operating system, database and networks
      v. Recovery from Failures – BCP, DRP
      vi. Help Desk Functions – recording, monitoring & tracking
      vii. Service Level Agreements – monitoring & compliance
      viii. Documentation – operations manuals, service reports

2. **Program change**
   a. **Objective:** To ensure that modified systems continue to meet financial reporting objectives.
   b. **Activities:**
      i. Change Management Process – definition, roles & responsibilities
      ii. Change Requests – record, manage, track
      iii. Making Changes – analyze, design, develop
      iv. Test Changes – test plan, test cases, UAT

3. **Access security**
   a. **Objective:** To ensure that access to programs and data is authenticated and authorized to meet financial reporting objectives.
   b. **Activities:**
      i. Security Organization & Management
      ii. Security Policies & Procedures
      iii. Application Security
      iv. Data Security
      v. Operating System Security
      vi. Network Security – internal network, perimeter network
      vii. Physical Security – access controls, environment controls
      viii. System Administration & Privileged Accounts – Sysadmins, DBAs, Super users

4. **Application system acquisition, development, and maintenance**
   a. **Objective:** To ensure that systems are developed, configured and implemented to meet financial reporting objectives.
   b. **Activities:**
      i. Overall Mgmt. of Development Activities
      ii. Project Initiation
      iii. Analysis & Design
      iv. Construction
      v. Testing & Quality Assurance

B. APPLICATION CONTROLS: Application controls include both automated or manual controls that operate at a business process level. Automated Application controls are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems.

C. GENERAL IT CONTROLS VS. APPLICATION CONTROLS: These two categories of control over IT systems are interrelated. The relationship between the application controls and the General IT Controls is such that General IT Controls are needed to support the functioning of application controls, and both are needed to ensure complete and accurate information processing through IT systems.

D. IT DEPENDENT CONTROLS:
1. IT dependent controls are basically manual controls that make use of some form of data or information or report produced from IT systems and applications.
2. In this case, even though the control is performed manually, the design and effectiveness of such controls depends on the reliability of source data.
3. Due to the inherent dependency on IT, the effectiveness and reliability of Automated application controls and IT dependent controls require the General IT Controls to be effective.

TEST YOUR KNOWLEDGE

1. General IT controls support the functioning of Application controls. Correct/Incorrect.

Answer:

Correct. General IT controls support the functioning of automated application controls and IT dependent controls.

2. Explain the objective and enlist the activities involved in the General IT Controls over "Program Change".

Answer: Write Point A(2)

9. AUDIT STRATEGY, PLANNING AND PROGRAMME

Q.NO.1 WHAT ARE THE FACTORS TO BE CONSIDERED BY AN AUDITOR IN ESTABLISHING OVERALL AUDIT STRATEGY.

ANSWER:

In establishing the overall audit strategy, the auditor shall

1. Identify the **characteristics of the engagement** that define its scope.
   Example:
   - *The expected audit coverage, including the number and locations of components to be included.*
   - *The nature of the business segments to be audited, including the need for specialized knowledge.*
   - *The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.*
2. Ascertain the **reporting objectives of the engagement** to plan the timing of the audit and the nature of the communications required.
   Example:
   - *The entity's timetable for reporting, such as at interim and final stages.*
   - *The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.*
   - *The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued.*
3. Consider the **factors that, in the auditor's professional judgment, are significant** in directing the engagement team's efforts.
   Examples:
   - *Significant industry developments such as changes in industry regulations and new reporting requirements.*
   - *Significant changes in the financial reporting framework, such as changes in accounting standards.*
   - *Other significant relevant developments, such as changes in the legal environment affecting the entity*
4. Consider the **results of preliminary engagement activities** and, where applicable. *(see note)*
5. **Knowledge gained on other engagements** performed by the engagement partner for the entity is relevant.
   Example:
   - *Identification of areas where there may be a higher risk of material misstatement.*
   - *Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them.*

- *Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.*

6. Ascertain the **nature, timing and extent of resources** necessary to perform the engagement.

Note: The following activities are included in preliminary engagement activities:

a. Performing procedures required by SA 220, "Quality Control for an Audit of Financial Statements" regarding the continuance of the client relationship and the specific audit engagement.
b. Evaluating compliance with ethical requirements, including independence, as required by SA 220;
c. Establishing an understanding of the terms of the engagement, as required by SA 210 and
d. Communicating with the predecessor auditor, if applicable.

TEST YOUR KNOWLEDGE:

1. **Mr. Duke, a practicing-chartered accountant has conducted the Tax audit of Jackson Ltd for the financial year 2019-20. He is also appointed as the company auditor for the financial year 2020-21. One of the engagement team member is of the view that they cannot use the knowledge obtained, while conducting the tax audit while establishing the audit strategy for the current years company audit. Comment.**

Answer: Write Point 5 from above answer

Q.NO.2 HOW OVERALL AUDIT STRATEGY WILL ASSIST THE AUDITOR IN DEVOLOPMENT OF AUDIT PLAN? / WHAT ARE THE BENEFITS OF OVERALL AUDIT STRATEGY?

ANSWER:

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

1. The **resources to deploy** for specific audit areas, such as the use of appropriately experienced team members for high-risk areas or the involvement of experts on complex matters;
2. The **amount of resources to allocate** to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations etc.
3. **When these resources are to be deployed,** such as whether at an interim audit stage or from beginning of the audit; and
4. How such **resources are managed, directed and supervised**, such as
   a. When team briefing and debriefing meetings are expected to be held?
   b. How engagement partner and manager reviews are expected to take place (for example, on-site or off-site)?

TEST YOUR KNOWLEDGE:

1. **Assignment of appropriately experienced team members to areas where there may be lower risks of material misstatement is an appropriate decision. Correct/Incorrect.**

Answer:

Incorrect. Assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement is an appropriate decision.

2. **Overall audit strategy sets the scope, timing, and direction of the audit, and guides the development of the more detailed audit plan. The process of establishing the overall audit strategy assists the auditor to determine such matters as for example - the resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high-risk areas or the involvement of experts on complex matters. Explain the other three such matters.**

Answer: Refer above answer

Q.NO.3 WHAT ASPECTS ARE REQUIRED TO BE COVERED WHILE DEVOLOPING AN AUDIT PLAN?

ANSWER:

A. ASPECTS TO BE COVERED IN AUDIT PLAN: "The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business."

Plans should be made to cover, among other things:

1. Acquiring **knowledge of the client's accounting systems,** policies and internal control procedures;
2. Establishing the expected degree of **reliance to be placed on internal control;**
3. Determining and programming the **nature, timing, and extent of the audit procedures** to be performed; and
4. **Coordinating the work** to be performed.

Plans should be further developed and revised as necessary during the course of the audit.

B. RELATIONSHIP BETWEEN AUDIT STRATEGY AND AUDIT PLAN:

1. Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.
2. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes but are closely inter-related since changes in one may result in consequential changes to the other.

TEST YOUR KNOWLEDGE:

1. **The auditor shall establish an audit plan that sets the scope, timing and direction of the audit, and that guides the development of the audit strategy. Correct/Incorrect.**

Answer:

Incorrect. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

2. **Engagement Partner CA M of MN Associates wanted to develop an audit plan of KLM Fabrics Ltd. Discuss the matters to be described in such an audit plan.**

Answer: Write above answer

Q.NO.4 WHAT ARE THE BENEFITS OF PLANNING IN THE AUDIT OF FINANCIAL STATEMENTS?

ANSWER:

Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

a. Helping the auditor to **devote appropriate attention to important areas** of the audit.
b. Helping the auditor **identify and resolve potential problems** on a timely basis.
c. Helping the auditor **properly organize and manage the audit engagement** so that it is performed in an effective and efficient manner.
d. Assisting in the **selection of engagement team members** with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
e. Facilitating the **direction and supervision of engagement team members** and the review of their work.
f. Assisting, where applicable, in **coordination of work done by auditors** of components and experts.

Q.NO.5 KNOWLEDGE OF THE CLIENT'S BUSINESS IT IS ONE OF THE IMPORTANT PRINCIPLES IN DEVELOPING AN OVERALL AUDIT PLAN. WHAT UNDERSTANDING AUDITOR SHALL OBTAIN REGARDING THE CLIENTS BUSINESS?

ANSWER:

Knowledge of the Client's Business is one of the important principles in developing an overall audit plan. In fact without adequate knowledge of client's business, a proper audit is not possible.

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:

1. Relevant **industry, regulatory and other external factors** including the applicable financial reporting framework.

   Example:

   a. The competitive environment, including demand, capacity, product and price competition as well as cyclical or seasonal activity.

b. Supplier and customer relationships, such as types of suppliers and customers (e.g., related parties, unified buying groups) and the related contracts with those entities.
c. Technological developments, such as those related to the entity's products
d. The effect of regulation on entity operations.

2. The **nature of the entity,** including:
   a. its operations;
   b. its ownership and governance structures;
   c. the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
   d. the way that the entity is structured and how it is financed;

3. **Accounting Policies:**
   a. The entity's selection and application of accounting policies, including the reasons for changes thereto.
   b. 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.

4. **Objectives and strategies:** The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
   Examples of potential business risks include:
   a. Failure to keep up to date with new products, technologies or services.
   b. Excessive reliance on a key supplier, product or individual, such as the owner.
   c. Lack of personnel with expertise to react to changes in the industry.
   d. Insufficient or excessive production capacity caused by inaccurate estimation of demand.
   e. Loss of financing due to the entity's inability to meet financial covenants.

5. The **measurement and review of the entity's financial performance.**
   Example: External information such as analysts' reports and credit rating agency reports may be useful information for us to obtain an understanding of an entity's performance measures. Such reports can often be obtained from the entity.

TEST YOUR KNOWLEDGE:

1. **Without adequate knowledge of client's business, a proper audit is not possible. It is one of the important principles in developing an overall audit plan. Explain in context with relevant SA, knowledge to be obtained by the auditor in establishing overall plan. Also explain how such an understanding would be helpful to the auditor.**

Answer: Write above answer

Q.NO.6 AUDIT PLANNING IS A CONTINUOUS PROCESS. EXPLAIN.

ANSWER:

1. As per SA-300, “Planning an Audit of Financial Statements”, Planning is not a discrete phase of an audit, but rather a continual and iterative process.
2. Often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.
3. Planning the audit involves considering the following matters:
   a. The analytical procedures to be applied as risk assessment procedures.
   b. Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.
   c. The determination of materiality.
   d. The involvement of experts.
   e. The performance of other risk assessment procedures.

Q.NO.7 OVERALL AUDIT STRATEGY AND THE AUDIT PLAN IS THE AUDITOR’S RESPONSIBILITY. EXPLAIN.

ANSWER:

1. Development of Overall audit strategy and the audit plan is the auditor’s responsibility.
2. **Involvement of management and clients staff:**
   a. The auditor may decide to discuss elements of planning with the entity’s management to facilitate the conduct and management of the audit engagement.
   b. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit.
   c. Discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.
3. **Involvement of Engagement team:** The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process.
4. Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor’s responsibility.

Q.NO.8 WRITE A SHORT NOTE ON CHANGES TO PLANNING DECISIONS DURING THE COURSE OF THE AUDIT.

ANSWER:

1. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit.
2. Reasons for changing planning decisions:
   a. Unexpected events
   b. Changes in conditions

c. Information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures.
For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

TEST YOUR KNOWLEDGE:

1. Once the audit plan has been drafted and communicated, it is obligatory on the auditor to follow the same. Correct / Incorrect.

Answer:

Incorrect. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit.

Q.NO.9 WHAT ARE THE FACTORS WHICH AFFECT THE DIRECTION, SUPERVISION AND REVIEW OF ENGAGEMENT TEAM MEMBERS.

ANSWER:

1. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work.
2. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:
   a. The size and complexity of the entity.
   b. The area of the audit.
   c. The assessed risks of material misstatement. For example, higher the risk of material misstatements, higher the direction, supervision and review.
   d. The capabilities and competence of the individual team members performing the audit work.

TEST YOUR KNOWLEDGE:

1. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors. Explain giving examples.

Answer: Refer above answer

Q.NO.10 WRITE ABOUT DOCUMENTATION OF OVERALL AUDIT STRATEGY AND AUDIT PLAN.

ANSWER:

1. The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team.
2. The auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.
3. The auditor shall document the following:

a. the overall audit strategy;
b. the audit plan; and
c. any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.
d. A summary of discussions with the entity's key decision makers.
e. Other communications or agreements with management or those charged with governance regarding the scope, or changes in scope, of our services.
f. Auditor's report on the entity's financial statements.

Q.NO.11 WRITE ABOUT AUDIT PROGRAMME. ALSO, STATE POINTS TO BE CONSIDERED AND ELEMENTS OF AUDIT PROGRAMME.

ANSWER:

A. MEANING:

1. An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts for the purpose of obtaining sufficient evidence to enable the auditor to express an opinion. It is nothing but implementation guide for audit plan with clear instructions.
2. In other words, an audit programme is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for obtaining sufficient appropriate audit evidence.

B. EVOLVING ONE AUDIT PROGRAMME- NOT PRACTICABLE FOR ALL BUSINESSES:

1. Businesses vary in nature, size and composition, work which is suitable to one business may not be suitable to others, efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment.
2. On account of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable.
3. However, it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

C. POINTS TO BE CONSIDERED WHILE DEVOLOPING AUDIT PROGRAMME:

1. Stay within the scope and limitation of the assignment.
2. Prepare a written audit programme setting forth the procedures that are needed to implement the audit plan.
3. Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
4. Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.

5. Include the audit objectives for each area and sufficient details which serve as a set of instructions for the assistants involved in audit and help in controlling the proper execution of the work.
6. Consider all possibilities of error.
7. Co-ordinate the procedures to be applied to related items.

D. PERIODICAL REVIEW OF AUDIT PROGRAMME:

1. 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.
2. Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences.
3. The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed.
4. However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc.
5. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work.
6. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review is undertaken to keep the programme as up-to date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

TEST YOUR KNOWLEDGE

1. **M/s TP & Co., a firm of Chartered Accountants, is auditor of KSR Ltd. for many years. KSR Ltd. has diversified their business into newer areas during the last year. The senior member of the audit team handed over the standard audit programme of earlier years to the audit assistants and instructed them to follow the same. The assistants are conducting the audit accordingly. Whether the attitude of the audit assistants is justified or they are required to keep an open mind? Guide them.**

Answer: Write Point A and D from above answer

Q.NO.12 WHAT ARE THE ADVANTAGES OF AUDIT PROGRAMME?

ANSWER:

The advantages of an audit programme are:

1. It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.
2. It is essential, particularly for major audits, to provide a total perspective of the work to be performed.
3. Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.
4. There is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, such danger is significantly less and the audit can proceed systematically.
5. The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.
6. The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.
7. It serves as a guide for audits to be carried out in the succeeding year.
8. A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor.

Q.NO.13 WHAT ARE THE DISADVANTAGES OF AUDIT PROGRAMME?

ANSWER:

The disadvantages are:

1. 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.
2. The programme often tends to become rigid and inflexible, in cases, the business may change in its operation of conduct, but the old programme may still be carried on.
3. 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.
4. A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

Q.NO.14 WHAT IS MATERIALITY IN AUDIT OF FINANCIAL STATEMENTS. ALSO EXPLAIN HOW TO FIX THE MATERIALITY IN THE AUDIT OF FINANCIAL STATEMENTS.

ANSWER:

A. MEANING:

1. Materiality is an important consideration for an auditor to evaluate whether the financial statements are free from material misstatements.
2. SA 320 on "Materiality in Planning and Performing an Audit" requires that an auditor should consider materiality and its relationship with audit risk while conducting an audit.

3. A misstatement is considered to be material if it could influence the decision-making process of user of financial statements.
4. What could be considered material for all situations cannot be defined precisely and an amount or transaction material in one situation may not be material in other situation. For example, Rs. 5,000 may be material for a small entity, but even Rs. 100,000 may not be material for a large entity.
5. In certain cases, quantitative limits of materiality is specified. A few of such cases are given below:
   a. A company should disclose by way of notes additional information regarding any item of income or expenditure which exceeds 1% of the revenue from operations or Rs. 1,00,000 whichever is higher (Refer general Instructions for preparation of Statement of Profit and Loss in Schedule III to the Companies Act, 2013).
   b. A company should disclose in Notes to Accounts, shares in the company held by each shareholder holding more than 5 per cent shares specifying the number of shares held.
6. Also, materiality levels may change as audit progresses. The materiality fixed at the time of planning may be different from materiality during the performance and conclusion of audit.

B. FIXING MATERIALITY:

1. **Determining materiality:** The auditor shall apply appropriate percentage on selected benchmark for determining materiality level. Generally, the percentage applied on PBT Benchmark is usually higher than Turnover benchmark. (Ex: Materiality = 5% of net profit or 0.5% of turnover)

2. **Levels of materiality:**
   a. **Overall Materiality:** Materiality for financial statements as a whole (Pervasive level).
   b. **Performance materiality:** A specific materiality level for particular class of transactions, account balance or disclosure which is usually less than overall materiality for financial statements as a whole. (Assertion level). Also includes a general materiality level for all classes of transactions, balances, and disclosures.

3. **Factors in identifying benchmarks:** The following are various Factors for determining benchmarks:
   a. The elements of assets, liabilities, incomes, and expenses.
   b. Any indication in applicable financial reporting framework. Example: As per Sch III an item which is 0.5% of turnover or 1,00,000/- whichever is higher shall be separately stated.
   c. The entities capital structure and its ownership structure.
   d. Information needs of majority of users in such industry.
   e. Based on Applicable law or regulation. Example: Under income tax Payments in cash more than Rs. 10,000/-, 20,000/- and receipts more than Rs. 2,00,000/- are to be reported.

4. **Various examples of benchmarks:**
   a. Profit Before Tax (Net profit)
   b. Turnover from continuing operations

c. Gross Profit
d. Total Expenses
e. Net worth or Net asset value

5. **Sources for selecting appropriate benchmarks:**
   a. Prior period financial statements.
   b. Latest Quarterly results announced by the entity.
   c. Budgets of current year and upcoming years.
   d. Current year financial statements.

TEST YOUR KNOWLEDGE:

1. There is direct relationship between materiality and the degree of audit risk. Correct/Incorrect.

Answer:

Incorrect. 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.

2. "Determining materiality involves the exercise of professional judgment." Discuss stating the factors that may affect the identification of an appropriate benchmark. Also give example.

Answer: Refer Point B(3) from above answer

3. You are being appointed as the auditor of Track Ltd. for the first time. You want to determine the materiality level and for that you have applied percentage to choose benchmark as a starting point in determining materiality for the financial statements as a whole. What are the factors that may affect the identification of an appropriate benchmark?

Answer: Refer Point B(3) from above answer

Q.NO.15 WHAT ARE THE FACTORS THAT MAY INDICATE THE EXISTENCE OF ONE OR MORE PARTICULAR CLASSES OF TRANSACTIONS, ACCOUNT BALANCES OR DISCLOSURES FOR WHICH MISSTATEMENTS OF LESSER AMOUNTS COULD REASONABLY BE EXPECTED TO INFLUENCE THE ECONOMIC DECISIONS OF USERS?

ANSWER:

Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

1. Whether **law, regulations or the applicable financial reporting framework** affect users' expectations regarding the measurement or disclosure of certain items.
   Ex: Related party transactions, and the remuneration of management and those charged with governance.
2. The **key disclosures** in relation to the industry in which the entity operates.
   Ex: Research and development costs for a pharmaceutical company.
3. Whether **attention is focused on a particular aspect of the entity's business** that is separately disclosed in the financial statements.
   Ex: A newly acquired business.

TEST YOUR KNOWLEDGE:

1. **Whether misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements? Explain with examples.**

<u>**Answer:**</u> Refer above answer

Q.NO.16 WRITE ABOUT REVISION AND DOCUMENTATION OF MATERIALITY?

<u>**ANSWER:**</u>

A. **REVISION IN MATERIALITY LEVEL:** The overall materiality and performance materiality may need to be changed as the audit progresses in the following cases:
   1. A <u>change in circumstances</u> that occurred during the audit.
   2. Availability of <u>additional information.</u>
   3. A <u>change in actual financial results</u> than the anticipated results at the beginning of the audit.
   4. <u>Increase in estimated risk</u> than the original prediction resulting in revision of materiality level.
   5. A <u>change in auditor's knowledge of client's business</u> and understanding of the same.

B. **DOCUMENTATION OF MATERIALITY:** The auditor shall document the following:
   1. Materiality for the financial statements as a whole (Overall materiality);
   2. If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures.
   3. General Performance materiality: and
   4. Any revision of the above.

Q.NO.17 IN MOST OF THE ASSERTIONS MUCH OF THE EVIDENCE BE DRAWN AND EACH ONE SHOULD BE CONSIDERED AND WEIGHED TO ASCERTAIN ITS WEIGHT TO PROVE OR DISPROVE THE ASSERTION. IN THIS PROCESS, AN AUDITOR WOULD BE IN A POSITION TO IDENTIFY THE EVIDENCE THAT BRINGS THE HIGHEST SATISFACTION TO HIM ABOUT THE APPROPRIATENESS OR OTHERWISE OF THE ASSERTION?

<u>**ANSWER:**</u>

1. In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion.
2. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.
3. An auditor picks up evidence from a variety of fields and it is generally of the following broad types:
   a. Documentary examination,
   b. Physical examination,
   c. Statements and explanation of management, officials and employees,
   d. Statements and explanations of third parties,
   e. Arithmetical calculations by the auditor,
   f. State of internal controls and internal checks,
   g. Inter-relationship of the various accounting data,
   h. Subsidiary and memorandum records,
   i. Minutes,
   j. Subsequent action by the client and by others.

   Example:
   i. For cash in hand, the best evidence is count.
   ii. For investment pledged with a bank, the banker's certificate

For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence: some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion.

PRELIMINARY ENGAGEMENT ACTIVITIES

Preliminary engagement activities include the following:

1. **Performing procedures regarding the Continuance of Client Relationships and Audit Engagements:**
   a. It should be ensured that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed and that conclusions reached in this regard are appropriate.
   b. The firm 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.
   c. Matters such as integrity of principal owners and key management, competence of engagement team to perform the audit engagement and implications of matters that have arisen during current and previous audit engagement may need to be considered.
   d. Besides, in case of initial engagements, communication with predecessor auditor should be made, where there has been a change of auditors.

2. **Evaluating compliance with ethical requirements including independence:**
    a. The auditor shall continuously evaluate compliance with ethical requirements including independence.
    b. "Independence" means that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.
    c. 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.
    d. If matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action.
    e. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall: -
        (i) Obtain relevant information from the firm to identify and evaluate circumstances and relationships that create threats to independence.
        (ii) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement and
        (iii) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.
3. **Establishing an understanding of terms of engagement:** It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. It ensures that there is no confusion with the client regarding terms of the engagement.

Note: Performing preliminary engagement activities assists the auditor in identifying and evaluating events or circumstances that may affect auditor's ability to plan and perform audit engagement.

TEST YOUR UNDERSTANDING

1. **MG & Co, a firm of auditors, having a standing of 30 years is appointed as a statutory auditor of company engaged in manufacturing of defence equipment. Due to opening of defence sector by government to private players in recent times, many new companies have entered the fray to manufacture sophisticated defence equipment. Considering technical and complex nature of operations, the auditors recognize that involvement of experts in the audit is required. Does consideration for involvement of experts by auditors fall in the domain of planning audit?**

Answer:

Consideration for involvement of experts by auditors falls within domain of planning. While planning an audit, auditor would have to consider whether involvement of experts is necessary. In the stated case, company is involved in technical and complex operations. Therefore, while planning an audit, auditors would have to consider whether involvement of expert is necessary.

2. **CA Kartik is planning for audit of a company engaged in manufacturing of cosmetics. Considering nature of operations of the company, he had planned to include testing of controls of the company over purchases, sales and inventories. One fine day, he reaches the corporate office and asks for manuals and required documentation to ensure surprise element in testing. He had never shared with management his intention to carry out above procedures. Is approach of CA Kartik proper?**

Answer:

In the case, CA Kartik has reached office of the company without sharing with management his intention to test the controls. The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement without compromising effectiveness of audit. Sharing details of visit to test controls does not compromise effectiveness of audit. It is for the better facilitation and conduct of audit. Therefore, approach of CA Kartik is not proper.

3. **CA Mary, while planning audit of a company, feels that she would inquire from inhouse legal counsel of the company status of pending litigation matters against the company to identify and assess risks of material misstatements. Considering above description, are you able to identify said procedures? Where these identified procedures are included in planning in accordance with SA-300?**

Answer:

These are planned risk assessment procedures to identify and assess risk of material misstatement. The objective of planned inquiry of inhouse legal counsel is to identify and assess risk of material misstatement. Such planned risk assessment procedures are included in audit plan in accordance with SA-300.

4. **CA Shubhendu is statutory auditor of a social media company. Due to change in information technology regulations by government, it has become mandatory for such companies to constitute "grievance redressal mechanism" for users of social media platform of the company. Failure to comply with regulations can potentially lead to civil and criminal liabilities against the company. Is above factor to be considered by auditor while framing audit strategy?**

Answer:

Changes in laws and regulations affecting the company is a factor to be considered while establishing overall audit strategy. There has been change in information technology regulations applicable to the company. Non-compliance of the same can have implications in form of civil and criminal liabilities.

Such an important matter concerning changes in laws and regulations is to be considered by auditor while establishing overall audit strategy.

5. **Rohit, undergoing practical training, is part of an engagement team conducting audit of a company engaged in manufacturing of paints. He has been provided with audit programme pertaining to sales. It lists out various items to be checked and verified by him including invoices, rate lists, posting in debtors accounts, correlation of invoices with e-way bills on sample basis etc. During verification, he notices that many e-way bills have been cancelled by the company within 24 hours of their generation in month of March. There is no specific instruction in audit programme in this regard. He keeps mum. Is attitude of Rohit proper?**

Answer:

Attitude of Rohit is not proper. The assistants should observe matters objectively and bring significant matters to the notice of supervisor/principal. Reasons for cancellation of many e-way bills in month of March need to be looked into. Matter should be informed to engagement partner

6. **CA A. Raja is auditor of Build Well Forgings Private Limited having a revenue of ₹ 25 crore. The company has been sanctioned a term loan of ₹ 50 lacs from a bank. However, as at end of the year, only ₹ 1 lac was availed due to delay in procurement of asset. The financial statements of the company do not disclose nature of security against which loan has been taken. Schedule III of Companies Act,2013 requires disclosure in this respect. Discuss, whether, non-disclosure of nature of security is material for auditor.**

Answer:

If there is any statutory requirement of disclosure, it is to be considered material. Schedule III mandates disclosure of nature of security in relation to loan. The amount involved is irrelevant.

10. AUDIT SAMPLING

Q.NO.1 DEFINE THE TERM AUDIT SAMPLING. ALSO, STATE OBJECTIVES AS PER SA 530.

ANSWER:

A. **MEANING:** As per SA 530, "AUDIT SAMPLING", it refers to application of audit procedures, to less than 100% of items in the population, in order to form a conclusion on the entire population from which the sample is selected.

B. **OBJECTIVES OF AUDITOR AS PER SA 530:** 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.

Q.NO.2 DEFINE THE TERM POPULATION. ALSO, STATE THE CHARECTERISTICS OF POPULATION.

ANSWER:

A. **DEFINITIONS:**

1. **POPULATION:** Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
2. **SAMPLING UNIT:** The individual items that make up the population are known as sampling units. The population can be divided into sampling units in a variety of ways. Audit procedures are applied on these units and the conclusions drawn from them are projected on the population.

B. **CHARECTERISTICS OF POPULATION:**

1. **Appropriateness:**
   a. The auditor will need to determine that the population from which the sample is drawn is appropriate for the specific audit objective.
   b. Appropriate means population from which the samples are drawn shall be relevant for the specific objective under audit this is because when the samples are drawn, the audit procedures are applied on the sample and the conclusions are projected on the population.
2. **Completeness:** The population also needs to be complete, which means that if the auditor intends to use the sample to draw conclusions, the population needs to include all relevant items.
3. **Reliable:** When performing the audit sampling, the auditor performs audit procedures to ensure that the information upon which the audit sampling is performed is sufficiently complete and accurate. Auditor should obtain evidence about the reliability of population. If population is not reliable with respect to accuracy and source, the sample drawn will definitely not be relevant for the specific audit objective.

TEST YOUR KNOWLEDGE:

1. **Universe refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. Correct/Incorrect.**

Answer:

Incorrect. Population refers to the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Q.NO.3 WHAT ARE THE VARIOUS APPROACHES TO SAMPLING?

ANSWER:

Audit sampling can be applied using either:

A. STATISTICAL SAMPLING:

1. Statistical sampling is an approach to sampling that has the random selection of the sample units.
2. It involves the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics.
3. Sample is chosen by applying certain mathematical and statistical methods.
4. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items.
5. There is no personal bias of the auditor in case of statistical sampling.

B. NON-STATISTICAL SAMPLING:

1. A sampling approach that does not have the above features is considered as non-statistical sampling.
2. The sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor.
3. It is neither objective nor scientific.
4. The risk of personal bias in selection of sample items cannot be eliminated.
5. For example, March, June and September may be selected in year one and different months would be selected in the next year, On basis of value of items, top 10 highest value. Etc.

C. CONCLUSION:

1. The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgement.
2. However, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.
3. Whatever may be the approach non-statistical or statistical sampling, the sample must be representative of entire population.

TEST YOUR KNOWLEDGE:

1. **Statistical sampling being more scientific and without personal bias will always be appropriate to use under all circumstances. Correct/Incorrect.**

<u>Answer:</u>

Incorrect. Statistical sampling is widely accepted way of sampling as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way. Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort. For instance, when exact accuracy is required or in case of legal requirements etc.

Q.NO.4 EXPLAIN THE ADVANTAGES OF STATISTICAL SAMPLING ?

<u>ANSWER:</u>

The advantages of statistical sampling may be summarized as follows –

1. The <u>amount of testing (sample size) does not increase</u> in proportion to the increase in the size of the area (universe) tested.
2. The sample selection is <u>more objective</u> and thereby more defensible.
3. The method provides a means of estimating the <u>minimum sample size</u> associated with a specified risk and precision.
4. It provides a means for deriving a <u>"calculated risk."</u>
5. It may provide a <u>better description of a large mass of data</u> than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.
6. It is <u>widely accepted way of sampling</u> as it is more scientific, without personal bias and the result of sample can be evaluated and projected in more reliable way.

Q.NO.5 WHAT ARE THE VARIOUS FACTORS TO BE CONSIDERED BY THE AUDITOR FOR DECIDING UPON THE EXTENT OF CHECKING ON A SAMPLING PLAN?

<u>ANSWER:</u>

1. The extent of checking to be undertaken is a <u>matter of professional judgement</u> of the auditor.
2. There is <u>nothing statutorily stated anywhere</u> which specifies what work is to be done, how it is to be done and to what extent.
3. Further it <u>is not mandatory for auditor to adopt sampling</u> techniques and his duty is only to express opinion.
4. When the auditor <u>decided to express opinion based on part checking,</u> then he shall <u>adopt standards and techniques</u> that are widely accepted.
5. Since statistical law of sampling is scientifically tested, it can be <u>relied upon to a greater extent</u>.
6. The factors that should be considered for deciding upon the extent of checking on a sampling plan are following:

a. Size of the organisation under audit.
b. State of the internal control.
c. Adequacy and reliability of books and records.
d. Tolerable error range.
e. Degree of the desired confidence.

TEST YOUT KNOWLEDGE:

1. **The extent of the checking to be undertaken is primarily a matter of judgment of auditor. It is at the interest of the auditor that if he decides to form an opinion on the basis of part checking, he should adopt standards and techniques which are widely followed. Explain.**

Answer: Refer above answer

Q.NO.6 WHAT ARE THE REQUIREMENTS AS TO SAMPLE DESIGN, SAMPLE SIZE AND SAMPLE SELECTION?

ANSWER:

1. **SAMPLE DESIGN:** When designing an audit sample, the auditor shall consider the purpose of the audit procedures and the characteristics of the population from which the sample will be drawn.
2. **SAMPLE SIZE:** The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level.
3. **SAMPLE SELECTION:** The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. Sample selected must be representative of the population.

Q.NO.7 WHAT ARE THE FACTORS TO BE CONSIDERED BY AN AUDITOR WHILE DECIDING AN APPROPRIATE SAMPLE SIZE?

ANSWER:

The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. The following factors are required to be considered by the auditor while deciding appropriate sample size for test of controls / test of details:

1. The **desired level of assurance** required by the auditor (Higher the assurance required by the auditor, bigger will be the sample size).
2. **Expected rate of deviation or misstatement** i.e. risk of material misstatement (higher the expected rate of deviation or misstatement , larger the sample size).
3. **Effectiveness of internal controls** (If the controls are more effective, then lesser sample size will be required).

4. **Tolerable rate of deviation or misstatement** (lower the tolerable rate of deviation, larger the sample size needs to be).
5. **Characteristics of population** or stratification of population (In case of homogenous population lesser sample size, in case of heterogenous population larger sample size will be required).

Note:

- **Tolerable misstatement –** A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.
- **Tolerable rate of deviation –** A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

TEST YOUR KNOWLEDGE:

1. **The sample size can be determined by the application of a statistically based formula or through the exercise of professional judgment. When circumstances are similar, the effect on sample size of factors will be similar regardless of whether a statistical or non-statistical approach is chosen. Explain stating the examples of factors that the auditor when determining the sample size for test of controls.**

Answer: Write above answer

2. **With reference to SA 530 "Audit Sampling", explain briefly the following factors that the auditor may consider when determining the sample size for the Test of Details –**
   a. **The desired level of assurance**
   b. **Stratification of the pollution.**

Answer: Write point 1 and 5

Q.NO.8 WHAT ARE VARIOUS METHODS FOR SELECTION OF SAMPLE?

ANSWER:

Some of the important methods of selecting the sample are discussed below –

A. **RANDOM SAMPLING:** Random selection ensures that all items in the population 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–

   1. **Simple Random Sampling:**
      a. Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected.

b. It is considered that random number tables are simple and easy to use and also provide assurance that the auditors' bias does not affect the selection.
c. Each item in a population is selected by use of random number table either with a help of computer or picking up a number in a random way (may be randomly from a drum).
d. Today random numbers are also generated using various applications on the cellphones like the random number generator.
e. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range i.e. it is suitable for a homogeneous population having a similar range.
   Example: The population can be considered homogeneous, if say, trade receivables balances fall within the range of Rs. 55,000 to Rs. 2,25,000 and not in the range between Rs. 525 to Rs. 10,50,000

2. **Stratified Sampling:**
   a. 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.
   b. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum.
   c. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment.
   d. ***Example,*** *In the above case, trade receivables balances may be divided into four groups as follows:-*
      i. balances in excess of Rs. 10,00,000;
      ii. balances in the range of Rs. 7,75,001 to Rs. 10,00,000;
      iii. balances in the range of Rs. 5,50,001 to Rs. 7,75,000;
      iv. balances in the range of Rs. 2,25,001 to Rs. 5,50,000; and
      v. balances Rs. 2,25,000 and below.

      From these above groups the auditor may pick up different percentage of items from each of the group.

      i. From the top group i.e. balances in excess of Rs. 10,00,000, the auditor may examine all the items;
      ii. from the second group 25 per cent of the items;
      iii. from the third group 10 per cent of the items; and
      iv. from the lowest group 2 per cent of the items may be selected.

      Random sample is chosen from each stratum using random number tables.

B. INTERVAL SAMPLING OR SYSTEMATIC SAMPLING:

1. Systematic selection is a selection method in which the number of sampling units in the population is divided by the sample size to give a sampling interval.
   For example, 50 is sampling interval, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected.

2. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables.

C. MONETARY UNIT SAMPLING: It is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

D. HAPHAZARD SAMPLING:

1. Haphazard selection, in which the auditor selects the sample without following a structured technique.
2. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability.
3. This ensure that all items in the population have a chance of selection.
4. This method is not superior to other methods, as we the auditor does not follow any structured technique.

E. BLOCK SAMPLING:

1. This method involves selection of a block(s) of contiguous items from within the population.
2. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other.
3. Usually, a range of continuous transaction shall have similar characteristics, therefore, selection of a group at one time will not give a reasonable basis for opinion on the overall population as different types of transactions and unusual transactions may not be covered in the group taken all at once.
4. ***Example,*** *Take the first 200 sales invoices from the sales day book in the month of September; alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows items to the completion.*

TEST YOUR KNOWLEDGE:

1. **The method which involves dividing the population into groups of items is knows as block sampling. Correct/Incorrect.**

Answer:

Incorrect. The method which involves dividing the population into groups of items is known as Stratified random sampling whereas block sampling involves the selection of a defined block of consecutive items.

2. **The objective of stratification is to increase the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.**

Answer:

Incorrect. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

Q.NO.9 WRIE A SHORT NOTE ON STRATIFICATION AND VALUE WEIGHTED SELECTION?

ANSWER:

1. **STRATIFICATION:**
   a. Audit efficiency may be improved if the auditor stratifies a population by dividing it into subpopulations which have an identifying characteristic.
   b. The objective of stratification is to select sample from all parts of population having different characteristics.
   c. When performing tests of details, the population is often stratified based on monetary value.

2. **VALUE-WEIGHTED SELECTION:**
   a. When performing tests of details, it may be useful to identify the sampling unit as the individual monetary units.
   b. The auditor will be more focused towards larger value items (higher chances of selection) and can results in smaller sample size.
   c. This approach may be used in combination with the systematic method of sample and is most efficient when selecting items using random selection.

TEST YOUR KNOWLEDGE:

1. **XYZ Ltd is engaged in trading of electronic goods and having huge accounts receivables. For analyzing the whole accounts receivables, auditor wanted to use sampling technique. In considering the characteristics of the population from which the sample will be drawn, the auditor determines that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value - weighted sampling techniques. Advise the auditor in accordance with SA 530.**

Answer: Write above answer

Q.NO.10 WHAT PRECAUTIONS SHOULD BE TAKEN BY THE AUDITOR WHILE APPLYING TEST CHECK TECHNIQUES?

ANSWER:

Precautions to be taken while applying test check techniques are

1. Thorough study of accounting system should be done before adopting sampling. Proper study of internal control systems.
2. Areas which are not suitable for sampling should be carefully considered. Eg: compliance with statutory provisions, transactions of unusual nature etc.
3. Proper planning for Sampling methods to be used and explaining the staff,
4. Transactions and balances have to be properly classified (stratified).
5. Sample size should be appropriately determined.
6. Sample should be chosen in unbiased way.

7. Errors located in the sample should be analysed properly.

Q.NO.11 WHAT IS SAMPLING RISK? ALSO EXPLAIN ITS IMPACT ON AUDIT.

ANSWER:

A. **MEANING:** 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.

This risk will always be in existence when auditor uses sampling technique in conducting his audit.

B. **IMPACT OF SAMPLING RISK:**

1. **On test of controls:**
   a. **Risk of over reliance:** Treating that the controls are more effective than they actually are. 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.
   b. **Risk of under reliance:** Treating that the controls are less effective than they actually are. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

2. **On test of details:**
   a. **Risk of Incorrect Acceptance:** Treating that a material misstatement does not exist when in fact it exists in the population. This type of risk leads to audit risk.
   b. **Risk of Incorrect Rejection:** Treating that a material misstatement exists when in fact it does not exist in the population. This may not affect the audit risk.

TEST YOUR KNOWLEDGE:

1. Low acceptable sampling risk requires larger sample size. Correct/Incorrect.

Answer:

Correct. Sampling risk arises from possibility that the auditor's conclusion based upon sample may be different from conclusion that would have been reached if same audit procedures were applied on the entire population. If acceptable sampling risk is low, large sample size is needed.

Q.NO.12 WRITE A SHORT ON NON-SAMPLING RISK.

ANSWER:

1. The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.
2. Examples of non-sampling risk include use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.

3. Sources of Non-Sampling risk are
    a. Human Mistakes.
    b. Misinterpreting the sample results.
    c. Applying audit procedures not appropriate to the objectives of audit.
    d. Relying on erroneous information e.g., erroneous confirmation.

Q.NO.13 THE APPROACH TO AUDIT AND EXTENT OF CHECKING ARE UNDERGOING A PROGRESSIVE CHANGE IN FAVOUR OF MORE ATTENTION TOWARDS THE QUESTIONS OF PRINCIPLE AND CONTROLS WITH A CURTAILMENT OF NON- CONSEQUENTIAL ROUTINE CHECKING. DISCUSS THE GIVEN STATEMENT.

ANSWER:

1. No conscious effort in human society is divested of economic considerations and auditing is no exception.
2. There is a growing realisation that the traditional approach to audit (Le., 100% verification) is economically wasteful because all the efforts are directed to check all transactions without any exception.
3. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved.
4. Now a days, the management of the organisations, are focusing more on internal controls, to prevent, detect and correct frauds and errors. As a result, the possibilities of routine errors and frauds have greatly diminished (reduced).
5. Thus, the auditors often find extensive routine checking is not giving any significant benefit in the audit. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention towards the questions of internal controls with a curtailment of routine checking.
6. The extent of the checking to be undertaken is primarily a matter of judgment of the auditor. There is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent it has to be done.

Q.NO.14 WRITE A SHORT NOTE ON PERFORMING AUDIT PROCEDURES AS PER SA 530.

ANSWER:

1. The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.
2. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item.
    Example:
    a. An example of when it is necessary to perform the procedure on a replacement item is when a voided check (Cancelled cheque) is selected while testing for evidence of payment authorization. If the auditor is satisfied that the check has been properly cancelled such that it does not constitute a deviation, an appropriately chosen replacement is examined. A

replacement would then mean a proper and valid cheque through which payment has been made.

b. Another example for replacement of a sample could be, if all transactions of computerized sales are being checked, for example sales recorded through a bar code scanner, and incidentally a sample of manual billing gets selected, then such item can be replaced after adequately checking the correctness of the manual bill with the supporting documents available.

3. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details.

   Example:

   a. An example of when the auditor is unable to apply the designed audit procedures to a selected item is when documentation relating to that item has been lost. If the documentation of a sales is lost, like the sales order record, sales invoice, document for dispatch etc, then confirmation can be sought from the debtor as per SA 505. If it is a cash sale, the cash book can be cross verified for the existence of such transactions.

   b. When no reply has been received in response to a positive confirmation request, an example of a suitable alternative procedure might be the examination of subsequent cash receipts together with evidence.

Q.NO.15 WRITE A SHORT NOTE ON PROJECTION OF MISSTATEMENT BASED ON SAMPLING.

ANSWER:

1. The auditor is required to project misstatements for the population to obtain a broad view of the scale of misstatement.
2. When a misstatement has been established as an anomaly, it may be excluded when to the population. (Non-anomalous projection)
3. In case of tests of details, the auditor shall project misstatements found in the sample to the population.
4. In case of tests of controls, no explicit projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

Note: Anomaly refers to a misstatement or deviation that is demonstrably not representative of population and hence it is not considered while calculating projected misstatement.

TEST YOUR KNOWLEDGE

1. **In stratified sampling, the conclusion drawn on each stratum can be directly projected to the whole population. Correct/Incorrect.**

Answer:

Incorrect. In case of stratified sampling, the conclusions are drawn on the stratum. The combination of all the conclusions on stratum together will be used to determine the possible effect of misstatement or deviation. Hence the samples are used to derive conclusion only on the respective stratum from where they are drawn and not the whole population.

Q.NO.16 WRITE ABOUT EVALUATION OF SAMPLE RESULTS.

ANSWER:

The auditor shall evaluate

1. The results of the sample and
2. Assess whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

Q.NO.17 WRITE ABOUT NATURE AND CAUSE OF DEVIATIONS AND MISSTATEMENTS.

ANSWER:

1. In analyzing the deviations and misstatements identified, the auditor may observe that many have a common feature, for example, type of transaction, location, product line or period of time.
2. In such circumstances, the auditor may decide to identify all items in the population that possess the common feature, and extend audit procedures to those items. In addition, such deviations or misstatements may be intentional, and may indicate the possibility of fraud.
3. Therefore, the auditor shall investigate the nature and causes of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.
4. In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population.
5. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

TEST YOUR UNDERSTANDING

1. **An auditor, while conducting audit of an entity, has selected samples based upon his personal experience and knowledge. Later on, it turns out that selected samples were not representative and it has led to faulty selection of samples. The auditor contends that samples were selected based upon his personal experience and knowledge. Can auditor escape from his responsibility in this regard?**

Answer:

In the provided situation, the auditor has selected samples based upon his personal experience and knowledge. It, is a case of non-statistical sampling approach adopted by the auditor. Whatever may be the approach nonstatistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The auditor cannot escape his responsibility in this regard.

11. ANALYTICAL PROCEDURES

Q.NO.1 EXPLAIN THE MEANING OF ANALYTICAL PROCEDURES. ALSO GIVE EXAMPLES OF ANALYTICAL PROCEDURES.

ANSWER:

A. MEANING:

1. As per the Standard on Auditing (SA) 520 "Analytical Procedures", the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.
2. It involves investigation of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

B. EXAMPLES OF ANALYTICAL PROCEDURES:

1. **Consideration of relationships:**
   a. 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.
   Example, An increase in sales must lead to increase in profit of the entity. (Margin of safety)
   b. Between financial information and relevant non-financial information, such as payroll costs to number of employees.
   Example, An increase in number of employees may lead to increase in earnings.

2. **Comparison of entity's financial information:**
   a. Comparable information for prior periods.
   b. Anticipated results of the entity, such as budgets or forecasts.
   c. Similar Industry information concerning the entity such as industry average or other entities in the similar industry.
   d. Comparison with auditors expected results.
   e. Comparison of financial and non-financial information.

TEST YOUR KNOWLEDGE:

1. **CA Amar wants to verify the payments made by XYZ Ltd. on account of building rent during the FY 2020-21. The rent amounts to Rs.50,000/- per month for the year. The monthly rent payments are consistent with the rent agreement. However, the other companies in the similar industry are paying rent of Rs. 10,000/- per month for a similar location. How will applying the analytical procedures impact the verification process of such rental payments by XYZ Ltd.?**

Answer:

If CA Amar checks in detail the monthly rent payments, he may find that such payments are consistent with the rent agreement i.e. XYZ Ltd. paid Rs. 50,000/- per month as rent and the same is getting reflected in the rent agreement. Here, CA Amar may not be able to find out the inconsistency in the rent payment with respect to rent payment prevalent in the similar industry for rent of the similar location.

If CA Amar applies analytical procedure i.e. compares the rent payment by XYZ Ltd. with the similar payments made by companies in similar industry and similar area, he will notice an inconsistency in such rent payments as the other companies are paying a very less monthly rent in similar industry for similar area.

However, if CA Amar does not make such comparison and only checks the monthly payments and rent agreement of XYZ Ltd., he would not have found such inconsistency and as such the misstatement may remain undetected.

2. **Analytical procedure involves analysis of relationship among financial and non-financial data. Explain with the help of an example as to how, the statutory auditor of ABC Ltd. will analyse such relationship with respect to the total wages paid by ABC Ltd. during the FY 2020-21.**

Answer:

As per SA 520, Analytical Procedures means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. The following example explains the analysis of relationship between financial and non-financial data while applying analytical procedures.

The statutory auditor of ABC Ltd. has to verify the total wages paid by the company having factories in various states. He can verify the same by analyzing the relationship between wages per worker and total number of workers across all the factories.

i.e., Total wages = Wages per worker x Total number of workers.

Here wages per worker is financial data i.e., in Rs. and total number of workers is a number which is a non-financial data. Thus, the statutory auditor of ABC Ltd. is evaluating financial information i.e., total wages paid (in Rs.) by analyzing the relationship between wages per worker (in Rs.) which is financial data and number of workers which is a non-financial data.

Analytical procedures include the consideration of comparisons of the entity's financial information with as well as consideration of relationships.

3. **As per the Standard on Auditing (SA) 520 "Analytical Procedures" 'the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among financial data only. Correct/Incorrect.**

<u>**Answer:**</u>

Incorrect. As per the Standard on Auditing (SA) 520 "Analytical Procedures" the term "analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

4. **The statutory auditor of the company can apply analytical procedures to the standalone financial statements of a company only and not to the consolidated financial statements.**

<u>**Answer:**</u>

Incorrect. Analytical procedures may be applied to consolidated financial statements, components and individual elements of information.

Q.NO.2 EXPLAIN THE PURPOSE OF ANALYTICAL PROCEDURES. / EXPLAIN THE OBJECTIVES OF AN AUDITOR AS PER SA 520.

<u>**ANSWER:**</u>

1. Analytical procedures <u>use comparisons and relationships</u> to determine whether account balances or other data appear to be reasonable.
   Examples:
   In XYZ Ltd., after applying analytical procedures as comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio. Therefore, it became necessary for the auditor to make further enquiries as it may be due to pilferage of inventories/ misappropriation of a part of the sale proceeds/a change in the cost of sales without a corresponding increase in the sales price.

2. Further, analytical procedures can be performed by making <u>inter-firm and intra-firm comparison.</u>
   Examples:
   a. *If balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss for the same period of another entity engaged in the same trade and working under similar circumstances, it would be possible to find out the cause of the variation in the rate of profitability that exists.*
   b. *Similarly, it would also be possible to compare the balances on the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years.*

3. **PURPOSE OF ANALYTICAL PROCEDURES:**
   a. To obtain relevant and reliable audit evidence by <u>identifying the existence of unusual transactions</u> or events, and amounts, ratios, and trends when using <u>substantive analytical procedures</u>.

b. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud (when used as risk assessment procedures).
c. 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 in consistent with auditor's understanding about the entity.

TEST YOUR KNOWLEDGE:

1. **Only purpose of analytical procedures is to obtain relevant and reliable audit evidence when using substantive analytical procedures.**

Answer:

Incorrect. Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. 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.

2. **Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud. Substantiate with the help of examples.**

Answer: Refer above answer

Q.NO.3 EXPLAIN THE TIMING OF ANALYTICAL PROCEDURES. ALSO EXPLAIN IN DETAIL HOW THE ANALYTICAL PROCEDURES CAN BE USED IN PLANNING PHASE.

ANSWER:

1. **THREE STAGES OF USAGE:** Analytical procedures are used in three stages:
   a. Planning phase
   b. Testing Phase
   c. Conclusion phase

2. **USAGE OF ANALYTICAL PROCEDURES DURING PLANNING PHASE:**
   a. In the planning stage, analytical procedures help the auditor in understanding the client's business and in identifying areas of potential risk by indicating aspects of and developments in the entity's business of which he is previously unaware

b. This information will assist the auditor in determining the nature, timing and extent of his other audit procedures.
c. Analytical procedures in planning the audit use both financial data and non-financial information.

TEST YOUR KNOWLEDGE:

1. **Explain how a statutory auditor of a company can apply analytical procedures at the planning phase of audit.**

Answer: Write above answer

Q.NO.4 WHAT ARE SUBSTANTIVE ANALYTICAL PROCEDURES?

ANSWER:

1. Substantive procedure includes Test of Details and Analytical Procedures. Therefore, analytical procedures are one of the substantive audit procedures.
2. When to use substantive analytical procedures: It is based on the auditor's judgment so as to reduce audit risk to an acceptably low level.
3. The auditor may inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures, and also inquire the results of any such analytical procedures performed by the entity.
4. It may be effective to use analytical data prepared by management, provided the auditor is satisfied that such data is properly prepared.

TEST YOUR KNOWLEDGE:

1. **The auditor's substantive procedure at the assertion level means substantive analytical procedures only. Correct/Incorrect.**

Answer:

Incorrect. Substantive procedure includes Test of Details and Analytical Procedures. Therefore, analytical procedures are one of the substantive audit procedures.

Q.NO.5 WHAT ARE THE FACTORS TO BE CONSIDERED BY THE AUDITOR WHILE TAKING DECISION RELATING TO SUBSTANTIVE ANALYTICAL PROCEDURES?

ANSWER:

1. **AVAILABILITY OF DATA:** The availability of reliable and relevant data will facilitate effective analytical procedures.
2. **DISAGGREGATION:** The degree of disaggregation in available data can directly affect the degree of its usefulness in detecting misstatements.
3. **ACCOUNT TYPE:** Substantive analytical procedures are more useful for certain types of accounts than for others. Income statement accounts tend to be more predictable because they reflect

accumulated transactions over a period, whereas balance sheet accounts represent the net effect of transactions at a point in time or are subject to greater management judgment.

4. **SOURCE:** Some classes of transactions tend to be more predictable because they consist of numerous, similar transactions, (e.g., through routine processes). Whereas the transactions recorded by non-routine and estimation SCOTs (Significant Classes of Transactions) are often subject to management judgment and therefore more difficult to predict.
5. **PREDICTABILITY:** Substantive analytical procedures are more appropriate when an account balance or relationships between items of data are predictable (e.g., between sales and cost of sales or between trade receivables and cash receipts). A predictable relationship is one that may reasonably be expected to exist and continue over time.
6. **NATURE OF ASSERTION:** Substantive analytical procedures may be more effective in providing evidence for some assertions (e.g., completeness or valuation) than for others (e.g., rights and obligations). Predictive analytical procedures using data analytics can be used to address completeness, valuation/measurement and occurrence.
7. **WHAT CAN GO WRONG (WCGW):** When we are designing audit procedures to address an inherent risk or "what can go wrong", we consider the nature of the risk of material misstatement in order to determine if a substantive analytical procedure can be used to obtain audit evidence. When inherent risk is higher, we may design tests of details to address the higher inherent risk. When significant risks have been identified, audit evidence obtained solely from substantive analytical procedures is unlikely to be sufficient.

TEST YOUR KNOWLEDGE:

1. **"The auditor's substantive procedures at the assertion level may be tests of details, substantive analytical procedures, or a combination of both. The decision about which audit procedures to perform, including whether to use substantive analytical procedures is based on the auditor's judgment about the expected effectiveness and efficiency of the available audit procedures to reduce audit risk at the assertion level to an acceptably low level" Explain the factors that are to be considered while performing such tests.**

Answer: Write above answer

Q.NO.6 EXPLAIN ABOUT TECHNIQUES AVAILABLE AS SUBSTANTIVE ANALYTICAL PROCEDURES?

ANSWER:

1. **TREND ANALYSIS:**
   a. Trend analysis is a commonly used technique.
   b. It is the comparison of current data with the prior period balance or with a trend in two or more prior period balances.
   c. The auditor evaluates whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.

2. **RATIO ANALYSIS:**
    a. Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts.
    b. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales).
    c. Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.
    d. Examples of Financial ratios may include:
        i. Trade receivables or inventory turnover
        ii. Freight expense as a percentage of sales revenue

3. **REASONABLENESS TESTS:**
    a. Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense).
    b. These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts.
    c. In other words, these tests are made by reviewing the relationship of certain account balances to other balances for reasonableness of amounts.
    d. Examples
        i. Interest expense against interest bearing obligations
        ii. Raw Material Consumption to Production (quantity)
        iii. Wastage & Scrap % against production & raw material consumption (quantity)
        iv. Work-in-Progress based on issued of materials & Sales (quantity)
        v. Sales discounts and commissions against sales volume
        vi. Rental revenues based on occupancy of premises

4. **STRUCTURAL MODELLING:** A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

TEST YOUR KNOWLEDGE:

1. **Auditor can depend on routine checks to disclose all the mistakes or manipulation that may exist in accounts. Correct/Incorrect.**

Answer:

Incorrect. Routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied like trend and ratio analysis in addition to reasonable tests.

2. **Reasonableness test rely only on the events of the prior period like other analytical procedures.**

Answer:

Incorrect. Unlike trend analysis, Reasonableness test does not rely on events of prior periods, but upon non-financial data for the audit period under consideration.

3. **While applying the Substantive Analytical Procedures what techniques can be used by the statutory auditor of a company to obtain sufficient and appropriate audit evidence?**

Answer: Write above answer

Q.NO.7 WHAT ARE THE STEPS INVOLVED IN PERFORMING ANALYTICAL PPOCEDURES AS A SUBSTANTIVE AUDIT PROCEDURE? / WRITE ABOUT ANALYTICAL PROCEDURES AS SUBSTANTIVE TESTS?

ANSWER:

When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures, the auditor shall:

1. Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;
2. Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;
3. Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and
4. Determine whether financial statements contain any material misstatement by doing further investigation.

Q.NO.8 WRITE ABOUT SUITABILITY OF PARTICULAR ANALYTICAL PROCEDURES FOR GIVEN ASSERTIONS?

ANSWER:

1. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.
2. However, the suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that may cause the financial statements to be materially misstated.
3. In some cases, even an unsophisticated predictive model may be effective as an analytical procedure.
4. Further different analytical procedures provide different levels of assurance.

5. The determination of the suitability of particular substantive analytical procedure is influenced by the nature of the assertion and the auditor's assessment of the risk of material misstatement.

TEST YOUR KNOWLEDGE:

1. **When designing and performing substantive analytical procedures, either alone or in combination with tests of details, as substantive procedures in accordance with SA 330, the auditor shall determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions. Explain the other relevant points in this context.**

Answer: Write above answer

Q.NO.9 RELIABILTY OF RESULTS OF ANALYTICAL PROCEDURES DEPENDS ON RELIABILITY OF UNDERLYING DATA. EXPLAIN THE FACTORS WHICH EFFECT THE RELIABILITY OF DATA?

ANSWER:

The reliability of results of analytical procedures depends on reliability of underlying data. Accordingly, the following are relevant when determining whether data is reliable for purposes of designing substantive analytical procedures:

1. **Source of the information available.** For example, information may be more reliable when it is obtained from independent sources outside the entity;
2. **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;
3. **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
4. **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.

TEST YOUR KNOWLEDGE

1. **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."**

Answer: Write above answer

2. **CA X, auditor of XYZ Ltd. wants to design substantive analytical procedure and for that he wants to check whether the data is reliable or not. Mention the relevant points which he has to consider whether data is reliable for purpose of designing the substantive analytical procedures.**

Answer: Refer above answer

Q.NO.10 EXPLAIN THE MATTERS RELEVANT TO THE AUDITOR'S EVALUATION OF WHETHER THE EXPECTATION CAN BE DEVELOPED SUFFICIENTLY PRECISELY TO IDENTIFY A MISSTATEMENT THAT MAY CAUSE THE FINANCIAL STATEMENTS TO BE MATERIALLY MISSTATED?

ANSWER:

Matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include:

1. The **accuracy with which the expected results** of substantive analytical procedures can be predicted.
   For example, the auditor may expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.
2. The degree to which **information can be disaggregated.**
   For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.
3. The **availability of the information,** both financial and non-financial.
   For example, the auditor may consider whether financial information, such as budgets or forecasts, and non-financial information, such as the number of units produced or sold, is available to design substantive analytical procedures. If the information is available, the auditor may also consider the reliability of the information.

Q.NO.11 HOW THE AUDITOR SHALL INVESTIGATE THE FLUCTUATIONS OR DEVIATIONS IDENTIFIED BY PERFORMING ANALYTICAL PROCEDURES?

ANSWER:

If analytical procedures performed in accordance with SA 520 identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

1. **INQUIRING OF MANAGEMENT:** Requesting the management to provide additional information regarding why there are such huge differences. Further evaluate the response provided by management with audit evidence obtained.
2. **PERFORMING ADDITIONAL AUDIT PROCEDURES:** If management is unable to provide an appropriate explanation, then the auditor may perform additional procedures to identify any material misstatements, if available.

TEST YOUR KNOWLEDGE:

1. **The statutory auditor of MNO Ltd., CA Kishore identifies certain inconsistencies while applying analytical procedures to the financial and non financial data of MNO Ltd. What should CA Kishore do in this case with reference to SA 520 on "Analytical Procedures"?**

Answer: Write above answer

Q.NO.12 WHETHER IT IS POSSIBLE TO INDEPENDENTLY VERIFY THE CORRECTNESS OF SOME OF THE ITEMS OF EXPENSES INCLUDED IN THE STATEMENT OF PROFIT AND LOSS? EXPLAIN WITH THE HELP OF SOME EXAMPLES.

ANSWER:

1. Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss.
2. For instance, the cost of importing goods which are subjected to an ad-valorem duty at uniform rate can be verified from the amount of duty paid.
3. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of excise duty/ GST paid.
4. Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, e.g . commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc.
5. Such calculation of ratios, trends and comparisons is also termed as analytical review. Thus, it is important to note that Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

Q.NO.13 WHAT ARE THE CONSIDERATIONS SPECIFIC TO PUBLIC SECTOR ENTITITES WITH REGARD TO ANALYTICAL PROCEDURES?

ANSWER:

1. The relationships between individual financial statements items traditionally considered in the audit of business entities may not always be relevant in the audit of governments or other non-business public sector entities.
   For example, in many public sector entities there may be little direct relationship between revenue and expenditure.
2. In addition, because expenditure on the acquisition of assets may not be capitalized, there may be no relationship between expenditures and revenue.

For example, inventories and fixed assets and the amount of those assets reported in the financial statements.

3. Also, industry data or statistics for <u>comparative purposes may not be available</u> in the public sector.
4. However, <u>other relationships may be relevant</u>, for example, variations in the cost per kilometre of road construction or the number of vehicles acquired compared with vehicles retired.

TEST YOUR UNDERSTANDING

1. An auditor of a company intends to apply analytical procedures for verifying revenue. Discuss any two analytical procedures which may be performed by auditor relating to revenues.

Answer:

Analytical procedures in relation to revenue can include:-

1. Comparing revenue of current year with previous year and investigating significant fluctuations
2. Comparing revenue of current year with budgeted targets and investigating significant fluctuations.

12. AUDIT OF BANKS

INTRODUCTION

A Bank is an entity which does the following two functions:
1. Accepting deposits and
2. Lend loans

Banking sector is the backbone of any economy as it is essential for sustainable socio-economic growth and financial stability in the economy. The banking sector is also crucial as it deals with mammoth amounts of public monies and is highly sensitive to reputational risk. Like all economic activities, the banking sector is also exposed to various risks in its operations.

It is of utmost importance to ensure that banking sector stays healthy, safe and sound. For safe and sound banking sector, one of the most important factors is reliable financial information supported by quality bank audits.

Peculiar features of the bank:
1. Huge volumes and complexity of transactions.
2. Wide geographical spread of banks' network.
3. Large range of products and services offered.
4. Extensive use of technology.
5. Strict vigilance by the banking regulator etc.

Q.NO.1 WHAT ARE VARIOUS CATEGORIES/TYPES OF BANKS?

ANSWER:

1. **COMMERCIAL BANKS:** These are the most wide spread banking institutions in India, that provide a number of products and services to general public and other segments of economy. Two of its main functions are:-
   a. Accepting deposits and
   b. Granting advances.

2. **REGIONAL RURAL BANKS:** Also known as RRBs are the banks that have been set up in rural areas in different states of the country to cater to the basic banking and financial needs of the rural communities. Examples are :- Punjab Gramin Bank , Tripura Gramin Bank , Allahabad UP Gramin Bank , Andhra Pradesh Grameen Vikas Bank, etc.

3. **CO-OPERATIVE BANKS:** They function like Commercial Banks only but are set up on the basis of Cooperative Principles and registered under the Cooperative Societies Act of the respective state or the Multistate Cooperative Societies Act and usually cater to the needs of the agricultural and

rural sectors. Examples are :- The Gujarat State Co-operative Bank Ltd. , Chhatisgarh Rajya Sahakari Bank Maryadit , etc.

4. **PAYMENTS BANKS:** Payments banks are a new type of banks which have been recently introduced by RBI. They are allowed to accept restricted deposits but they cannot issue loans and credit cards. However , customers can open Current & Savings accounts and also avail the facility of ATM cum Debit cards , Internet-banking & Mobile banking. Examples are :- Airtel Payments Bank , India Post Payments Bank, Paytm Payments Bank , etc.

5. **DEVELOPMENT BANKS:** These banks had been conceptualized to provide funds for infrastructural facilities important for the economic growth of the country. Examples are:- Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Small Industries Development Bank of India (SIDBI) , etc.

6. **SMALL FINANCE BANKS:** These have been set up by RBI to make available basic financial and banking facilities to the unserved and unorganised sectors like small marginal farmers, small & micro business units, etc. Examples are:- Equitas Small Finance Bank , AU Small Finance Bank , etc.

Q.NO.2 HOW RBI REGULATES THE BANKING SECTOR IN INDIA?

ANSWER:

The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country. RBI is responsible for development and supervision of the constituents of the Indian financial system.

1. **ISSUE BANKING LICENSE:**
   a. As per Sec 22 of Banking Regulation Act, every bank should obtain a Banking license from RBI to conduct banking business in India.
   b. No bank can commence the business of banking or open new branches without obtaining licence from RBI.
   c. Banking operations are only conducted at the branches, while other offices act as controlling authorities or administrative offices.

2. **BANKER'S BANK:** RBI is the bank of all banks in India as it provides the loan to banks/bankers, accept the deposit of banks, and rediscount the bills of banks.

3. **DETERMINE CRR AND SLR:** Each commercial bank is required to maintain certain portion of their Net Demand and Time Deposits in the form of cash with the Reserve Bank, called Cash Reserve Ratio (CRR) and in the form of investment in approved securities, called Statutory Liquidity Ratio (SLR).

4. **POWER TO INSPECT ANY BANK:** As per Section 35 of Banking Regulation Act, 1949, RBI has the power to inspect any bank.

5. **MONEY SUPPLY AND CONTROLLER OF CREDIT:** To control demand and supply of money in Economy, it is also responsible for formulating and implementing the monetary policies such as Open Market Operations, varying the Repo rates, reserve ratios etc.

6. **PRUDENTIAL NORMS:**
   a. RBI issues "Prudential Norms" to be followed by the commercial banks to strengthen the balance sheets of banks.
   b. Few of them are related to income recognition, asset classification and provisioning etc.

7. **ENSURE GOOD CORPORATE GOVERNANCE**
   a. RBI ensures good corporate governance in banks.
   b. RBI issued guidelines for fit and proper criteria to become directors of banks.
   c. RBI may appoint additional directors in the board of bank, in case of irregularities.

TEST YOUR KNOWLEDGE:

1. **RBI has been entrusted with the responsibility of regulating the activities of commercial banks only. Correct/Incorrect.**

Answer:

Incorrect. RBI has been entrusted with the responsibility of regulating the activities of commercial and other banks.

2. **The functioning of banking industry in India is regulated by the Reserve Bank of India (RBI) which acts as the Central Bank of our country. Explain**

Answer: Write above answer

Q.NO.3 WHAT IS REGULATORY FRAMEWORK FOR BANKS IN INDIA?

ANSWER:

REGULATORY FRAMEWORK: Some of the examples of laws and regulations applicable to the banking industry are as follows:

1. Banking Regulation Act, 1949
2. RBI Act, 1934.
3. Companies Act, 2013.
4. State bank of India act, 1955
5. Banking companies (Acquisition and Transfer of Undertakings) Act, 1970 & 1980.
6. Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.(SARFAESI)

7. Regional Rural Banks Act, 1976
8. Information Technology Act, 2000.
9. Prevention of Money laundering Act, 2002.
10. Credit Information Companies Regulation Act, 2005.
11. Payment and Settlement Systems Act, 2007

Q.NO.4 WHAT ARE VARIOUS TYPES OF BANKS ON THE BASIS OF LEVEL OF COMPUTERISATION?

ANSWER:

Banks may be divided into three board categorises based on the level of computerisation:

1. **NON-COMPUTERISED BANKS :** Transactions can be done only at bank branches during working hours using paper and pen.
2. **PARTIALLY COMPUTERISED BANKS:** Some transactions are computerised while major are non-computerised.
3. **FULLY COMPUTERISED BANKS:** Core banking allows inter-connectivity between branches of the same bank and with CBS , customers can operate their accounts as well as avail banking services from any branch of the bank over the network.

TEST YOUR KNOWLEDGE:

1. **In the computerised environment, the auditor need not be familiar with latest applicable RBI guidelines that have bearing on the classification/ provisions and income recognition.**

Answer:

Incorrect. In the Computerised environment, it is imperative that the auditor is familiar with, and is satisfied that, all the norms/parameters as per the latest applicable RBI guidelines are incorporated and built into the system that generates information/data having a bearing on the classification/ provisions and income recognition.

Q.NO.5 EXPLAIN THE NPA NORMS FOR THE FOLLOWING ADVANCES:

A. **ACCOUNTS REGULARIZED NEAR ABOUT THE BALANCE SHEET DATE**
B. **GOVERNMENT GUARANTEED ADVANCES**
C. **ADVANCES UNDER CONSORTIUM**
D. **ACCOUNTS WHERE THERE IS EROSION IN THE VALUE OF SECURITY**
E. **ADVANCES AGAINST TERM DEPOSITS, NSCS, KVPS**
F. **AGRICULTURAL ADVANCES AFFECTED BY NATURAL CALAMITIES**
G. **ADVANCES TO STAFF**
H. **AGRICULTURAL ADVANCES**

ANSWER:

A. **ACCOUNTS REGULARIZED NEAR ABOUT THE BALANCE SHEET DATE:**
   1. These are the accounts with few credits received just before the date of balance sheet.

2. The asset classification of such accounts should be handled with care. If the account indicates inherent weakness on the basis of the data available, the account should be deemed as a NPA.

B. GOVERNMENT GUARANTEED ADVANCES:

1. Central Govt, guaranteed Advances, where the guarantee is not invoked/ repudiated would be classified as Standard Assets but regarded as NPA for Income Recognition purpose.
2. The situation would be different if the advance is guaranteed by State Government, where advance is to be considered NPA if it remains overdue for more than 90 days for both Provisioning and Income recognition purposes.

C. ADVANCES UNDER CONSORTIUM:

1. Consortium advances mean advancing loans to a borrower by two or more Banks jointly by forming a Consortium.
2. Usually, a Bank with a higher share will lead the consortium.
3. Consortium advances should be based on the record of recovery of the respective individual member banks.
4. Where the remittances by the borrower under consortium lending arrangements are received by the lead bank and the lead bank is not transferring the share of other member banks, the account should be deemed to be NPA as per respective provisions.
5. The banks participating in the consortium, therefore, need to arrange to get their share of recovery transferred from the lead bank or to get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

D. ACCOUNTS WHERE THERE IS EROSION IN THE VALUE OF SECURITY: Erosion means the gradual destruction or diminution of something. They should be straight-away classified as doubtful or loss asset as appropriate.

1. **As Doubtful asset:** If the realisable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, Such assets may be straightaway classified under doubtful category and provisioning should be made as applicable to doubtful assets.
2. **As Loss asset:** If the realisable value of the security, as assessed by the bank/ approved valuers/ RBI is less than 10 per cent of the outstanding in the borrower accounts. Then the existence of security should be ignored, and the asset should be straightaway classified as loss asset. It shall be fully written off.

E. ADVANCES AGAINST TERM DEPOSITS. NSCS, and KVPS: Advances against Term Deposits, NSCs, and KVP/IVP need not be treated as NPAs, provided adequate margin is available in the accounts.

F. AGRICULTURAL ADVANCES AFFECTED BY NATURAL CALAMITIES:

1. Banks may decide about their own relief measures when agricultural advances are affected by natural calamities.

2. E.g., They may convert a short-term production loan into a term loan or re-schedulement of the repayment period and the sanctioning of fresh short-term loan.
3. In such cases, the NPA classification would be governed by such rescheduled terms.

G. ADVANCES TO STAFF:

1. Interest-bearing staff advances as a banker should be included as part of advances portfolio of the bank.
2. Such loans/advances should be classified as NPA only when there is a default in repayment of instalment of principal or payment of interest on the respective due dates i.e., when there is a default in repayment of instalment on the respective due dates for beyond 90 days.
3. However, the staff advances by a bank as an employer and not as a banker are required to be included under the sub-head 'Others' under the schedule of Other Assets. (Salary advance)
4. In the case of housing loan or similar advances granted to staff members where interest is payable after recovery of principal, interest need not be considered as overdue from the first quarter onwards.

H. AGRICULTURAL ADVANCES: Agricultural Advances are of two types,

1. Agricultural Advances for "long duration" crops (LDC) and
2. Agricultural Advances for "short duration" crops (SDC)

The following NPA norms would apply to agricultural advances:

a. **SDC:** A loan will be treated as NPA. if the instalment remains overdue for two crop seasons.
b. **LDC:** A loan will be treated as NPA, if the instalment remains overdue for one crop season.

NOTE: The "long duration" crops would be crops with crop season longer than one year and crops, which are not "long duration" crops would be treated as "short duration" crops.

The crop season for each crop, which means the period up to harvesting of the crops raised, would be as determined by the State Level Bankers' Committee in each State.

TEST YOUR KNOWLEDGE:

1. Yess Bank is having a branch which is located in the rural areas which comprises of majority of agricultural advances. The manager of the branch wants to treat advances as NPA which are overdue for more than 90 days. Comment.

Answer: Write Point H from above answer

Q.NO.6 EXPLAIN THE NATURE OF SECURITIES THAT WILL BE ACCEPTED BY BANK AND WHAT ARE VARIOYUS MODES OF CREATION OF SECURITY?

ANSWER:

A. NATURE OF SECURITY

1. **Primary security** refers to the security offered by the borrower for bank finance or the one against which credit has been extended by the bank. This security is the principal security for an advance.
2. **Collateral security** is an additional security. Security can be in any form i.e. tangible or intangible asset, movable or immovable asset.

Examples of most common types of securities accepted by banks are the following:

a. Immovable Property
b. Goods/Stocks/Debtors/Trade Receivables
c. Gold Ornaments and Bullion
d. Plantations (For Agricultural Advances)
e. Third Party Guarantees
f. Life Insurance Policies
g. Personal Security of Guarantor
h. Stock Exchange Securities and Other Instruments

B. MODES OF CRERATION OF SECURITY:

1. **Mortgage:** Mortgage are of several kinds but the most important are the Registered Mortgage and the Equitable Mortgage.
   a. **Registered Mortgage** can be affected by a registered instrument called the 'Mortgage Deed' signed by the mortgagor. It registers the property to the mortgagee as a security.
   b. **Equitable mortgage,** on the other hand, is effected by a mere delivery of title deeds or other documents of title with intent to create security thereof.

2. **Pledge:**
   a. A pledge involves bailment or delivery of goods by the borrower to the lending bank with the intention of creating a charge thereon as security for the advance.
   b. The legal ownership of the goods remains with the pledger while the lending banker gets certain defined interests in the goods.

3. **Hypothecation:**
   a. Neither ownership nor possession is transferred to the bank.
   b. However, the borrower holds the physical possession of the goods as an agent/trustee of the bank.
   c. The borrower periodically submits statements regarding quantity and value of hypothecated assets (stocks, debtors, etc.) to the lending banker on the basis of which the drawing power of the borrower is fixed.

4. **Assignment:**

a. Assignment represents a transfer of an existing or future debt, right or property belonging to a person in favour of another person.
b. Only actionable claims (i.e., claim to any debt other than a debt secured by a mortgage of immovable property or by hypothecation or pledge of moveable property) such as book debts and life insurance policies are accepted by banks as security by way of assignment.

5. **Set-off:**
    a. The right of set-off enables a bank to combine two accounts (a deposit account and a loan account) of the same person provided both the accounts are in the same name and same right (i.e., the capacity of the account holder in both the accounts should be the same).
    b. For the purpose of set-off, all the branches of a bank are treated as one single entity. The right of set-off can be exercised in respect of time-barred debts also.

6. **Lien:** Lien is creation of a legal charge with consent of the owner, which gives lender a legal right to seize and dispose / liquidate the asset under lien.

Q.NO.7 WRITE ABOUT AUDIT OF DRAWING POWER OF ADVANCES?

ANSWER:

1. **MEANING:** Drawing Power generally addressed as "DP" is an important concept for Cash Credit (CC) facility availed from banks and financial institutions. Drawing power is the limit up to which a firm or company can withdraw from the working capital limit sanctioned.

2. **DRAWING POWER IS DIFFERENT FROM SANCTIONED LIMIT:** The Sanctioned limit is the total exposure that a bank can take on a particular client for facilities like cash credit, overdraft, export packing credit, non-funded exposures etc.

3. **BANKS DUTIES:**
    a. All accounts should be always kept within both the drawing power and the sanctioned limit.
    b. The accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the Management/Head Office regularly. Banks should ensure that drawings in the working capital account are covered by the adequacy of the current assets.
    c. Drawing power is required to be arrived at based on current stock statement.
    d. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months.
    e. It needs to be ensured that the drawing power is calculated as per the guidelines formulated by the Board of Directors of the respective bank.
    f. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power.

4. **AUDITORS CONSIDERATIONS:**
   a. The stock statements, quarterly returns and other statements submitted by the borrower to the bank should be scrutinized in detail.
   b. The audited Annual Report submitted by the borrower should be scrutinized properly.
   c. The monthly/quarterly stock statement and the audited accounts should be compared and the reasons for deviations, if any, should be ascertained.

5. **STOCK AUDIT:**
   a. The stock audit should be carried out by the bank for all accounts having funded exposure of more than 5 crores.
   b. Auditors can also advise for stock audit in other cases if the situation warrants the same.
   c. Member banks should obtain the stock audit reports from lead bank (in case of consortium advances) in the cases where the Bank is not leader of the consortium of working capital.
   d. The report submitted by the stock auditors should be reviewed during the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power.

TEST YOUR KNOWLEDGE:

1. **In a bank, all accounts should be kept within the drawing power and the sanctioned limit. The accounts which exceed the sanctioned limit or drawing power should be brought to the notice of the management regularly. Analyse the following points to be considered in the computation of drawing power in case of bank audit.**
   a) Bank's Duties b) Auditor's concern c) Computation of DP d) Stock audit

Answer: Write above answer

2. **Compute the Drawing Power for Cash Credit A/c of S Limited for the month of March 2022 with following information:**

	Amount
Stock	50,000
Debtors	45,000
(including debtors of 5,000 for an invoice dated 17.11.2021)	
Sundry creditors	15,000
Sanctioned Limit	45,000
Margin on stock is 20% and on debtors is 50%.	

Note: Debtors older than 3 months are ineligible for calculation of DP.

Answer:

Computation of Drawing Power of S Ltd:

Particulars		Amount	DP
a) **Stock:**			
Stock at realisable value		50,000	
Less: Unpaid Stock			
-Sundry creditors	15,000	15,000	
Paid for stock		35,000	
Margin @ 20%		7,000	**28,000**
b) **Debtors:**			
Total Debtors		45,000	
Less: Ineligible debtors		5,000	
Eligible debtors		40,000	
Margin @ 50%		20,000	**20,000**
Total Drawing Power			**48,000**

The sanctioned limit given in the question is Rs. 45,000 whereas drawing power as per the above working is Rs. 48,000. So, drawing power would be restricted to sanctioned limit i.e., Rs. 45,000

Q.NO.8 EXPLAIN THE PROVISIONS RELATING TO APPOINTMENT OF AUDITORS OF BANK?

ANSWER:

1. **ELIGIBILITY. QUALIFICATIONS AND DISQUALIFICATIONS OF AUDITOR:** Same as auditor of company as prescribed under section 141 of the Companies Act, 2013.
2. **AUTHORITY TO APPOINTMENT:**
   a. **Auditor of a banking company:** Appointed by shareholders of the bank at the AGM after approval of RBI.
   b. **Auditor of a nationalised bank**: By BOD subject to certain approvals from RBI.
   c. **Auditors of the SBI:** Appointed by the CAG of India in consultation with CG
   d. **Auditors of subsidiaries of SBI**: Appointed by SBI
   e. **Auditors of regional rural banks**: By BOD with approval of CG.
3. **REMUNERATION OF AUDITOR:**
   a. **Auditor of a banking company:** Fixed in accordance with the provisions of section 142 of the Companies Act. 2013 (i.e., by the company in general meeting).
   b. **Auditors of nationalised banks. SBI and RRBs:** Fixed by the Reserve Bank of India in consultation with the Central Government.
4. **POWERS OF AUDITOR:** Same powers as those of a company auditor prescribed in companies act, 2013 like access to the books, accounts, documents, and vouchers etc.

Q.NO.9 WHAT ARE THE MATTERS WHICH THE ENGAGEMENT TEAM DISCUSS WHILE CONDUCTING BANK AUDIT? ALSO, STATE ADVANTAGES OF SUCH DISCUSSIONS.

ANSWER:

1. **ENGAGEMENT TEAM DISCUSSIONS:** The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control. They should assess the potential for material misstatements of the financial statements.

   These discussions are ordinarily done at the planning stage of an audit. All these discussions should be appropriately documented for future reference.

2. **MATTERS TO BE DISCUSSED IN GENERAL:** The engagement team discussion ordinarily includes a discussion of the following matters:
   a. Errors that may be more likely to occur.
   b. Errors which have been identified in prior years.
   c. Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures.
   d. Need to maintain professional skepticism throughout the audit engagement.
   e. Audit responses to Engagement Risks
   f. Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances)

3. **ADVANTAGES OF DISCUSSIONS:**
   a. Provides an opportunity for more experienced engagement team members, including the audit engagement partner, to share their insights based on their knowledge of the bank and its environment including its business risks.
   b. Provides an understanding amongst the engagement team members about effect of the results of the risk assessment procedures including decisions about the nature, timing, and extent of further audit procedures.
   c. Specific emphasis (attention) should be provided to the susceptibility of the bank's financial statements to material misstatement due to fraud, that enables the engagement team to consider an appropriate response to fraud risks.

TEST YOUR KNOWLEDGE:

1. **"The engagement team should hold discussions to gain better understanding of the bank and its environment, including internal control, and also to assess the potential for material misstatements of the financial statements. All these discussions should be appropriately documented for future reference". Explain.**

Answer: Write above answer

Q.NO.10 WRITE ABOUT OVERVIEW OF CONDUCTING BANK AUDIT.

ANSWER:

1. **INITIAL CONSIDERATION BY THE STATUTORY AUDITOR:**
    a. **Communication with Previous Auditor:** As per Clause (8) of the Part I of the First Schedule to the Chartered Accountants Act, 1949, a chartered accountant in practice cannot accept position as auditor previously held by another chartered accountant without first communicating with him in writing.
    b. **Acceptance & Continuance:** Performing procedures required by SA 220, "Quality Control for Audit Work" regarding the acceptance of the client relationship and the specific audit engagement (Assessing Engagement risk); and
    c. **Declaration of Indebtedness:** The RBI has advised that the banks, before appointing their statutory central/branch auditors, should obtain a declaration of indebtedness.
    d. **Terms of Audit Engagements:** SA 210 requires that for each period to be audited, the auditor should agree on the terms of the audit engagement, and they should be documented, in order to prevent any confusion.
    e. **Internal Assignments:** The audit firms should not undertake statutory audit assignment if they are associated with internal assignments in the bank during the same year.
    f. **Establish the Engagement Team:** The assignment of qualified and experienced professionals of engagement team should be done on the basis of size, nature, and complexity of the bank's operations.

2. **UNDERSTANDING THE BANK AND ITS ENVIRONMENT INCLUDING ACCOUNTING PROCESS:** SA 315 lay downs that the auditor should obtain an understanding of the entity and its environment, including its internal control and accounting process,
    a. To <u>identify and assess the risks of material misstatement</u> of the financial statements whether due to fraud or error, and
    b. To <u>design and perform further audit procedures.</u>

3. **ENGAGEMENT TEAM DISCUSSIONS:** The engagement team should hold discussions to <u>gain better understanding</u> of banks and its , including internal control, and also to assess the potential for material misstatements of the financial statements.

4. **DEVELOP THE AUDIT PLAN:** SA 300 deals with the auditor's responsibility to plan an audit of financial statements in an effective manner. It requires the <u>involvement of all the key members of the engagement team</u> while planning an audit.

5. **Audit Planning Memorandum:** The auditor should summarise the audit plan by preparing an audit planning memorandum in order to:
    a. Describe the expected scope and extent of the audit procedures to be performed by the auditor
    b. Highlight all significant issues and risks identified during their planning and risk assessment activities, as well as the decisions concerning reliance on controls
    c. Provide evidence that they have planned the audit engagement appropriately and have responded to engagement risk, pervasive risks, specific risks, and other matters affecting the audit engagement.

6. **DETERMINE AUDIT MATERIALITY:** The auditor should consider the relationship between the audit materiality and audit risk when conducting an audit. The determination of audit materiality is a matter of professional judgment.

7. **CONSIDER GOING CONCERN:** In obtaining an understanding of the bank, the auditor should consider whether there are events and conditions which may cast significant doubt on the bank's ability to continue as a going concern.

8. **ASSESS THE RISK OF FRAUD INCLUDING MONEY LAUNDERING:** The RBI has framed specific guidelines that deal with prevention of money laundering and "Know Your Customer (KYC)" norms. The RBI has from time to time issued guidelines ("Know Your Customer Guidelines – Anti Money Laundering Standards"), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities.

9. **RISK ASSOCIATED WITH OUTSOURCING OF ACTIVITIES:** The modern day banks make extensive use of outsourcing as a means of both reducing costs as well as making use of services of an expert not available internally. There are, however, a number of risks associated with outsourcing of activities by banks and therefore, it is quintessential for the banks to effectively manage those risks.

10. **MAINTAINING PROFESSIONAL SCEPTICISM:** As per SA 240, the attitude of professional scepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.

11. **STRESS TESTING:** RBI has required that all commercial banks shall put in place a Broad approved 'Stress Testing framework' to suit their individual requirements which would integrate into their risk management systems.

12. **BASEL III FRAMEWORK:** In the document titled 'Basel III', A global regulatory framework for more resilient in banks and banking systems', released by the BCBS in December 2010, it has proposed certain minimum set of criteria for inclusion of instruments in the new definition of regulatory capital.

    BCBS: Basel Committee on Banking Supervision.

13. **RELIANCE ON / REVIEW OF OTHER REPORTS:** The auditor should take into account the adverse comments, if any, on advances appearing in the following-
    a. Previous audit reports.
    b. Latest internal inspection reports of bank officials.
    c. Reserve Bank's latest inspection report.
    d. Concurrent / Internal audit report.
    e. Report on verification of security
    f. Any other internal reports specially related to particular accounts.

Q.NO.11 HOW TO CONDUCT AUDIT OF ADVANCES OF BANKING COMPANIES?

ANSWER:

A. TYPES OF ADVANCES:

1. **Funded loans** are those loans where there is an actual transfer of funds from the bank to the borrower. Examples of funded loans are Term loans, Cash credits, Overdrafts, Demand Loans, Bills Discounted and Purchased.
2. **Non-funded facilities** are those which do not involve such transfer. Examples of non-funded loans are Letters of credit, Bank guarantees, etc.

B. AUDIT OF ADVANVCES: Advances generally constitute a major part of the assets of the bank. The auditor should examine all large advances while other advances may be examined on a sampling basis.

Note: An advance may be considered to be a large advance if the year-end balance is in excess of ₹ 10 crore or 10% of the aggregate year-end advances of the branch, whichever is less.

C. EVALUATION OF INTERNAL CONTROLS OVER ADVANCES: The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. In general, the internal controls over advances should include, inter alia, the following:

1. The bank should make an advance only after satisfying itself as to the credit worthiness of the borrower and after obtaining sanction from the appropriate authorities of the bank.
2. All the necessary documents (e.g., agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
3. The compliance with the terms of sanction and end use of funds should be ensured.
4. Sufficient margin as specified in the sanction letter should be kept against securities taken so as to cover for any decline in the value thereof. The availability of sufficient margin needs to be ensured at regular intervals.
5. If the securities taken are in the nature of shares, debentures, etc., the ownership of the same should be transferred in the name of the bank and the effective control of such securities be retained as a part of documentation.
6. All securities requiring registration should be registered in the name of the bank or otherwise accompanied by documents sufficient to give title to the bank.
7. In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipt. The godowns should be frequently inspected by responsible officers of the branch concerned, in addition to the inspectors of the bank.
8. Drawing Power Register should be updated every month to record the value of securities hypothecated. These entries should be checked by an officer.
9. The accounts should be kept within both the drawing power and the sanctioned limit.
10. All the accounts which exceed the sanctioned limit or drawing power or are otherwise irregular should be brought to the notice of the controlling authority regularly.

11. The operation of each advance account should be reviewed at least once a year and at more frequent intervals in the case of large advances.

D. **THE AUDITOR SHOULD OBTAIN THE EVIDENCE REGARDING THE FOLLOWING:** In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

1. Amounts included in balance sheet in respect of advances which are outstanding at the date of the balance sheet.
2. Advances represent amount due to the bank.
3. Amounts due to the bank are appropriately supported by loan documents and other documents as applicable to the nature of advances.
4. There are no unrecorded advances.
5. The stated basis of valuation of advances is appropriate and properly applied and the recoverability of advances is recognised in their valuation.
6. The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.
7. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

TEST YOUR KNOWLEDGE:

1. The auditor should examine the efficacy of various internal controls over advances to determine the nature, timing and extent of his substantive procedures. Explain this statement.

Answer: Refer above answer

Q.NO.12 HOW TO CONDUCT AUDIT OF INCOMES OF BANK?

ANSWER:

A. **OBJECTIVE:** In carrying out an audit of income, the auditor is primarily concerned with obtaining reasonable assurance that the recorded income arose from transactions and ensure that there is no unrecorded income.

B. **BASIC INCOME RECOGNITION POLICY:** RBI has advised that in respect of any income which **exceeds 1% of the total income of the bank or 1% of the net profit before taxes,** should be considered on accrual as per AS-9.

1. If any item of income is not considered to be material as per the above norms, it may be recognised when received and the auditors need not qualify the statements in that situation.
2. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection.

C. AUDIT OF VARIOUS INCOMES OF BANK:

1. Interest income in case of NPA's:

a. **Policy for Income Recognition:** The policy of income recognition shall be based on the record of recovery, i.e., Income from NPA's is not recognised on accrual basis but is booked as income only when it is actually received.

   Exception: Interest on advances against the following may be taken to income account on the due date, provided adequate margin is available in the accounts.
   i. Term Deposits,
   ii. National Savings Certificates (NSCs),
   iii. Indira Vikas Patras (IVPs),
   iv. Kisan Vikas Patras (KVPs) etc.

b. **Reversal of Income:** If any advance becomes NPA. the entire interest accrued and credited to income account in the past periods, should be reversed if the same is not realised.

c. **Memorandum Account:** If an account turns as NPA, banks should reverse the interest already charged and not collected, by debiting Profit and Loss account, and stop further application of interest.
   However, banks may continue to record such accrued interest in a Memorandum account in their books for control purposes.

d. **Partial Recoveries in NPA'S:**
   i. If there is no clear agreement between the bank and the borrower for the purpose of appropriation of recoveries in NPAs (i.e., towards principal or interest due), banks are required to exercise of appropriation of recoveries in a uniform and consistent manner.
   ii. The appropriate policy to be followed is to recognise income as per AS 9 when certainty attaches to realisation and accordingly amount reversed or not recognised in the past should be accounted.
   iii. Interest partly/fully realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credit facilities sanctioned to the borrowers concerned.

2. Bills discounting income: In the case of bills purchased outstanding at the close of the year the discount received thereon should be properly apportioned between the two years. [The Unexpired discount / rebate on bills discounted should be recorded as "Other Liabilities"].

3. Income from bills for collection: In the case of bills for collection, the auditor should also examine the procedure for crediting the party on whose behalf the bill has been collected. The procedure is usually such that the customer's account is credited only after the bill has actually been collected from the drawee. The commission of the branch becomes due only when the bill has been collected.

4. **Income from rescheduling/renegotiation of loans:** Fees and commissions earned by the banks as a result of re-negotiations or rescheduling of outstanding debts should be recognised on an accrual basis over the period of time covered by the re-negotiated or rescheduled extension of credit.

5. **Income from Investments:**
   a. **Interest Income on Investments:** This includes all income derived from Government securities, bonds and debentures of corporates and other investments by way of interest and dividend, except income earned by way of dividends, etc., from subsidiaries and joint ventures abroad/in India.
   b. **Profit on Sale of Investments:** Investments are dealt in the course of banking activity and hence the net profit or loss on sale of investments is taken to profit and loss account.
   c. **Profit/Loss on Revaluation of Investments:** In terms of guidelines issued by the RBI, investments are to be valued at periodical intervals and depreciation or appreciation in valuation should be recognised and taken to profit and loss account.

Q.NO.13 WRITE A SHORT ON REVERSAL OF INCOME IN BANK AUDIT?

ANSWER:

1. If any advance, including bills purchased and discounted, becomes NPA as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.
2. In respect of NPA's, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.
3. Further, in case of banks which have wrongly recognised income in the past should:
   a. Reverse the interest if it was recognised as income during the current year or
   b. Make a provision for an equivalent amount if it was recognized as income in the previous year(s).
4. Furthermore, the auditor should enquire if there are any large debits in the Interest Income account that have not been explained. It should be enquired is there are any communications from borrowers pointing out differences in Interest charge, and whether action as justified has been taken in this regard.

TEST YOUR KNOWLEDGE:

1. **In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not recognize income on non-performing assets until it is realized. When a credit facility is classified**

as non-performing for the first time, interest accrued and credited to the income account in the corresponding previous year which has not been realized should be reversed or provided for. This will apply to Government guaranteed accounts also. Analyse and Explain.

Answer: Write above answer

Q.NO.14 HOW TO CONDUCT AUDIT OF EXPENSES OF A BANK?

ANSWER:

A. AUDIT OF INTEREST EXPENSE:

1. **Verification of reasonableness of interest paid:**
   a. **Comparison Within the Same Year:** The auditor may work out a weighted average interest rate and then compare this rate with the actual average rate of interest paid on each deposit and enquire into the difference if material.
   b. **Comparison with the previous year:** The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

2. **Checking the calculation of interest:** The auditor should, on a test check basis, verify the calculation of interest and satisfy himself that:
   a. **Period of Interest:** Interest has been provided on all deposits up to the date of the balance sheet.
   b. **Rate of Interest:**
      i. **Basic rule:** Interest rates are in accordance with the bank's internal regulations, of the RBI directives, and agreements with the respective depositors.
      ii. **In case of Fixed Deposits:** it should be examined whether the Interest Rate in the accounting system are in accordance with the Interest Rate mentioned in the Fixed Deposit Receipt/Certificate.
      iii. **In case of inter-branch balances:** Interest has been provided at the rates prescribed by the head office.

   NOTE: The auditor should obtain the interest rate card for various types of term deposits and analyse the interest cost for the period.

B. AUDIT OF OPERATING EXPENSES:

1. **Internal control:** The auditor should study and evaluate the system of internal control relating to expenses, including authorisation procedures.
2. **Invoice / Receipts:** The auditor should verify the expenses with reference to documents evidencing the payment for expenses.
3. **Analytical procedures:** The auditor should perform an overall analytical review for the payments to assess the reasonableness of expenditure.

C. **AUDIT OF PROVISIONS AND CONTINGENCIES:**

1. **Provisions made in respect of the NPA:** The auditor should ascertain compliance with the various regulatory requirements:
   a. For the classification of loans and receivables into standard, sub-standard, doubtful, loss and non-performing assets and
   b. For provisioning of those assets.
2. **Provision for Tax:** The auditor should obtain the tax provision computation from the bank's management. The auditor should re-compute the provision for tax by applying the applicable tax rate after considering the allowances and disallowances as per Income Tax Act, 1961.
3. **Other Provisions:** The other provisions for expenditure should be examined in relation to the circumstances warranting the provisioning and the adequacy of the same by discussing and obtaining the explanations from the bank's management.

Q.NO.15 EXPLAIN ABOUT THE REPORTING REQUIREMENTS OF AUDITORS OF BANKS?

ANSWER:

A. **REPORTING TO CG:** In the case of a nationalised bank and State Bank of India, the auditor is required to make a report to the Central Government in which he must state the following:

1. Whether the balance sheet and profit and loss containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs and Profit or loss of the bank.
2. Whether he has been given any explanation or information requested, and whether it is satisfactory.
3. Whether the transactions of the bank, which have come to his notice, have been within the powers of that bank.
4. Whether the returns received from the offices and branches of the bank have been found adequate for the purpose of his audit.

B. **FORMAT OF REPORT:**

1. **Compliance with SA'S:** The auditors, central as well as branch, should also ensure that the audit report issued by them complies with the requirements of relevant Standards on Auditing.
2. **Additional disclosure by Central Auditor:** The auditor should ensure that not only information relating to number of unaudited branches is given but quantification of advances, deposits, interest income and interest expense for such unaudited branches has also been disclosed in the audit report. (SA 600 requirement)
3. **Matters to be stated as per Sec. 143:** It may be noted that, in addition to the aforesaid, the auditor of a banking company is also required to state in his report in respect of matters covered by Section 143 of the Companies Act, 2013.
4. **CARO applicability:** The reporting requirements relating to the Companies (Auditor's Report) Order, 2016 is not applicable to a banking company.

C. LONG FORM AUDIT REPORT:

1. **Applicable for:** All banks.
2. **On what matters:** As specified by the Reserve Bank of India.
3. **Time limit for submission:** The LFAR is to be submitted before 30th June every year.

D. REPORTING OF FRAUD:

1. **RBI Circular:** The RBI issued a Circular relating to Legal Aspects of Bank Frauds applicable to all scheduled commercial banks (excluding Regional Rural Banks).

   The said circular provided as under: "If an accounting professional, whether in the course of internal or external audit, finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".
2. **As per SA 240:** Also, if the auditor while performing his normal duties comes across any fraud, he should report the matter to the RBI in addition to Chairman/Managing Director/Chief Executive of the concerned bank.
3. **As per SA 250:** Auditor should also consider the provisions of SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"

E. DUTY TO REPORT ON FRAUDS UNDER SECTION 143(12) OF THE COMPANIES ACT, 2013: Same as company auditors appointed under section 139 of the companies act, 2013. This is in addition to reporting to RBI.

TEST YOUR KNOWLEDGE:

1. **In the case of a nationalized bank, the auditor is required to make a report to the Central Government. The report of auditors of State Bank of India is also to be made to the Central Government and is almost identical to the auditor's report in the case of a nationalized bank. Explain what the auditor would state in his report.**

Answer: Refer Point A

Q.NO.16 WRITE ABOUT AUDITORS UNDERSTANDING OF RISK MANAGEMENT PROCESS WHILE CONDUCTING AUDIT OF A BANK?

ANSWER:

Management develops controls and uses performance indicators to aid in managing key business and financial risks.

An effective risk management system in a bank generally requires the following:

1. **INVOLVEMENT IN THE CONTROL PROCESS BY THOSE CHARGED WITH GOVERNANCE:** Those charged with governance (BOD/Chief Executive Officer) should approve written risk management

policies. The policies should be consistent with the bank's business objectives and strategies, regulatory requirements etc.

2. **IDENTIFICATION, MEASUREMENT AND MONITORING OF RISKS:** Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against preapproved limits and criteria.
3. **CONTROL ACTIVITIES:** A bank should have appropriate controls to manage its risks, including effective segregation of duties, verification and approval of transactions, physical security and contingency planning etc.
4. **MONITORING ACTIVITIES:** Risk management models, methodologies used to measure and manage risk should be regularly assessed and updated.
5. **RELIABLE INFORMATION SYSTEMS:** Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis.

Q.NO.17 WHAT IS THE LIST OF REPORTS THAT ARE REQUIRED TO BE FURNISHED BY STATUTORY CENTRAL AUDITOR OF A BANK?

ANSWER:

Presently, the Statutory Central Auditors (SCAs) have to furnish the following reports in addition to their main audit report:

1. Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act, 2013.
2. Long Form Audit Report.
3. Report on compliance with SLR requirements.
4. Report on whether the treasury operations of the bank have been conducted in accordance with the instructions issued by the RBI from time to time.
5. Report on whether the income recognition, asset classification and provisioning have been made as per the guidelines issued by the RBI from time to time.
6. Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention.
7. Report on status of the compliance by the bank with regard to the implementation of recommendations of the Ghosh Committee relating to frauds and malpractices and of the recommendations of Jilani Committee on internal control and inspection/credit system.
8. Report on instances of adverse credit-deposit ratio in the rural areas.

MISCELLANEOUS:

On Take-out finance: *A takeout loan is a method of financing whereby a loan that is procured later is used to replace the initial loan. More specifically, a takeout loan, or takeout financing, is long-term financing that the lender promises to provide at a particular date or when particular criteria for completion of a project are met. Takeout loans are commonly used in property development. In the* *case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognize income unless realised from the borrower/taking-over institution (if the arrangement so provides).*

Objective of takeout finance:

- *To expand sources of Finance for infrastructure projects by facilitating participation of new entities*
- *To address sectoral/group/entity exposure issues and asset liabillity in mis-match concerns of tenders*
- *To boost the availability of longer tenor debt finance for projects*

TEST YOUR UNDERSTANDING

1. **The financial statements of a bank are prepared in a specified format. Discuss legal provisions in this regard as applicable to financial statements of a nationalized bank.**

Answer:

Sub-sections (1) and (2) of Section 29 of the Banking Regulations Act, 1949 deal with the form and content of financial statements of a banking company and their authentication. These provisions are also applicable to nationalised banks. Every banking company is required to prepare a Balance Sheet and a Profit and Loss Account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit. Form A of the Third Schedule to the Banking Regulation Act, 1949, contains the form of Balance Sheet and Form B contains the form of Profit and Loss Account.

2. **Ranjana Ceramic Private Limited is sanctioned a cash credit facility of ₹ 100 lacs from a branch of LMO Bank. Besides, branch has also sanctioned a one-time bank guarantee of ₹ 10 lacs on behalf of the company in favour of a statutory authority. Discuss, what type of credit facilities have been sanctioned by branch of LMO bank to the company along with probable purpose for each of credit facility.**

Answer:

Cash credit facility sanctioned by bank to company is in nature of funded credit facility. Its purpose is to meet working capital requirements of business. Bank guarantee sanctioned to the company is in nature of non-funded credit facility. Its probable purpose could be requirement of a guarantee by a statutory authority in exchange of company fulfilling some statutory obligations.

3. **During course of audit of branch of a nationalized bank, you find that system has generated a report marking ten term loan accounts as SMA. Discuss, meaning of SMA accounts and significance of such a classification.**

Answer:

Special Mention Account (SMA) is an account which is exhibiting signs of incipient stress resulting in the borrower defaulting in timely servicing of debt obligations, though the account has not yet been classified as NPA as per the RBI guidelines.

In the given case, ten term loan accounts have been classified as SMA. It means that there are overdues in the accounts for a period of 0 to 90 days. Since period of 90 days has not been exceeded as on the date, such accounts have not been classified as NPA as per RBI norms.

Such a classification is significant as early recognition of such accounts enables banks to initiate timely remedial actions to prevent potential slippages of such accounts into NPAs.

4. **CA P is conducting stock audit of a borrower availing cash credit facility of ₹ 100 lacs from branch of a bank. The cash credit facility is against security of paid stocks and debtors up to 90 days. Margin stipulated is 25% for stocks and 40% for debtors. Following further information is available as on 31.12.22: -**

Value of stocks	**125 Lacs**
Value of stocks (fully damaged) included in above	**5 Lacs**
Value of debtors	**50 Lacs**
Value of stocks (fully damaged) included in above	**10 Lacs**
Value of creditors for goods	**50 Lacs**

Is Drawing Power computed by CA P for ₹ 82.50 lacs proper?

Answer:

The computation of Drawing power is as under: -

Value of stocks as on 31.12.22	125 lacs
Less: value of damaged stocks	5 lacs
	120 lacs
Less: creditors for goods as on 31.12.22	50 lacs
Value of Paid stocks	70.00 lacs
Less: Margin @ 25%	17.50 lacs

Drawing power (A)	52.50 lacs
Value of debtors as on 31.12.22	50 lacs
Less: debtors exceeding 90 days	10 lacs
	40 lacs
Less: Margin @ 40%	16 lacs
Drawing Power (B)	24 lacs
Drawing Power (A+B)	76.50 lacs

The drawing power calculated by CA P is not proper. Drawing Power comes to ₹ 76.50 lacs

5. **You are verifying interest on deposits paid by branch of a nationalized bank. Discuss, any two "analytical procedures", to verify interest on deposits paid by branch.**

Answer:

The auditor should obtain from the bank an analysis of various types of deposits outstanding at the end of each quarter. From such information, the auditor may work out a weighted average interest rate. The auditor may then compare this rate with the actual average rate of interest paid on the relevant deposits as per the annual accounts and enquire into the difference, if material. The auditor should also compare the average rate of interest paid on the relevant deposits with the corresponding figures for the previous years and analyse any material differences.

13. AUDIT OF ITEMS OF FINANCIAL STATEMENTS

Q.NO.1 WHAT ARE THE VARIOUS ASSERTIONS TO BE VERIFIED BY THE AUDITOR REGARDING VARIOUS ITEMS OF FINANCIAL STATEMENTS?

ANSWER:

A. ASSERTION FOR BALANCE SHEET ITEMS:

1. **EXISTENCE:** Assets, liabilities and equity balances exist as at the period end.
2. **COMPLETENESS:** All assets, liabilities and equity balances that were supposed to be recorded have been recognized in the financial statements.
3. **CUT-OFF:** Whether all assets and liabilities are reported in the appropriate period.
4. **VALUATION:** Assets, liabilities and equity balances have been valued Appropriately i.e. the amounts at which they are recorded are appropriate. There has been no overstatement or understatement.
5. **RIGHTS & OBLIGATIONS:** Entity has the right to assets i.e. (whether the entity has ownership and legal title to assets) and the liabilities recognized in the financial statements represent all the entity's obligations to repayment as at a given date.
6. **PRESENTATION AND DISCLOSURE:** Whether particular items in the financial statements are properly classified, described and disclosed.

B. ASSERTION FOR PROFIT AND LOSS ITEMS:

1. **OCCURRENCE:** Transactions recognized in the financial statements have occurred and relate to the entity.
2. **COMPLETENESS:** All transactions that were supposed to be recorded have been recognized in the financial statements. Transactions have not been omitted.
3. **CUT-OFF:** Whether all income and expenses are reported in the correct accounting period.
4. **MEASUREMENT:** Transactions have been recorded accurately at their appropriate amounts in the financial statements. There have been no errors while preparing documents or in posting transactions to ledger. The figures and explanations are not misstated.
5. **PRESENTATION AND DISCLOSURE:** Transactions have been classified and presented fairly in the financial statements. Transactions and events are appropriately segregated or disaggregated.

C. ASSERTION FOR DISCLOSUES IN NOTES TO ACCOUNTS:

1. **OCCURRENCE AND EXISTENCE:** Whether all the disclosures shown in the notes to accounts has been occurred or existed during the year.
2. **COMPLETENESS:** Whether all the disclosures as per the applicable financial reporting framework have been given.
3. **VALUATION AND MEASUREMENT:** Whether the disclosures have been shown at proper amount.

TEST YOUR KNOWLEDGE:

1. **If Company X's balance sheet shows building with carrying amount of ₹ 100 lakh, the auditor shall assume only one point that the management has only asserted that the building recognized in the balance sheet exists as at the period-end.**

Answer:

Incorrect. If Company X's balance sheet shows building with carrying amount of ₹ 100 lakh, the auditor shall assume that the management has claimed/ asserted that:

a. The building recognized in the balance sheet exists as at the period end (existence assertion);
b. Company X owns and controls such building (Rights and obligations assertion);
c. The building has been valued accurately in accordance with the measurement principles (Valuation assertion);
d. All buildings owned and controlled by Company X are included within the carrying amount of Rs. 100 lakhs (Completeness assertion).

PROFIT AND LOSS ITEMS

Q.NO.2 WHAT AUDITOR SHALL UNDERSTAND REGARDING SALES OF THE CLIENT AND ALSO EXPLAIN BREIF AUDIT PROCEDURES?

ANSWER:

A. UNDERSTANDING OF SALES: The auditor shall obtain an understanding of the following:

1. Type of services or products the entity provides:
2. Demand for the services or products
3. Major selling product/service
4. Introduction of new products/service line
5. Discontinuance of products/services
6. Major customers
7. Sales term (Credit or cash sales).

B. BRIEF AUDIT PROCEDURES:

1. An auditor needs to obtain an understanding of the management control (internal control) in respect of sales process.
2. An auditor tests the controls the entity has set up for the sales cycle to determine how strong and reliable they are.
3. The auditor selects a random sample of transactions and examines the related customer purchase orders, invoices, and customer statements.
4. Substantive analytical procedures will consist of sales trend analysis, comparison with previous accounting period, category-wise sales analysis.

Q.NO.3 WRITE DETAILED AUDIT PROCEDURES REGARDING SALES OF ENTITY?

ANSWER:

A. OCCURRENCE:

1. Ensure revenue is not overstated by performing following audit procedures:
    a. Check whether a single sales invoice is recorded twice or a cancelled sales invoice could also be recorded.
    b. Test check few invoices with their relevant entries in sales journal.
    c. Obtain confirmation from few customers to ensure genuineness of sales transaction
    d. Whether any fictitious customers and sales have been recorded.
    e. Whether any shipments were done without the consent and agreement of the customer, especially at the year end to inflate the sales figure
    f. Whether unearned revenue recorded as earned. o Whether any substantial uncertainty exists about collectability.
    g. Whether customer obligations are contingent on other actions (financing, resale, etc.).
2. Review sequence of sales invoices
3. Review journal entries for unusual transactions
4. Calculate the ratio of sales return to sales and compare it with previous year and enquire for the reasons for increase/ decrease.
5. Check the sales return with sales invoice, challan, credit note, stock register, etc.

B. COMPLETENESS: All sales made during the period were recorded and there is no understatement or overstatement.

1. Perform cut-off procedures to ensure that revenues are recognised in the current accounting period and sales were not tampered towards the period end.
2. Cut-off errors will usually arise when companies recognise revenue based on the date on which the sales invoices are generated rather than the date on which the risks and rewards are transferred to the buyer.
3. In order to perform a robust sales cut-off test, auditors need to understand and consider the specific cut-off error risk of each engagement.
4. Auditors should also verify the credit notes issued after the accounting period. Sometimes sales team or sales personnel can make fictitious sales before the year-end to meet performance target and cancel out those sales with a post year end credit note.
5. Check whether quantity is appearing in sales register or not and check reconciliation of total sales/goods dispatched as per stock records and financial records and statutory records like GST.
6. Review GST tax and GST returns and ensure that the same are reconciled with revenue reported in the profit and loss account.

C. MEASUREMENT: All sales are accurately measured as per applicable accounting standards and correctly journalized, summarized, and posted.

1. Trace a few transactions from inception to completion. (Examination in depth)
2. If the client is engaged in export sales, then compliance with AS 11 shall be ensured.

3. Auditor must understand client's operations and related GAAP issues e.g. point of sale revenue recognition vs. percentage of completion, wherever applicable.
4. Compare the rate of sales affected with related parties and review them for collectability, as well as whether they were properly authorized and the value of such transactions were reasonable and at arm's length.

D. DISCLOSURE REQUIREMENTS:

1. Ensure whether the following disclosures as required under Schedule III (Part II) to Companies Act, 2013 have been made:
   (A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from—
   a. Sale of products;
   b. Sale of services;
   c. Grants or donations received (relevant in case of section 8 companies only),]
   d. Other operating revenues;

   Less: Excise duty.

   (B) In respect of a finance company, revenue from operations shall include revenue from—
   a. Interest; and
   b. Other financial services.
2. Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.
   a. Whether brokerage and discount on sales other than usual trade discount has been disclosed.
   b. Whether the transactions with related parties are appropriately disclosed in notes to accounts.

Q.NO.4 HOW THE AUDITOR SHOULD VERIFY OTHER INCOME?

ANSWER:

A. VARIOUS KINDS OF OTHER INCOME:

2. **Interest income** on fixed deposits is recognized on a time proportion basis taking into account the amount outstanding and the applicable interest rate.
3. **Dividends** are recognised in the statement of profit and loss only when:
   a. the entity's right to receive payment of the dividend is established;
   b. it is probable that the economic benefits associated with the dividend will flow to the entity; and
   c. the amount of the dividend can be measured reliably.
4. **Gain/(loss) on sale of investment in mutual funds** is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

B. INTEREST INCOME: For verifying interest income on fixed deposits:

1. Obtain a list of fixed deposits opened during the period under audit along with the applicable interest rate and the number of days for which the deposit was outstanding during the period.
2. Verify the arithmetical accuracy of the interest calculation made by the entity by recomputing i.e. multiplying the deposit amount with the applicable rate and number of days during the period under audit.
3. For deposits still outstanding as at the period- end, trace the same to the direct confirmations obtained from the respective bank/ financial institution.
4. Obtain a confirmation of interest income from the bank and verify that the interest income as per bank reconciles to the calculation shared by the entity.
5. Also, obtain a copy of Form 26AS (TDS withholding by the bank/ financial institution) and reconcile the interest reflected therein to the calculation shared by client.

C. DIVIDEND INCOME: Dividends are recognised in the statement of profit and loss only when:

1. the entity's right to receive payment of the dividend is established;
2. it is probable that the economic benefits associated with the dividend will flow to the entity; and
3. the amount of the dividend can be measured reliably.

D. GAIN/(LOSS) ON SALE OF INVESTMENT IN MUTUALFUNDS: It is recorded as other income on transfer of title from the entity and is determined as the difference between the redemption price and carrying value of the investments.

E. DISCLOSURE REQUIREMENTS:

1. Ensure whether the following disclosures as required under Schedule III (Part II) to Companies Act, 2013 have been made:
   Other income
   Other income shall be classified as:
   a. Interest Income (in case of a company other than a finance company);
   b. Dividend Income;
   c. Net gain/loss on sale of investments;
   d. Other non-operating income (net of expenses directly attributable to such income).
2. **Additional disclosure:**
   Undisclosed income: The Company shall give details of any transaction not recorded in the books of accounts that has been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (such as, search or survey or any other relevant provisions of the Income Tax Act, 1961), unless there is immunity for disclosure under any scheme and also shall state whether the previously unrecorded income and related assets have been properly recorded in the books of account during the year.

TEST YOUR KNOWLEDGE:

1. **Dividends are recognised in the statement of profit and loss only when the entity's right to receive payment of the dividend is established.**

Answer:

Incorrect. Dividends are recognised in the statement of profit and loss only when:

a. the entity's right to receive payment of the dividend is established;
b. it is probable that the economic benefits associated with the dividend will flow to the entity; and
c. the amount of the dividend can be measured reliably.

Q.NO.5 WRITE BRIEF AUDIT PROCDURES REGARDING PURCHASES?

ANSWER:

1. An auditor needs to identify the control points over purchases like:
   a. whether segregation of duties exist,
   b. whether competitive quotes are invited,
   c. whether a purchase committee exists who authorises purchase price, issues and authorizes purchase orders,
   d. who checks the quality, quantity and specifications of the goods received and prepares Goods Receipt Note (GRN),
   e. whether a 2 way/ 3-way match process exists (i.e., tally between purchase order, GRN and vendor invoice), how the purchases have been recognised in the system.
2. An auditor tests the controls the entity has set up for the purchase cycle to determine whether they are effective or not. If the controls are effective, the auditor can reduce the extent of substantive testing.
3. The auditor selects a random sample of transactions and examines the related purchase orders, GRN, purchase invoices, inward gate entry register and vendor reconciliation/ statements.
4. Performing substantive audit procedures is must. Substantive analytical procedure will consist of purchase trend analysis, comparison with previous accounting period, category wise purchases.

Q.NO.6 WRITE DETAILED AUDIT PROCEDURES REGARDING PURCHASES OF ENTITY?

ANSWER:

A. OCCURRENCE:

1. Whether any fictitious vendors have been booked.
2. Whether quality inspection of goods was done.
3. Whether a goods receipt note was prepared and signed by an appropriate client personnel.
4. The purchase invoice received should be the "Original" copy (and not photocopy/ carbon copy) against which the entity has recorded the purchase in its books of account.
5. Purchase invoice should be in the name of entity. However, in case of different branches, it should be addressed to the appropriate branch.
6. Input tax component should have been booked in the input tax ledger.

7. In case of purchases made from related parties, the auditor needs to verify if requisite approval from Board of Directors has been obtained and verify that the price charged is arm's length.

B. COMPLETENESS:

1. Perform cut-off test to ensure that purchases are recognised in the correct accounting period.
2. Ensure correct accounting treatment of goods – in – transit as per the agreed terms with the vendor regarding transfer of risk and reward of ownership in goods.
3. Obtain written representation from the management that all the purchases that took place during the year have been properly recorded in the books.
4. Review journal entries for unusual transactions.

C. ANALYTICAL PROCEDURES:

1. **Consumption Analysis:** Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from the management, if any significant variations are found.
2. **Stock Composition Analysis:** Auditor to collect the reports from management for composition of stock i.e., raw materials as a percentage of total stock and compare the same with previous year and ask for reasons from management in case of significant variations
3. **Ratios:** Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years.
4. Auditor should review **quantitative reconciliation** of closing stocks with opening stock, purchases, and consumption.

D. DISCLOSURES: Ensure whether the following disclosures as required under Schedule III (Part II) to Companies Act, 2013 have been made:

- Whether purchases of stock-in-trade have been specifically disclosed.
- Whether changes in inventories of finished goods, stock–in-trade and work- in-progress specifically disclosed. have been
- Whether the transactions with related parties are appropriately disclosed in notes to accounts.

Q.NO.7 HOW THE AUDITOR SHOULD VERIFY EMPLOYEE BENEFIT EXPENSES?

ANSWER:

A. UNDERSTANDING ABOUT THE ORGANISATION AND ITS HIRING, APPRAISAL AND RETIREMENT PROCESS: Auditor needs to obtain a clear understanding about the organisation and its hiring, appraisal, and retirement process in the following manner:

1. An auditor tests the controls the entity has set around employee benefit payment process to determine how effective they are. If they are effective, the auditor can reduce the substantive testing.

2. Common internal controls over the employee benefit payment cycle includes
    a. maintaining of attendance records,
    b. employee master,
    c. authorisation and approval of monthly payroll processing and disbursement,
    d. computation of employee deductions like payroll taxes, accrual of other benefits like gratuity, leave encashment, bonus etc

B. DETAILED AUDIT PROCEDURES:

1. Obtain an understanding of entity's process of capturing employee attendance.
2. Obtain a list of employees as at the period- end along with a monthly movement split between new hires, leavers, and continuing employees.
3. For a sample (selected randomly) of new hires, obtain the appointment letter and verify whether the salary for first month and subsequent months was processed as per the agreed terms.
4. For a sample (selected randomly) of resigned employees, obtain their full and final computation and verify whether all their dues including post-retirement benefits like gratuity, leave encashment have been made.
5. Obtain the monthly salary registers for all 12 months.
6. Verify if accrual/ provision has been made for all employee benefits and obligations like bonus, gratuity, leave encashment, etc.
7. In case provident fund (PF), employee state insurance (ESI) is applicable to the entity
    a. Compile a reasonability by applying the rate to the basic wages and comparing to the amount recorded in books and analyse reasons for variance, if any.
    b. Also, obtain monthly deposit challans to verify if the month-on-month liability was subsequently deposited with the authorities and within the defined timelines.
8. Perform analytical procedures to obtain audit evidence as to overall reasonableness of employee benefit expenses which may include production per employee analysis.

C. DISCLOSURE REQUIREMENTS: Ensure whether the following disclosures as required under Schedule III (Part II) to Companies Act, 2013 have been made:

(a) Employee Benefits Expense [showing separately

- salaries and wages,
- contribution to provident and other funds,
- expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP),
- staff welfare expenses.

TEST YOUR KNOWLEDGE:

1. Employee benefits expenses represent the sum an entity pays to its employees for their labour/ efforts only

Answer:

Incorrect. Employee benefits expenses, commonly called payroll expenses, represent the aggregate sum an entity pays to its employees for their labour/ efforts, as well as associated expenses such as perquisites/ benefits, postemployment benefits like gratuity, superannuation, leave encashment, provident fund contribution etc. as well as towards their hiring, their welfare and training.

Q.NO.8 HOW THE AUDITOR SHOULD VERIFY DEPRECIATION AND AMORTISATION EXPENSES?

ANSWER:

1. Obtain an understanding of entity's process of charging depreciation and amortization.
2. Obtain the fixed asset register maintained by the entity. There is always a risk that an entity could capitalize expense of revenue nature to increase its profit or charge capital expenditure directly in income and expense statement to reduce its profit. To address this risk, the auditor may choose to check the nature of asset from fixed asset register and further, there is always a risk that fake asset has been capitalized in the books and to mitigate this risk, auditors should physically verify the fixed assets, at least the ones that are material in value. Obtain a list of all additions/ deletions along with their proper approval from the authorised person for the same.
3. Select the sample of assets from the Fixed Assets Register, on materiality considerations and verify the rates of depreciation and depreciation calculations.
4. Obtain the list of all the components identified by the management.
5. Check the arithmetical accuracy of records and perform independent calculations.
6. Ensure that the depreciation and amortization has been charged as per the useful lives of PPE and intangible assets.
7. Ensure that residual values have been properly verified as that impacts the computation of depreciation.
8. Ensure Intangible assets like patents, goodwill, copy rights have been properly amortized over the period.
9. Ensure depreciation is charged on the assets from the date when it is ready to use and not from the date of actual usage
10. Ensure depreciation on revalued amount has been properly accounted from revaluation reserve.
11. Check the depreciation computation as per Income tax Act, 1961 for income tax purposes.

DISCLOSURE REQUIREMENTS: Ensure whether the following disclosures as required have been made:

- Accounting policy for depreciation and amortization.
- Useful lives of assets as per Schedule II to the Companies Act, 2013.
- Residual value of assets.
- Depreciation method.

TEST YOUR KNOWLEDGE:

1. Tangible assets are depreciated when the asset is actually put to active use.

Answer:

Incorrect. Depreciation is a fall in value of asset due to obsolescence, usage and effluxion of time, Therefore, depreciation is charged when the asset is ready for use . Active use of asset is not a mandatory criterion for charge of depreciation.

Q.NO.9 HOW THE AUDITOR SHOULD VERIFY OTHER EXPENSES?

ANSWER:

A. **GENERAL POINTS:** While the auditor may choose to analyse the monthly trends for expenses like rent, power and fuel, an auditor generally prefers to vouch for other expenses to verify following attributes:
   1. Whether the expenditure pertained to current period under audit;
   2. Whether the expenditure qualified as a revenue and not capital expenditure;
   3. Whether the expenditure had a valid supporting documents like travel tickets, insurance policy, third party invoice etc.;
   4. Whether the expenditure has been classified under the correct expense head;
   5. Whether the expenditure was authorised as per the delegation of authority;
   6. Whether the expenditure was in relation to the entity's business and not a personal expenditure.

B. **SPECIFIC POINTS:**
   1. **RENT EXPENSE:**
      a. Obtain a month wise expense schedule along with the rent agreements.
      b. Verify if expense has been recorded for all 12 months and whether the rent amount is as per the underlying agreement.
      c. Specific consideration should be given to escalation clause in the agreement to verify if the rent was required to be recorded on a straight-line basis during the period under audit.
      d. Also, verify if the agreement is in the name of the entity and whether the expense pertains to premises used for running business operations of the entity.

   2. **POWER AND FUEL EXPENSE:**
      a. Obtain a month wise expense schedule along with the power bills.
      b. Verify if expense has been recorded for all 12 months.
      c. Also, compile a month wise summary of power units consumed and the applicable rate and check the arithmetical accuracy of the bill raised on monthly basis.
      d. In relation to the units consumed, analyse the monthly power units consumed by linking it to units of finished goods produced and investigate reasons for variance in monthly trends.

   3. **INSURANCE EXPENSE:**
      a. Obtain a summary of insurance policies taken along with their validity period.

b. Verify whether the expense has been correctly classified between prepaid and expense for the period based on number of days.

4. **LEGAL AND PROFESSIONAL EXPENSES:**
   a. Obtain a month-wise and consultant-wise summary.
   b. In case of monthly retainership agreements, verify whether the expenditure for all 12 months has been recorded correctly.
   c. For non- recurring expenses, select a sample and vouch for the attributes discussed above.
   d. The auditor should be cautious while vouching for legal expenses as the same may highlight a dispute for which the entity may not have made any provision and the matter may also not have been discussed/ highlighted to the auditor for his specific consideration.

5. **TRAVEL, REPAIR AND MAINTENANCE, PRINTING AND STATIONERY, MISCELLANEOUS EXPENSES**
   a. The auditor should select a sample and vouch for the attributes discussed above.
   b. Wherever possible, the auditor should try to prepare a summary of expenditure on monthly basis and then analytically compare the trends.

DISCLOSURE REQUIREMENTS REGARDING OTHER EXPENSES:

- Ensure other expense have been classified under:
  - Rent.
  - Insurance.
  - Power and fuel.
  - Repairs and maintenance- Building, Plant and machinery, others.
  - Legal and professional.
  - Printing and stationary.
  - Travel expenses.
  - Miscellaneous expenses.

Q.NO.10 HOW THE AUDITOR SHOULD VERIFY GOODS SENT ON CONSIGNMENT?

ANSWER:

1. Verify the accounts sales submitted by the consignee showing goods sold and inventory of goods in hand.
2. Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment inventory was in the hands of the consignee at the beginning of the year, the same should be considered in the reconciliation.
3. Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the

commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.

4. Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the inventory in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.
5. See that goods in hand with the consignee have been shown separately under the head inventories.

Q.NO.11 HOW THE AUDITOR SHOULD VERIFY FOREIGN TRAVEL EXPENSES?

ANSWER:

1. Examine Travelling Allowance bills submitted by the employees stating the details of tour, details of expenses, etc.
2. Verify that the tour programme was properly authorised by the competent authority.
3. Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill and hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.
4. See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.
5. Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange.
6. For a company the amount of foreign exchange spent is to be disclosed separately in the accounts as per requirement of Schedule III to the Companies Act, 2013 and Accounting Standard 11 "The Effects of Changes in Foreign Exchange Rates".

Q.NO.12 HOW THE AUDITOR SHOULD VERIFY ADVERTISEMENT EXPENSES?

ANSWER:

1. Verify the bills/invoices from advertising agency to ensure that rates charged for different types of advertisement are as per the contract.
2. See that the advertisement relates to client's business.
3. Inspect the receipt issued by the agency.
4. Ascertain the nature of expenditure – revenue or capital expenditure and see that it has been recorded properly.
5. Ascertain the period for which payment is made and see that prepaid amount, if any, is carried to the balance sheet.
6. See that all outstanding advertisement bills have been provided for.

Q.NO.13 HOW THE AUDITOR SHOULD VERIFY PAYMENT OF TAXES?

ANSWER:

1. Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, assessment form, notice of demand and the receipted challan.
2. Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid.
3. The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.
4. Nowadays, electronic payment of taxes is also in trend. Electronic payment of taxes means payment of taxes by way of internet banking facility or credit or debit cards.
5. The entity can make electronic payment of taxes also from the account of any other person. However, the challan for making such payment must clearly indicate the Permanent Account Number (PAN) of the assessee on whose behalf the payment is made. This should be checked by the auditor.
6. It is not necessary for the entity to make payment of taxes from his own account in an authorized bank. While vouching such e-payment, the auditor should cross verify the payments of taxes through the receipted challan along with PAN No /TAN No. etc.

Q.NO.14 HOW THE AUDITOR SHOULD VERIFY SALE OF SCRAP?

ANSWER:

1. Review the internal control as regards generation, storage and disposal of scrap.
2. Check whether the organization is maintaining reasonable record for generation of scrap.
3. Analyse the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.
4. Check the rates at which scrap has been sold and compare the rate with previous year.
5. Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.
6. Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.
7. Make an overall assessment of the value of realization from scrap as to its reasonableness.

Q.NO.15 HOW THE AUDITOR SHOULD VERIFY RECEIPT OF CAPITAL SUBSIDY?

ANSWER:

1. Check the application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.
2. Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.
3. Ensure that the conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.
4. Check relevant entries for receipt of subsidy.

5. Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

BALANCE SHEET ITEMS

Q.NO.16 HOW THE AUDITOR SHOULD VERIFY ISSUE OF SHARES AT DISCOUNT?

ANSWER:

The auditor shall verify the following matters:

1. A company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54 of the Companies Act, 2013.
2. Any share issued by a company at a discounted price shall be void.
3. Notwithstanding anything contained in sub-sections (1) and (2), a company may issue shares at a discount to its creditors when its debt is converted into shares in pursuance of any statutory resolution plan or debt restructuring scheme in accordance with any guidelines or directions or regulations specified by the Reserve Bank of India under the Reserve Bank of India Act, 1934 or the Banking (Regulation) Act, 1949.
4. Where any company fails to comply with the provisions of this section,
   a. such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less, and
   b. the company shall also be liable to refund all monies received with interest at the rate of twelve per cent per annum from the date of issue of such shares to the persons to whom such shares have been issued.

Q.NO.17 HOW THE AUDITOR SHOULD VERIFY ISSUE OF SWEAT EQUITY SHARES?

ANSWER:

A. **MEANING:** Sweat Equity Shares" mean equity shares issued by the company to employees or directors at a
   1. **discount** or
   2. for **consideration other than cash**

   for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

B. **AUDIT PROCEDURES:** The auditor needs to verify that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions have been complied with (as per Section 54):
   1. the issue is authorized by a special resolution passed by the company;

2. the resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;
3. where the equity shares of the company are listed on a recognised stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and
4. if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.
5. The rights, limitations, restrictions and provisions as applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank pari passu with other equity shareholders.

TEST YOUR KNOWLEDGE:

1. **"Sweat Equity Shares" means equity shares issued by the company to employees or directors at a premium or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.**

Answer:

Incorrect. "Sweat Equity Shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.

Q.NO.18 HOW THE AUDITOR SHOULD VERIFY RESERVES AND SURPLUS?

ANSWER:

A. **MEANING:** Reserves are the amounts appropriated out of profits that are not intended
   1. to meet any liability,
   2. contingency,
   3. commitment or
   4. diminution in the value of assets known to exist as at the date of the Balance Sheet.

B. **TYPES OF RESERVES:**
   1. **Revenue reserves** represent profits that are available for distribution to shareholders.
   2. **Capital Reserves** represents a reserve which does not include any amount regarded as free for distribution. They can be utilized only for certain limited purposes.

C. **AUDIT PROCEDURES:**
   1. Trace and tally the opening balance of reserves and surplus to the previous year audited financial statements.
   2. For addition/utilization in current year, in case of Profit and Loss balance:

a. Trace the movement to surplus/ deficit as per the Statement of profit and loss for the year under audit.
b. The movement should be traced in the Statement of Changes in Equity.

3. Verify the resolution passed by the board of directors regarding the recommendation of dividend, resolution passed by shareholders declaring the dividend.
4. **Securities Premium:**
   a. It needs to be confirmed that the company has issued shares in excess of the nominal value of the shares and for the same, the auditor should obtain and verify the resolution passed by the board of directors.
   b. Securities premium can be utilized only for specified purposes:
      i. towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;
      ii. in writing off the preliminary expenses of the Company;
      iii. in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
      iv. in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
      v. for the purchase of its own shares or other securities under Section 68. (Buyback)

D. DISCLOSURE REQUIREMENTS: Ensure whether the following disclosure requirements of Schedule III (Part I) to Companies Act, 2013 have been complied with:

(i) Reserves and Surplus shall be classified as:
   a. Capital Reserves;
   b. Capital Redemption Reserve;
   c. Securities Premium 8 [Omitted];
   d. Debenture Redemption Reserve;
   e. Revaluation Reserve;
   f. Share Options Outstanding Account;
   g. Other Reserves– (specify the nature and purpose of each reserve and the amount in respect thereof);
   h. Surplus i.e., balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/ from reserves, etc.; (Additions and deductions since last balance sheet to be shown under each of the specified heads);

(ii) A reserve specifically represented by earmarked investments shall be termed as a "fund".

(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head "Surplus". Similarly, the balance of "Reserves and Surplus", after adjusting negative balance of surplus, if any, shall be shown under the head "Reserves and Surplus" even if the resulting figure is in the negative.

TEST YOUR KNOWLEDGE:

1. **A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised.**

Answer:

Correct. A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But the amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 52 and 55 respectively of the Companies Act, 2013.

2. **ABC Ltd. has issued shares for cash at a premium of Rs 450, that is, at amount in excess of the nominal value of the shares which is Rs 10 for cash. Section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account. Advise the means in which the amount in the account can be applied.**

Answer: Write Point C(4)

Q.NO.19 HOW THE AUDITOR SHOULD VERIFY BORROWINGS?

ANSWER:

A. EXISTENCE:

1. Review board minutes for approval of new lending agreements to check the approval of loans.
2. Verify the details of the loan recorded with loan agreement.
3. Agree details of leases and hire purchase creditors recorded to underlying contracts/agreements.
4. In case of Debentures, examine trust deed for terms and dates of redemption, borrowing restrictions and compliance with covenants.
5. When debt is retired, ensure that a discharge is received on assets securing the debt.
6. Obtain Written Representation that all the liabilities which have been recorded represent a valid claim by the lenders.

B. COMPLETENESS:

1. Obtain a schedule of short term and long-term borrowings showing beginning and ending balances and borrowings taken and repaid during the year.
2. Trace the closing balances as per the schedules to the general ledger.
3. Review subsequent transactions after the end of the reporting period to determine if there are unrecorded liabilities at yearend and the transactions are recorded in the correct period.
4. Direct confirmation procedures:
   a. Send the confirmation request to the lenders.
   b. Send reminders for non-replies.
   c. Compare the balances are per the confirmations obtained to the books of the accounts.
   d. Ask for reconciliations, if there are any differences

C. VALUATION:

1. Determine that the accounting policies and methods of recording debt are appropriate and applied consistently.
2. Agree loan balance and loan payables to the loan agreement.
3. Recompute the interest and discount or premium on redemption, if any.
4. Check computation of the amortization of premium or discount, if any.
5. For foreign currency loans, check the closing exchange rate(s) used and verify the computations of the restatements of foreign currency balances outstanding at year end. (As per AS 11).
6. Read the provisions in loan and debt agreements and perform the following: (a) Test that the entity is in compliance with loan covenants and other significant provisions of the agreements. (b) If there are any provisions with which the entity is not in compliance, determine whether the debt should be classified as current. If enforcement of the provisions has been waived by the lender in case of breach of any covenant by the entity, obtain confirmation of the waiver from the lender.
7. Examine the due dates on loans for proper classification between long-term and short-term.
8. Where instalments of long-term loans falling due within the next twelve months have been disclosed in the financial statements (e.g. in parentheses or by way of a footnote), verify the correctness of the amount of such instalments.
9. Examine the debt agreements for any restrictive covenants. Review restrictive covenant and provisions relating to default and ensure disclosure thereof in the financial statements.
10. Examine the important terms in the loan agreements and the documents, if any, evidencing charge in respect of such loans and advances. Examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with including disclosure of the same to the extent mandated by statute and considered necessary for proper understanding of the user of financial statements.
11. In case the value of the security falls below the amount of the loan outstanding, examine whether the loan is classified as secured only to the extent of the market value of the security.
12. Examine the hire purchase agreements for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts, and also examine the security aspect.
13. He should carefully review the borrowings from related parties and ensure compliance with AS 18 or IND AS 24.
14. Verify whether liabilities towards bank in respect of bills discounted, bills negotiated, cheques discounted, etc. are correctly reflected and disclosed in the financial statements.
15. The auditor should also verify that the amount borrowed is within the borrowing powers of the company as laid down by the Articles of Association and Memorandum of Association.
16. Verify that the company has not contravened the restrictions laid down by Section 180 (related to Restrictions on Powers of Board) of the Companies Act, in respect of the borrowings of the company. Also, check compliance of Sections 185 (related to Loans to Directors, etc.) and 186 (related to Loan and Investment by company) of the Companies Act, 2013.

17. Examine the purpose for which the amount is borrowed and ensure that the amount is not used against the interest of the company.
18. Where the entity has accepted deposits, examine whether the directives issued by the Reserve Bank of India or other appropriate authority have been complied with.

D. DISCLOSURE REQUIREMENTS: Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 are made for each amount disclosed under each of the following headings:

Long- Term Borrowings

(i) Long-term borrowings shall be classified as:
   (a) Bonds/debentures;
   (b) Term loans:
      (A) from banks.
      (B) from other parties.
   (c) Deferred payment liabilities;
   (d) Deposits;
   (e) Loans and advances from related parties;
   (f) Long term maturities of finance lease obligations;
   (g) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.

(v) Particulars of any redeemed bonds/debentures which the company has power to reissue shall be disclosed.

(vi) Terms of repayment of term loans and other loans shall be stated.

(vii) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

Other Long term Liabilities:

Other Long term Liabilities shall be classified as:

(a) Trade Payables;

(b) Others

Short Term Borrowings

Short-term borrowings shall be classified as:

a. Loans repayable on demand;

(A) from banks.
(B) from other parties.

b. Loans and advances from related parties;
c. Deposits;
d. Other loans and advances (specify nature).

- Borrowings shall further be sub classified as <u>secured and unsecured.</u> Nature of security shall be specified separately in each case.
- Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.
- Period and amount of default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.
- Current maturities of Long term borrowings shall be disclosed separately. Where the company has not used the borrowings from banks and financial institutions for the specific purpose for which it was taken at the balance sheet date, the company shall disclose the details of where they have been used.

E. ADDITIONAL DISCLOSURE REQUIREMENTS REGARDING BORROWINGS:

1. Where the Company has borrowings from banks or financial institutions on the basis of security of current assets, it shall disclose the following:-
   a. whether quarterly returns or statements of current assets filed by the Company with banks or financial institutions are in agreement with the books of accounts.
   b. if not, summary of reconciliation and reasons of material discrepancies, if any to be adequately disclosed.
2. **Wilful Defaulter:** Where a company is a declared wilful defaulter by any bank or financial institution or other lender, following details shall be given:
   a. Date of declaration as wilful defaulter,
   b. Details of defaults (amount and nature of defaults)
3. **Registration of charges or satisfaction with Registrar of Companies:** Where any charges or satisfaction yet to be registered with Registrar of Companies beyond the statutory period, details and reasons thereof shall be disclosed.
4. **Utilisation of Borrowed funds and share premium:**
   A. Where company has advanced or loaned or invested funds (either borrowed funds or share premium or any other sources or kind of funds) to any other person(s) or entity(ies), including foreign entities (Intermediaries) with the understanding (whether recorded in writing or otherwise) that the Intermediary shall:
      (i) directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company (Ultimate Beneficiaries) or
      (ii) provide any guarantee, security or the like to or on behalf of the Ultimate Beneficiaries; the company shall disclose the following:-
         - date and amount of fund advanced or loaned or invested in Intermediaries with complete details of each Intermediary.

- date and amount of fund further advanced or loaned or invested by such Intermediaries to other intermediaries or Ultimate Beneficiaries alongwith complete details of the ultimate beneficiaries.
- date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries
- declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003).;

B. Where a company has received any fund from any person(s) or entity(ies), including foreign entities (Funding Party) with the understanding (whether recorded in writing or otherwise) that the company shall:

(i) directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party (Ultimate Beneficiaries) or

(ii) provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries, the company shall disclose the following:-

- date and amount of fund received from Funding parties with complete details of each Funding party.
- date and amount of fund further advanced or loaned or invested other intermediaries or Ultimate Beneficiaries alongwith complete details of the other intermediaries' or ultimate beneficiaries.
- date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries
- declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003).

Q.NO.20 HOW THE AUDITOR SHOULD VERIFY TRADE RECEIVABLES?

ANSWER:

A. COMPLIANCE PROCEDURES: It is important to carry out Test of Controls for checking the effectiveness of internal control over sales as a part of the debtors' audit procedure. Following points need to be considered in respect of trade receivables:

1. Only bona fide(genuine) sales lead to trade receivables.
2. All such sales are made to approved customers.
3. All such sales are properly recorded in the books of accounts.
4. Once recorded, the debtors can be settled only by receipt of cash or on the authority of a responsible official.

5. Segregation of duties at every point in sales transaction. (accounting for debtors, collecting the payments, sending reminders etc.)
6. Debtors are collected on time.
7. In case debtors are not collected in time, sending reminders and taking legal actions if required.
8. Balances are regularly reviewed.
9. A proper system of follow up exists and if necessary, adequate provision for bad debt should be made by preparing adequate ageing schedule of the debtors.

B. SUBSTANTIVE AUDIT PROCEDURE:

1. **EXISTENCE:**
   a. Check whether there are controls in place to ensure that invoices cannot be recorded more than once.
   b. Ask for a period-end accounts receivable ageing report and trace the balance as per the report to the general ledger.
   c. Check whether realization is recorded invoice-wise or not. If not, check that money received from debtors is adjusted chronologically invoice-wise and on FIFO basis i.e. previous bill is adjusted first.
   d. If any large balance is due for a long time, auditor should ask for reasons and justification for the same.
   e. **Direct confirmation procedure:**
      i. A significant and important audit activity is to contact customers directly and ask them to confirm the amounts.
      ii. The trade receivables may be requested to confirm the balances either
         - as at the date of the balance sheet, or
         - as at any other selected date which is reasonably close to the date of the balance sheet.
      iii. The auditor can send either a positive confirmation request or a negative confirmation request.
      iv. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain trade receivables. In such cases, the auditor should consider whether there are valid grounds for such a request.
      v. If any discrepancies are revealed by the confirmations should be investigated and reconciled.
      vi. Where no reply is received, the auditor should perform alternate procedures regarding the balances. This could include:
         - Agreeing the balance to cash received subsequently;
         - Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these revenue transactions actually occurred. (Examination in depth for those balances)

2. **COMPLETENESS:**

a. The auditor needs to satisfy himself of the cut-offs. Without a cut-off, sales could be understated or overstated, hence there is a need to perform the following cut off procedure:
    i. For the invoices issued during the last few days (last 5 days of the reporting year) i.e., cut-off date and which have been included in the debtors; check that the goods should have been dispatched and not lying with the Company;
    ii. Ensure that all goods dispatched prior to the period/ year-end have been invoiced and included in debtors on a test check basis;
    iii. Ensure that no goods dispatched after the year- end have been invoiced and included in debtors for the period under audit.

b. Test invoices listed in receivable report. Select few invoices from the accounts receivable ageing report and compare them to supporting documentation.

c. Match invoices to shipping/ dispatch log. Match invoice dates to the shipment dates for those items in the shipping/ dispatch log, to see if sales are being recorded in the correct accounting period.

d. Review the receiving log to see if the Company has recorded an inordinately large amount of customer returns after the audit period, which would suggest that the Company may have shipped more goods near the end of the audit period than what the customers had authorized to inflate the profits of the company.

e. Review the process of giving discounts/ incentives and check whether the same were given as per the Company's policy/ general industry trends.

3. **VALUATION:**
    a. Review the process followed by the Company to derive an allowance for doubtful accounts.
    b. Obtain the ageing report of accounts receivable, split between not currently due, 30 days old, 30-60 days old, 60- 180 days old, 180- 365 days old and more than 365 days old.
    c. Also, obtain the list of debtors under litigation and compare with previous year.
    d. Prepare schedule of movements of bad debts – Provision accounts and debts written off and compare the proportion of bad debt expense to sales for the current year in comparison to prior years to see if the current expense appears reasonable.
    e. Check that write-offs of the receivable balances have been approved by an appropriate authority i.e., the Board of Directors in case of a company.

C. DISCLOSURE REQUIREMENTS:

1. Check that the restatement of foreign currency trade receivables has been done properly in accordance with AS 11.
2. Proper disclosure of Related Party Transactions regarding receivables have been made as per AS 18 or IND AS 24.
3. Ensure that the transactions with parties covered under Section 189 (Register of Contracts or Arrangements in which Directors are interested) of the Companies Act, 2013 are reported properly in Companies Auditors' Report Order (CARO),2020.

4. Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 are made for each amount disclosed under the heading "Trade Receivables"
   a. **<u>Trade Receivables ageing schedule:</u>**

					(Amount in ₹)	
Particulars	**Outstanding for following periods from due date of payment#**					
	Less than 6 months	**6 months - 1 year**	**1-2 years**	**2-3 years**	**More than 3 years**	**Total**
(i) Undisputed Trade receivables – considered good						
(ii) Undisputed Trade Receivables – considered doubtful						
(iii) Disputed Trade Receivables considered good						
(iv) Disputed Trade Receivables considered doubtful						

   b. Trade receivables shall be sub-classified as:
      - Secured, considered good;
      - Unsecured, considered good;
      - Doubtful.
   c. Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.
   d. Debts due by
      - directors or other officers of the company or any of them either severally or jointly with any other person or
      - firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q.NO.21 HOW THE AUDITOR SHOULD VERIFY CASH AND CASH EQUIVALENTS?

<u>ANSWER:</u>

1. Cash should be <u>physically verified</u> by the auditor as on the balance sheet date.
2. The cash should be checked not only on the last day of the year, but also checked again sometime after the close of the year <u>without giving notice of the auditor's</u> visit either to the entity or to his staff. (Surprise check)

3. If there are more than one cash balances, e.g., when there is a cashier, a petty cashier, a branch cashier and, in addition, there are imprest balances with employees, all of them should be checked simultaneously, as far as practicable.
4. It is desirable for the cashier to be present while cash is being counted and he should be made to sign the statement.
5. If it is not possible for the auditor to physically verify the cash balance as on balance sheet date, the auditor shall ask the management to deposit the cash with the bank as on balance sheet date, if possible.
6. The auditor needs to obtain bank reconciliation statements (BRS) for all bank accounts maintained by the entity as at the reporting period and additionally need to understand the client's process and periodicity of making the BRS.
7. The auditor should ensure that BRS is signed by the authorized personnel so that he is able to assign responsibility in case of any errors. The following points shall be kept in mind:
   a. Tallying the balance as per bank book to the bank confirmation/ statement.
   b. Checking of all material reconciling items included under *cheques issued but presented for payment*. In addition, the auditor should request for bank statements of subsequent period and should verify if the cheques issued have subsequently been cleared by the bank.
   c. Checking of all material reconciling items included under *cheques deposited but not credited by bank* and verifying if the balances were credited by bank subsequently by tallying to the bank statement of subsequent period.
   d. Checking of all material reconciling items included under amounts or charges debited/ credited by bank but not accounted for by requesting for bank statements.
8. **Direct Confirmation Procedure:**
   a. A significant and important audit activity is to contact banks/ financial institutions directly and ask them to confirm the amounts.
   b. The Company should be asked to investigate and reconcile the discrepancies, if any, including seeking written explanations/ clarifications from the banks/ financial institutions on any unresolved queries.
   c. The auditor should emphasize for confirmation of 100% of bank account balances.

9. **Disclosure requirements:** Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made:
   Cash and cash equivalents
   (i) Cash and cash equivalents shall be classified as:
   (a) Balances with banks;
   (b) Cheques, drafts on hand;
   (c) Cash on hand;
   (d) Others (specify nature)
   (ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.
   (iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months' maturity shall be disclosed separately.

Q.NO.22 HOW THE AUDITOR SHOULD VERIFY THE INVENTORIES?

ANSWER:

A. EXISTENCE:

1. Review entity's plan for performing inventory count.
2. Ensure that consigned goods have been segregated.
3. Auditor should participate in the inventory count with the management.
4. Test counts of inventory by auditor should include:
   i. observing employees are adhering
   j. to the agreed plan.
   k. assuring that there is appropriate supervision on the count procedure.
   l. assuring that all items are properly tagged.
   m. observing that proper amounts are shown on tags.
   n. determining that tags and summary sheets are controlled and reconciled.
   o. reconciliation of test counts with tags and summary sheets and discrepancies noted, if any, are summarized and agreed with client personnel.
   p. staying alert at all times and specifically being cautious about empty boxes, etc. and obsolete items.
   q. performing cut-off testing by documenting last 5-10 receiving reports and shipping documents as of the period end.
   r. ensuring exclusion of third party stock and damaged or obsolete stock.
   s. ensuring the accounting of all stock sheets.
   t. investigating any significant differences between the physical stock take and the stock records as per books. Further, the auditor should ask the entity's personnel to sign all stock count sheets and also agree the variances observed, if any, to avoid any conflicts.
5. When the entity uses periodic system for inventory count, it should be undertaken at the end of the period. If the entity uses perpetual system with proper and adequate records, inventory may be counted at interim dates.
6. Confirm or investigate any inventory of the entity lying with a third party (specifically relevant for cases where the entity gets job work done in its process of production).

B. COMPLETENESS:

1. Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).
   a. Compute inventory turnover ratio (COGS/ average inventory)
   b. Perform vertical analysis (inventory/ total assets)
   c. Compare budgetary expectations vis-à-vis actuals

2. Examine non-financial information related to inventory, such as weights and other measurements.
3. Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end.
4. With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions.
5. Verify the clerical and arithmetical accuracy of inventory listings.
6. Reconcile physical inventory amounts with perpetual records.
7. Reconcile physical counts with general
8. Perform analytical procedures (comparison tests with industry averages, budgets, prior years, trend analysis, etc.).
   a. Compute inventory turnover ratio (COGS/ average inventory)
   b. Perform vertical analysis (inventory/ total assets) —
9. Compare budgetary expectations vis-à-vis actuals
10. Examine non-financial information related to inventory, such as weights and other measurements.
11. Perform purchase and sales cut-off tests. Trace shipping documents (bills of lading and receiving reports, warehouse records, and inventory records) to accounting records immediately before and after year-end.
12. With respect to tagged inventory, perform tests for omitted transactions and tests for invalid transactions.
13. Verify the clerical and arithmetical accuracy of inventory listings.
14. Reconcile physical inventory amounts with perpetual records.
15. Reconcile physical counts with general ledger control totals.
16. Reconcile inventories which belong to client but are held with third parties like transporters, warehouses, port authorities etc.
17. Goods received on consignment basis have been properly segregated from other items of inventory.

C. RIGHTS:

1. Vouch recorded purchases to underlying documentation (purchase requisition, purchase order, receiving report, vendor invoice and cancelled cheque or payment file).
2. Evaluate the consigned goods.
3. Examine client correspondence, sales and receivables records, purchase documents.
4. Determine existence of collateral agreements.
5. Review consignment agreements.
6. Review material purchase commitment agreements.
7. Examine invoices for evidence of ownership i.e. the invoices shall be in the name of the client.
8. Auditor shall obtain confirmation for significant items of inventory.

9. For instances of inventory held by third party, the auditor should insist on obtaining declaration from the third party on its business letterhead and signed by an authorized personnel of that third party confirming that the items of inventory belong to the entity and are being held by such third party on behalf of and for the benefit of the entity under audit.

D. VALUATION:

1. Depending on how the business operates, the management may value inventory using First-in first-out (FIFO) or weighted average basis. Consider the reasonableness of the method adopted.
2. **For Raw materials and consumables**
   a. Ascertain what elements of cost are included e.g. carriage inward, non refundable duties etc.
   b. If standard costs are used, enquire into basis of standards; how these are compared with actual costs and how variances are analyzed and accounted for/ treated in accounting records.
   c. Test check cost prices used with purchase invoices received in the month(s) prior to counting.
   d. Follow up valuation of all damaged or obsolete inventories noted during observance of physical counting with a view to establishing a realistic net realizable value.
3. **For Work in progress**
   a. Ascertain how the various stages of production/ value additions are measured and in case estimates are made, understand the basis for such estimates.
   b. Ascertain what elements of cost are included. If overheads are included, ascertain the basis on which they are included and compare such basis with the available costing and financial data/ information maintained by the entity.
   c. Ensure that material costs exclude any abnormal wastage factors.
4. **For Finished goods and goods for resale**
   a. Enquire as to what costs are included, how these have been established and ensure that the overheads included have been determined based on normal costs and appear reasonable in relation to the information disclosed in the financial statements.
   b. Ensure that inventories are valued at net realizable value if they are likely to fetch a value lower than their cost. For any such items, also verify if the relevant semi/ partly processed inventories (work in progress) and raw materials have also been written down.
5. Follow up for items that are obsolete, damaged, slow moving and ascertain the possible realizable value of such items. Carefully examine the valuation of obsolete and damaged inventory. For the purpose, request the client to provide inventory ageing split and follow up for any inventories which at time of observance of physical counting were noted as being damaged or obsolete.
   a. Compare recorded costs with replacement costs.
   b. Examine vendor price lists to determine if recorded cost is less than current prices.
   c. Calculate inventory turnover ratio. Obsolete inventory may be revealed if ratio is significantly lower.

d. In manufacturing environments, test overhead allocation rates and ensure that only direct labor, direct material and overhead have been included.
e. Verify the correct application of lower-of cost-or-net realizable value principles.

E. DISCLOSURE REQUIREMENTS:

Ensure whether the following disclosures as required under Schedule III (Part I) to the Companies Act, 2013 have been made:

1. Whether inventory has been classified as:
   a. Raw materials
   b. Work-in-progress
   c. Finished goods
   d. Stock-in-trade (goods acquired for trading)
   e. Stores and spares
   f. Loose tools
   g. Others (specify nature).
2. Whether goods-in-transit have been disclosed separately under each sub-head of inventories.
3. Mode of valuation shall be stated.

Q.NO.23 HOW THE AUDITOR SHOULD VERIFY PROPERTY, PLANT AND EQUIPMENT?

ANSWER:

A. PROPERTY, PLANT AND EQUIPMENT:

1. **Recognition Criteria for PPE:** The cost of an item of PPE should be recognised as an asset if, and only if:
   a. It is probable that future economic benefits associated with the item will flow to the enterprise, and
   b. The cost of the item can be measured reliably.

   An enterprise evaluates under this recognition principle all its costs on property, plant and equipment at the time they are incurred. These costs include costs incurred:

   a. initially to acquire or construct an item of property, plant and equipment; and
   b. subsequently to add to, replace part of, or service it.
2. **Measurement at Recognition:** An item of property, plant and equipment that qualifies for recognition as an asset should be measured at its cost.
3. **Elements of Cost:** The cost of an item of property, plant and equipment comprises:
   a. its purchase price, including import duties and non –refundable purchase taxes, after deducting trade discounts and rebates.
   b. any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
   c. the initial estimate of the costs of dismantling, removing the item and restoring the site on which it is located, referred to as decommissioning, restoration and similar liabilities',

the obligation for which an enterprise incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

4. **Examples of directly attributable costs are:**
   a. costs of employee benefits (as defined in AS 15, Employee Benefits) arising directly from the construction or acquisition of the item of property, plant and equipment;
   b. costs of site preparation;
   c. initial delivery and handling costs;
   d. installation and assembly costs;
   e. costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
   f. professional fees.
5. **Examples of costs that are not costs of an item of property, plant and equipment are:**
   a. costs of opening a new facility or business, such as, inauguration costs;
   b. costs of introducing a new product or service (including costs of advertising and promotional activities);
   c. costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
   d. administration and other general overhead costs.

   The expenses have to be analysed and properly classified. The revenue expense like regular repairs on assets have to be charged off to the Statement of Profit and Loss.

B. EXISTENCE:

1. Review entity's plan for performing physical verification of PPE i.e., whether performed by own staff or by a third party and the policy regarding periodicity i.e., whether physical verification shall be done on annual basis or once in two years/ three years.
2. Obtain PPE physical verification report backed by the working sheets from the entity and perform the following procedures:
   a. Assess if all items of PPE are properly tagged and carry identification marks.
   b. Reconciliation of items of PPE as physically verified with the fixed asset register maintained by the entity.
   c. Verify the discrepancies noted, based on physical verification undertaken and the manner in which such discrepancies have been dealt with in the entity's books and financial statements.

C. COMPLETENESS:

1. Verify the movement in the PPE schedule (asset class-wise like building, Plant & machinery etc.) compiled by the management i.e., Opening balances + Additions during the period – Deletions during the period = Closing balances.
2. Check the arithmetical accuracy of the movement in PPE schedule.
3. For all material additions, verify if such expenditure meets the criteria of PPE as per AS 10.

4. Ensure that the entity is not recognizing costs of the day-to-day servicing in the carrying amount of an item of property, plant and equipment.
5. Verify whether the PPE additions have been approved by authorized personnel.
6. Verify whether proper internal processes and procedures like inviting competitive quotations/ floating tenders etc. were followed prior to finalising the vendor for procuring items of PPE.
7. In relation to deletion of PPE:
   a. understand from the management the reason and rationale for deletion
   b. Obtain the management approval and discard note authoring disposal of the asset from its active use.
   c. Verify the process followed for sale of discarded PPE, for example - inviting competitive quotes, tender.
   d. Verify that the management has accurately recorded the deletion of PPE.

D. RIGHTS AND OBLIGATIONS:

1. The auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity.
2. For all additions to land and building in particular, the auditor should check the conveyance deed/ sale deed to verify whether the entity is the legal and valid owner or not.
3. The auditor should insist and verify the original title deeds for all immoveable properties.
4. In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders.
5. In addition, the auditor should also verify the register of charges, available with the entity to assess that any charge has been created against the PPE.

E. DISCLOSURE REQUIREMENTS:

Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made under the heading "Property, Plant and Equipment":

- Classification shall be given as:
  (a) Land;
  (b) Buildings;
  (c) Plant and Equipment;
  (d) Furniture and Fixtures;
  (e) Vehicles;
  (f) Office equipment;
  (g) Others (specify nature).
- Assets under lease shall be separately specified under each class of asset.
- A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business

combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment) and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

- Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

Additional disclosures:

- **Title deeds of Immovable Property not held in name of the Company:** The company shall provide the details of all the immovable property (other than properties where the Company is the lessee and the lease agreements are duly executed in favour of the lessee) whose title deeds are not held in the name of the company in format given below and where such immovable property is jointly held with others, details are required to be given to the extent of the company's share.

Relevant line item in the Balance sheet	Description of item of property	Gross carrying value	Title deeds held in the name of	Whether title deed holder is a promoter, director or relative# of promoter*/director or employee of promoter/director	Property held since which date	Reason for not being held in the name of the company**
PPE -	Land Building	-	-	-	-	**also indicate if in dispute
Investment property	Land Building					
PPE retired from active use and held for disposal-	Land Building					
Others						

- Where the Company has revalued its Property, Plant and Equipment, the company shall disclose as to whether the revaluation is based on the valuation by a registered valuer as defined under rule 2 of the Companies (Registered Valuers and Valuation) Rules, 2017.
- **Capital-Work-in Progress (CWIP)**
  - For Capital-work-in progress, following ageing schedule shall be given:
    CWIP ageing schedule

(Amount in ₹)					
	Amount in CWIP for a period of				Total*
CWIP	Less than 1 year	1-2 years	2-3 years	More than 3 years	
Projects in Progress					
Projects temporarily suspended					

- For capital-work-in progress, whose completion is overdue or has exceeded its cost compared to its original plan, following CWIP completion schedule shall be given

(Amount in ₹)				
	To be completed in			
CWIP	Less than 1 year	1-2 years	2-3 years	More than 3 years
Project 1				
Project 2				

TEST YOUR KNOWLEDGE:

1. **The auditor A of ABC & Co.- firm of auditors is conducting the audit of XYZ Ltd and while performing testing of additions wanted to verify that all PPE (Property Pland and Equipment) purchase invoices are in the name of the entity he is auditing. For all additions to land, building in particular, the auditor desires to have concrete evidence about ownership. The auditor is worried about whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Advise the auditor.**

Answer: Write Point C from above answer

Q.NO.24 HOW THE AUDITOR SHOULD VERIFY INTANGIBLE ASSETS?

ANSWER:

A. EXISTENCE:

1. Since an intangible asset is an identifiable non-monetary asset, without physical substance, for establishing the existence of such assets, the auditor should verify
   a. whether such intangible asset is in active use in the production or supply of goods or services,
   b. for rental to others or
   c. for administrative purposes.

Example: for verifying the existence of software, the auditor should verify whether such software is in active use by the entity and for the purpose, the auditor should verify the sale of related services/ goods during the period under audit, in which such software has been used.

2. In case any intangible asset is not in active use, deletion should have been recorded in the books of account post approvals by the entity's management and amortization charge should have ceased beyond the date of deletion.

B. COMPLETENESS:

1. Verify the movement in the intangible assets schedule (asset class wise like software, designs/ drawings, goodwill etc.) compiled by the management i.e., Opening balances + Additions – Deletions = Closing balances.
2. Check the arithmetical accuracy of the movement in intangible assets schedule.
3. For all material additions, verify whether such expenditure meets the criterion for recognition of an intangible asset as per AS 26.
4. Ensure that no cost related to research (or from the research phase of an internal project) gets recognized as intangible asset.
5. Check the certificate or report or other similar documentation maintained by the entity to verify the date of use of the intangible.
6. Verify whether the additions (acquisitions) have been approved by appropriate entity's personnel.
7. Verify whether proper internal processes and procedures like inviting competitive quotations/ proper tenders etc. were followed.
8. In relation to deletion of PPE:
   a. understand from the management the reason and rationale for deletion
   b. Obtain the management approval and discard note authoring disposal of the asset from its active use.
   c. Verify that the management has accurately recorded the deletion of Intangible assets.

C. RIGHTS AND OBLIGATIONS: The auditor while performing testing of additions should also verify that all expense invoices/ purchase contracts are in the name of the entity that entitles legal title of ownership to the entity.

D. VALUATION: The auditor should:

1. Verify that the entity has charged amortization on all intangible assets;
2. Verify that the amortization method used reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
3. The auditor should also verify whether the management has done an impairment assessment to determine whether an intangible asset is impaired.

E. DISCLOSURE REQUIREMENTS:

Ensure that the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made under the heading "Intangible Assets":

(i) Classification shall be given as:

a. Goodwill;
b. Brands /trademarks;
c. Computer software;
d. Mastheads and publishing titles;
e. Mining rights;
f. Copyrights, and patents and other intellectual property rights, services and operating rights;
g. Recipes, formulae, models, designs and prototypes;
h. Licences and franchise;
i. Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of intangible assets) and other adjustments and the related depreciation and impairment losses or reversals shall be disclosed separately.

(iii) Where sums have been written-off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

Additional disclosures:

➢ **Intangible assets under development:**

a. For Intangible assets under development, following ageing schedule shall be given: Intangible assets under development ageing schedule

					(Amount in ₹)
	Amount in CWIP for a period of				Total*
Intangible asset under development	Less than 1 year	1-2 years	2-3 years	More than 3 years	
Projects in Progress					
Projects temporarily suspended					

b. For Intangible assets under development, whose completion is overdue or has exceeded its cost compared to its original plan, following Intangible assets under development completion schedule shall be given:

(Amount in ₹)				
	To be completed in			
Intangible asset under development	Less than 1 year	1-2 years	2-3 years	More than 3 years
Project 1				
Project 2				

Q.NO.25 HOW THE AUDITOR SHOULD VERIFY PROVISIONS AND CONTINGENT LIABILITIES?

ANSWER:

1. Obtain a list of all provisions and compare them with balances in the ledger.
2. Inspect the underlying agreements like agreement with customers to assess warranty commitments, any legal and other claims on the entity i.e., litigations.
3. Obtain the underlying working and the basis for each of the provisions made, from the management and verify whether the same is complete and accurate.
4. Wherever required, obtain expert's report, calculation and underlying working for the provision amount, example for warranty involving complex calculations, some entities get that valued through an actuary.
5. In case of any matter under legal dispute, the auditor should request for assessment made by a legal expert.
6. As per SA 500 – "Audit Evidence", issued by ICAI, when using the work of a management's expert, audit evidence that the auditor should obtain include:
   a. Evaluate the competence, capabilities and objectivity of that expert:
   b. Whether the expert is employed by the entity or is an outside party.
   c. Whether the expert is independent in respect of the entity.
   d. Auditor's previous experience of the work of the expert.
   e. Knowledge of the expert, his qualification, membership of a professional body or industry association, etc.
7. **DISCLOSURE REQUIREMENTS:** Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made:
   - **Long-term provisions:** The amounts shall be classified as:
     (a) Provision for employee benefits;
     (b) Others (specify nature).
   - **Short-term provisions:** The amounts shall be classified as:
     (a) Provision for employee benefits.
     (b) Others (specify nature).
   - **Contingent liabilities and commitments (to the extent not provided for)**
     - Contingent liabilities shall be classified as:
       - Claims against the company not acknowledged as debt;
       - Guarantees;

- Other money for which the company is contingently liable.
- Commitments shall be classified as:
  - Estimated amount of contracts remaining to be executed on capital account and not provided for;
  - Uncalled liability on shares and other investments partly paid;
  - Other commitments (specify nature)

➢ **In terms of AS 29, "Provisions, Contingent Liabilities and Contingent Assets", ensure whether following disclosures have been made:**

- For each class of provision, an enterprise shall disclose:
  - the carrying amount at the beginning and end of the period;
  - additional provisions made in the period, including increases to existing provisions;
  - amounts used (i.e. incurred and charged against the provision) during the period;
  - unused amounts reversed during the period.
- An enterprise shall disclose the following for each class of provision:
  - a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
  - an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events; and
  - the amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.
- Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:
  - an estimate of its financial effect
  - an indication of the uncertainties relating to any outflow; and
  - the possibility of any reimbursement.

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

Q.NO.26 HOW THE AUDITOR SHOULD VERIFY TRADE PAYABLES AND OTHER CURRENT LIABILITIES?

ANSWER:

B. EXISTENCE:

1. Check whether there are controls in place to ensure that any purchase/ expense invoice does not get recorded more than once and payable balances are automatically recorded in the general ledger at the time of recording of expense.
2. Obtain the accounts payable ageing report and trace its balances to the general ledger. If there are any differences, investigate reconciling items. Journal entries specially for large amounts should be carefully examined.
3. **Direct confirmation procedure**

a. The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain trade payables. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.
b. The trade creditors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be decided by the auditor in consultation with the Company.
c. The form of requesting confirmation from the trade creditor may be either (a) the form with balance as at year end wherein the trade creditor is requested to respond whether or not he is in agreement with the balance shown, or (b) the form with no balance wherein the trade creditor is requested to respond the balance as per his records. The use of the form with no balance is preferable.
d. Where no reply is received, the auditor should perform additional testing regarding the balances. This testing could include:
    - Testing of subsequent payments in respect of the trade payables to whom confirmations were rolled out but no replies received;
    - Agreeing the details of the respective balance to the underlying vendor invoices;
    - Preparing a detailed analysis of the balance, ensuring it consists of identifiable transactions and confirming that these purchases/ expense transactions actually occurred. (examination in depth)
e. If there are any related party payables, review whether they were properly authorized and the value of such transactions were reasonable and at arm's length.
f. Review a trend line of purchases/ expenses and accounts payable, or a comparison of the two over time, to see if there are any unusual trends. Make inquiries about reasons for changes in trends from the management.

C. COMPLETENESS:

1. The auditor needs to perform the following cut off procedures: o For the last 5 invoices received/ recorded at the end of the reporting date (cut off date) and which have been included in the trade payables; the goods should have been received/ risk and rewards of ownership in goods should have been transferred in favour of the entity; o All goods received prior to the period/ year- end should have been booked in the form of purchases and included in trade creditors.
2. Test purchases/ expenses on a sample basis selecting the same from the accounts payable ledgers and checking their supporting documents to ensure that the purchases were recorded at the correct amounts and correct dates.
3. Match purchase invoice dates to the gate entry (inward) dates to check whether the purchases are being recorded in the correct accounting period. This can include an examination of purchase/ expense invoices received subsequent to the period being audited, to see if they should have been included in the period under audit.

4. Review subsequent expense vouchers. Review all material expense vouchers recorded post the balance sheet date to see if they relate to transactions from within the audit period.
5. For advance received from customers/ revenue received in advance, obtain the customer wise listing along with its ageing and the nature. Enquire from the entity's management if there has been any dispute with the customer and if there is any additional liability to be recorded. For all such advances, the auditor should verify the underlying documentation based on which the entity had received the advance.
6. In relation to statutory dues liability like withholding tax (TDS) payable, GST payable, luxury tax payable, professional tax payable, PF and ESI payable etc., prepare a reasonability with respect to sales/ purchases/ employee benefit expenses. Example- GST liability for last month may be calculated by applying the applicable rate to the sales made and in case of any variance with the GST liability recorded by the entity, reasons for variance should be requested from client and in case found satisfactory, the same should be maintained as part of audit documentation.

D. VALUATION:

1. Review the process followed by the Company to identify if any old creditor balance/ liability needs to be written back. This will include a consistency comparison determination of whether the method is appropriate for the underlying business environment.
2. Obtain the ageing of payable balances, and the list of vendors with whom the Company has disputes and any claims from customers, under litigation and compare with previous year.
3. Check that write backs in the liability balances assessed as no longer payable have been approved by an appropriate and authorised member of senior management, for example – CEO/MD.
4. Check that the restatement of foreign currency trade payables has been done properly in accordance with AS 11.

E. DISCLOSURE REQUIREMENTS:

Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made:

- Whether the Company has disclosed the following details relating to micro and small enterprises in the notes:
    - the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year.
    - the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year.
    - the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006.
    - the amount of interest accrued and remaining unpaid at the end of each accounting year.

- the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

➢ **Trade payables due for payment:** The following ageing schedule shall be given for Trade payables due for payment:-

- Trade Payables ageing schedule:

(Amount in ₹)

Particulars	Outstanding for following periods from due date of payment#				
	Less than 1 year	1-2 years	2-3 years	More than 3 years	Total
(i) MSME					
(ii) Others					
(iii) Disputed Dues- MSME					
(iv) Disputed Dues Others					

➢ Other Current Liabilities

- Whether the amount disclosed under other current liabilities are classified as below: o Current maturities of finance lease obligations
  - Interest accrued but not due on borrowings
  - Interest accrued and due on borrowings
  - Income received in advance
  - Unpaid Dividends
  - Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital.
  - The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed.
  - It shall also be disclosed whether the company has sufficient authorised capital to cover the share capital amount resulting from allotment of shares out of such share application money.
  - Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable, i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under "Other current liabilities";
  - Unpaid matured deposits/debentures and interest accrued thereon

- Unpaid matured debentures and interest accrued thereon
- Others (specify nature).

Q.NO.27 HOW THE AUDITOR SHOULD VERIFY LOANS AND ADVANCES AND OTHER CURRENT ASSETS?

ANSWER:

A. EXISTENCE:

For establishing existence of loans and advances, direct confirmation procedures, similar to those performed for Accounts receivable balances are should be performed with the only difference that while performing circularisation of direct confirmations, in addition to the principal amount, interest receivable, if any, as per the agreed terms between the parties, may also be included as part of the balance to be confirmed.

B. COMPLETENESS:

1. Obtain a list of all advances and other current assets and compare them with balances in the ledger.
2. Verify loan agreements and acknowledgements of parties in respect of outstanding loans. A loan or an advance, if material, is granted only if authorised by the Memorandum and Articles of Association in the case of Company. In addition, the auditor should confirm that the loans advanced were within the competence of persons who had advanced the same, directors in the case of a Company, partners in the case of a firm and trustees in the case of a trust.
3. Inspect the minutes of meeting of board of directors to confirm if all material loans and advances were approved by the board of directors.
4. Verify that the loan has been acknowledged by the party and in addition, inspect if any security has been deposited against due repayment of the loan. Ascertain if loans are being recovered regularly as per agreed instalments.
5. If there are any related party loans and advances, review whether they were properly authorized and the value of such transactions were reasonable and at arm's length.
6. In relation to balances with statutory authorities like GST input credit, prepare a reasonability with respect to purchases/ expenses by applying the applicable rate to the purchases/ expenses and in case of any variance with the asset recorded by the entity, reasons for variance should be requested from the entity.
7. Further, the auditor should obtain statutory returns filed with the authorities like GST returns and verify whether the amount recorded as per books of account tallies with the claim made with the authorities.

C. VALUATION:

1. Assess the allowance for doubtful accounts. Review the process followed by the Company to derive an allowance for doubtful accounts. This will include a consistency comparison with the method used in the last year, and a determination of whether the method is appropriate for the underlying business environment.

2. Obtain the ageing report of loans and advances. Also, obtain the list of loans and advances under litigation and compare with previous year.
3. Scrutinize the analysis and identify those loans and advances that appear doubtful; discuss with management about the reasons as to why these loans/ advances are not included in the provision for doubtful balances.
4. Assess bad loans/ advances write-offs. Prepare schedule of movements on Bad loans/ advances – Provision Accounts and loans/ advances written off.
5. Check that write-offs or other reductions in the recoverable balances have been approved by the authorsied and appropriate senior authority
6. Check that the restatement of foreign currency loans and advances/ other current assets has been done properly in accordance with AS 11

D. DISCLOSURE REQUIREMENTS: Ensure whether the following disclosures as required under Schedule III (Part I) to Companies Act, 2013 have been made:

- **Long Term loans & Advances**
  - (i) Long-term loans and advances shall be classified as:
    - Capital Advances;
    - Loans and advances to related parties (giving details thereof);
    - Other loans and advances (specify nature).
  - (ii) The above shall also be separately sub classified as:
    (a) Secured, considered good;
    (b) Unsecured, considered good;
    (c) Doubtful.
  - (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
  - (iv) Loans and advances due by
    - Directors or other officers of the company or any of them either severally or jointly with any other persons or
    - amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

- **Short Term loans & Advances:**
  - (i) Short-term loans and advances shall be classified as:
    (a) Loans and advances to related parties (giving details thereof);
    (b) Others (specify nature).
  - (ii) The above shall also be sub-classified as:
    (a) Secured, considered good;
    (b) Unsecured, considered good;
    (c) Doubtful.
  - (iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.
  - (iv) Loans and advances due by

- directors or other officers of the company or any of them either severally or jointly with any other person or
- amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

➢ **Additional disclosures:**

Following disclosures shall be made where Loans or Advances in the nature of loans are granted to promoters, Directors, KMPs and the related parties (as defined under Companies Act, 2013,) either severally or jointly with any other person, that are:

(a) repayable on demand or

(b) without specifying any terms or period of repayment

Type of Borrower	Amount of loan or advance in the nature of loan outstanding	Percentage to the total Loans and Advances in the nature of loans
Promoters		
Directors		
KMPs		
Related Parties		

OTHER DISCLOSURE REQUIREMENTS:

A. CORPORATE SOCIAL RESPONSIBILITY (CSR): Where the company covered under section 135 of the companies act, the following shall be disclosed with regard to CSR activities:-

1. amount required to be spent by the company during the year,
2. amount of expenditure incurred,
3. shortfall at the end of the year,
4. total of previous years shortfall,
5. reason for shortfall,
6. nature of CSR activities,
7. details of related party transactions, e.g., contribution to a trust controlled by the company in relation to CSR expenditure as per relevant Accounting Standard,
8. where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year should be shown separately.

B. DETAILS OF BENAMI PROPERTY HELD: Where any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and the rules made thereunder, the company shall disclose the following:-

1. Details of such property, including year of acquisition,
2. Amount thereof,

3. Details of Beneficiaries,
4. If property is in the books, then reference to the item in the Balance Sheet,
5. If property is not in the books, then the fact shall be stated with reasons,
6. Where there are proceedings against the company under this law as an abetter of the transaction or as the transferor then the details shall be provided,
7. Nature of proceedings, status of same and company's view on same.

C. RELATIONSHIP WITH STRUCK OFF COMPANIES: Where the company has any transactions with companies struck off under section 248 of the Companies Act, 2013 or section 560 of Companies Act, 1956, the Company shall disclose the following details:

1. Name of struck off Company
2. Nature of transactions with struck off Company
   a. Investments in securities
   b. Receivables
   c. Payables
   d. Shares held by stuck off company
   e. Other outstanding balances (to be specified)
3. Balance outstanding
4. Relationship with the Struck off company, if any, to be disclosed

D. FOLLOWING RATIOS TO BE DISCLOSED:

a. Current Ratio,
b. Debt-Equity Ratio,
c. Debt Service Coverage Ratio,
d. Return on Equity Ratio,
e. Inventory turnover ratio,
f. Trade Receivables turnover ratio,
g. Trade payables turnover ratio,
h. Net capital turnover ratio,
i. Net profit ratio,
j. Return on Capital employed,
k. Return on investment.

Note: The company shall explain the items included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

E. DETAILS OF CRYPTO CURRENCY OR VIRTUAL CURRENCY: Where the Company has traded or invested in Crypto currency or Virtual Currency during the financial year, the following shall be disclosed:-

a. profit or loss on transactions involving Crypto currency or Virtual Currency
b. amount of currency held as at the reporting date, deposits or advances from any person for the purpose of trading or investing in Crypto Currency/ virtual currency.

F. DISCLOSURE REGARDING SHARE CALPITAL:

Ensure whether the following disclosure requirements of Schedule III (Part I) to Companies Act, 2013 have been complied with: Share Capital For each class of share capital (different classes of preference shares to be treated separately):

a. the number and amount of shares authorised;
b. the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;
c. par value per share;
d. a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;
e. the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;
f. shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;
g. shares in the company held by each shareholder holding more than 5 per cent. shares specifying the number of shares held;
h. shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;
i. for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:
   (B) Aggregate number and class of shares allotted as fully paid-up pursuant to contract(s) without payment being received in cash.
   (C) Aggregate number and class of shares allotted as fully paid-up by way of bonus shares.
   (D) Aggregate number and class of shares bought back.
j. terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date;
k. calls unpaid (showing aggregate value of calls unpaid by Directors and officers);
l. forfeited shares (amount originally paid-up).
m. A company shall disclose Shareholding of Promoters as below:

Shares held by promoters at the end of the year				% Change during the year***
S. No.	Promoter Name	No. of shares	% of total shares**	
Total				

G. UTILISATION OF BORROWED FUNDS AND SHARE PREMIUM:

(A) Where company has advanced or loaned or invested funds (either borrowed funds or share premium or any other sources or kind of funds) to any other person(s) or entity(ies), including foreign entities (Intermediaries) with the understanding (whether recorded in writing or otherwise) that the Intermediary shall

(i) directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company (Ultimate Beneficiaries) or

(ii) provide any guarantee, security or the like to or on behalf of the Ultimate Beneficiaries; the company shall disclose the following:-

- date and amount of fund advanced or loaned or invested in Intermediaries with complete details of each Intermediary.
- date and amount of fund further advanced or loaned or invested by such Intermediaries to other intermediaries or Ultimate Beneficiaries along with complete details of the ultimate beneficiaries.
- date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries
- declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003);

(B) Where a company has received any fund from any person(s) or entity(ies), including foreign entities (Funding Party) with the understanding (whether recorded in writing or otherwise) that the company shall

(i) directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the Funding Party (Ultimate Beneficiaries) or

(ii) provide any guarantee, security or the like on behalf of the Ultimate Beneficiaries, the company shall disclose the following:-

(I) date and amount of fund received from Funding parties with complete details of each Funding party.

(II) date and amount of fund further advanced or loaned or invested other intermediaries or Ultimate Beneficiaries along with complete details of the other intermediaries or ultimate beneficiaries.

(III) date and amount of guarantee, security or the like provided to or on behalf of the Ultimate Beneficiaries

(IV) declaration that relevant provisions of the Foreign Exchange Management Act, 1999 (42 of 1999) and Companies Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering act, 2002 (15 of 2003).]

TEST YOUR UNDERSTANDING

1. **A company is engaged in manufacturing of fabrics from yarn purchased from different suppliers. Occasionally, it also manufactures fabrics tailor made in accordance with requirements of certain mills from yarn received from these mills. The company raises bill of its labour charges only on mills for converting yarn into fabrics. The auditor of company tries to ensure that stocks of the company as at year end do not include stocks pertaining to these mills. Which assertion auditor tries to verify in above situation? How he can ensure that?**

Answer:

The auditor is trying to verify assertion relating to "Rights and Obligations". He is verifying that the company owns or controls the inventory recorded in the financial statements. Any inventory held by the company on behalf of another entity has not been recognized as part of inventory of the company.

This can be achieved by verifying stock records pertaining to goods received from mills and sent back to mills after carrying out necessary operations. Besides, agreements with such mills may also be verified.

2. **A company has availed cash credit facility of ₹ 2 crore (O/s balance ₹ 2 crore as at year end) from a bank for meeting its working capital requirements against security of stocks and debtors and guaranteed by directors of the company. Discuss, how the above cash credit facility, would be classified and disclosed in financial statements of company.**

Answer:

It shall be shown under the head "Borrowings" and classified as Short-term secured borrowings specifying nature of security. The above said outstanding amount shall be further sub-classified under heading "Loans repayable on Demand" from Banks. As per requirements of Schedule III of Companies Act, 2013, where loans have been guaranteed by directors or others, aggregate amount of such loans under each head shall be disclosed.

3. **Various ratios of current year and preceding year are disclosed in financial statements of a company in accordance with requirements of Schedule III of Companies Act, 2013. Discuss requirements of law in this regard (Do not list out names of ratios)**

Answer:

A company has to disclose various ratios in its financial statements in accordance with requirements of Schedule III of Companies Act, 2013. The company shall also explain the terms included in numerator and denominator for computing the above ratios. Further explanation shall be provided for any change in the ratio by more than 25% as compared to the preceding year.

4. **An auditor of a company is focusing upon revenues of a company. In this regard, besides performing usual detailed checking of sales, he wants to perform substantive analytical procedures in respect of sales. Discuss how he can perform such procedures.**

Answer:

Substantive analytical procedures in respect of sales will consist of sales trend analysis, comparison with previous accounting period, category-wise sales analysis, any analysis the auditor may find relevant and most important of all, building a sales expectation and comparing that with the client's sales records. The auditor will need to know the sales prices of the products or services over the year, monthly average sales price per product or service, discount policy.

5. **While verifying depreciation charged to statement of profit and loss account of a company, it is noticed by auditor that one new machinery was purchased and installed in month of April. The necessary trials were carried out and machinery was ready for use in April itself. However, owing to lack of orders in the market, the said machinery was put into actual operation from 1st October. The company has, accordingly, provided depreciation in its books on this machinery w.e.f. 1st October. Is above recording of deprecation by company proper in its books?**

Answer:

Depreciation of an asset begins when it is available for use i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by the management. Depreciation on asset is charged on asset from the date when it is ready for use and not from date of actual usage. Hence, recording of depreciation by company w.e.f. 1st October is not proper.

14. GOVERNMENT AUDIT

A. DEFINITION OF GOVERNMENT AUDIT:

Government Audit is the

- objective, systematic, professional and independent examination of financial, administrative and other operations of a public entity ,
- made subsequently to their execution
- for the purpose of evaluating and verifying them,
- presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future action by the responsible officials and in the case of examination of financial statements,
- expressing the appropriate professional opinion regarding the fairness of the presentation.

The objectives of government auditing are as follows:

1. **Accounting for Public Funds:** It serves as a mechanism or process for public accounting of government funds.
2. **Appraisal of Govt. Policies:** It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them.
3. **Corrective Actions:** Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.
4. **Administrative Accountability:** The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration

B. AUDIT OF GOVERNMENT EXPENDITURE: The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are:

1. **Audit against rules and orders:** The expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the audit against 'rules and orders'.
2. **Audit of Sanctions:** that there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the audit of sanctions.
3. **Audit against provision of funds:** There is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as audit against provision of funds.
4. **Propriety Audit:** That the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as propriety audit.

5. **Performance Audit:** The various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the performance audit.

C. PROPRIETY AUDIT:

1. **Objective:** According to 'Propriety audit' the auditors try to bring out cases of improper, avoidable, or ineffective expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.

   It is hard to frame any precise rules for regulating the course of audit against propriety. It depends common sense and straight logic of the auditors.

2. **General Principles:** However, some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:
   a. The expenditure should not be prima facie more than the occasion demands.
   b. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.
   c. No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
   d. Public moneys should not be utilised for the benefit of a particular person or section of the community unless:
      i. the amount of expenditure involved is insignificant; or
      ii. a claim for the amount could be enforced in a Court of law; or
      iii. the expenditure is in pursuance of a recognised policy or custom; and
      iv. the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

D. PERFORMANCE AUDIT:

1. **Meaning:** is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness.
2. It includes the following:
   a. **Efficiency audit:** It looks into whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them, i.e., the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner.

b. **Economy audit:** It looks into whether government have acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy.
c. **Effectiveness audit:** It is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives.

Note: The procedure for conducting performance audit covers identification of topic, preliminary study, planning, execution of audit, and reporting.

E. AUDIT OF GOVERNMENT RECEIPTS:

The audit of government receipts involves the following procedures

1. **Proper Assessment and Realisation:** Whether all revenues or other debts due to government have been correctly assessed, realised and credited to government account by the designated authorities;
2. **Adequate rules and regulations:** Whether adequate regulations and procedures have been framed by the department/agency concerned to secure an effective check on assessment, collection and proper allocation of cases;
3. **Internal controls:** Whether adequate checks are imposed to ensure the prompt detection and investigation of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or wilful omission or negligence to levy or collect taxes or to issue refunds.
4. **Actual implementation:** Whether such regulations and internal control procedures are actually being carried out.
5. **Review of judicial decisions:** A review of the judicial decisions taken by tax authorities is done to judge the effectiveness of the assessment procedure.

F. AUDIT OF GOVERNMENT STORES AND INVENTORIES:

Audit of the accounts of stores and inventories has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted :-

1. To ascertain whether the regulations governing purchase, receipt and issue, custody, sale and inventory taking of stores are well devised and properly carried out.
2. To bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control.
3. To verify that the purchases are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority.
4. To ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units.
5. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit.

6. To check the accounts of receipts, issues and balances regarding accuracy, correctness and reasonableness of balances in inventories with particular reference to the specified norms for level of consumption of inventory holding.
7. Any excess or idle inventory is specifically mentioned in the report and periodical verification of inventory is also conducted to ensure their existence.
8. The valuation of the inventories is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, inventory taking or other causes is carried out.

G. AUDIT OF COMMERCIAL ACCOUNTS:

1. Public enterprises are required to maintain commercial accounts and are generally classified under three categories—
   a. **Departmental enterprises** engaged in commercial and trading operations, which are subject to the same laws, financial and other regulations as other government departments and agencies;
   b. **Statutory bodies,** corporations, created by specific statutes mostly financed by government in the form of loans, grants, etc.; and
   c. **Government companies** set up under the Companies Act, 2013

2. The audit of above entities shall be done as follows:
   a. **Audit of departmental concerns:** It is undertaken in the same manner as any department of government where commercial accounts are kept.
   b. **Audit of statutory bodies or corporations:** It depends on the nature and type of the statute governing the bodies or corporations.
   c. **Audit of Government companies:** It conducted by their own auditors as per the provisions of the Companies Act, 2013.

H. APPOINTMENT, REMOVAL AND TENURE OF COMPTROLLER AND AUDITOR GENERAL OF INDIA:

1. The Constitution guarantees the independence of the C&AG of India by prescribing that he shall be appointed by the President of India and shall not be removed from office except on the ground of proven mis-behaviour or incapacity.
2. As in the case of a Judge of the Supreme Court, he can be removed only when each House of Parliament decides to do so by a majority of not less than 2/3rd of the members of the House present and voting.
3. The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 passed in pursuance of the provisions of the Constitution lays down a fixed tenure of the office prescribing that he shall be paid a salary which is equal to the salary of the Judge of the Supreme Court thereby further strengthening his independence.

I. POWERS OF CAG:

The C&AG Act gives the following powers to the C&AG in connection with the performance of his duties-

1. To inspect any office of accounts under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.
2. To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.
3. To put such questions or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which is his duty to prepare.
4. In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transactions as he may determine.

J. DUTIES OF CAG: The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 defines functions and powers in detail. The relevant provisions are discussed hereunder:

1. **Compile and submit Accounts of Union and States:**
   a. The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State.
   b. The compiled accounts shall be submitted to:
      i. Union Government accounts to the President
      ii. State Government accounts to the Governor of a State
      iii. Union territory accounts to Administrator of the Union Territory.
   c. The CAG is responsible providing all the assistance in the preparation of the annual financial statements as they may reasonably ask for.

2. **General Provisions Relating to Audit:** It shall be the duty of the Comptroller and Auditor General—
   a. To audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and whether the expenditure conforms to the authority which governs it;
   b. To audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;
   c. To audit and report on all trading, manufacturing and profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

3. **Audit of Receipts and Expenditure:** Where anybody or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the

case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

Meaning of Substantially financed: Where the grant or loan to a body or authority from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly in a financial year is **not less than ₹ 25 lakhs** and the amount of such grant or loan is **not less than 75% of the total expenditure** of that body or authority, such body or authority shall be deemed, for this purpose to be substantially financed by such grants or loans as the case may be.

4. **Audit of Grants or Loans:** Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given.

5. **Audit of Receipts of Union or States:** It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly.

6. **Audit of Accounts of Stores and Inventory:** The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

7. **Audit of Government Companies and Corporations:** The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013.

K. ROLE OF CAG IN AUDIT OF GOVERNMENT COMPANIES:

1. **Power to appoint auditors:**
   a. CAG has been given the power to appoint First Auditor or Subsequent Auditor and direct such auditor the manner in which the accounts of the Government company are required to be audited
   b. The auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India.

2. **Power to conduct Supplementary Audit & comment thereupon:** The Comptroller and Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to:

a. Conduct a supplementary audit under section 143(6)(a), of the financial statement of the company by such person or persons as he may authorize in this behalf;
b. Require information or additional information to be furnished to any person or persons, so authorised.
c. The CAG will comment on the supplementary audit report.
d. The supplementary audit report along with CAG comments shall be sent by the company to every person entitled to copies of audited financial statements under sub-section of section 136 i.e., every member of the company, to every trustee for the debenture-holder of any debentures issued by the company etc.

Note: Supplementary audit is an extension of statutory audit done u/s 139 of companies act, 2013.

3. **Power to conduct Test audit:** The CAG has been given the power to order for test audit, if the circumstances warrant the same.
   a. Section 19A of the Comptroller and Auditor- General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.
   b. Test audit shall be done by CAG himself.

TEST YOUR KNOWLEDGE

1. Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the Finance Minister may on the advice of the C&AG prescribe. Correct/Incorrect.

Answer:

Incorrect. Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C&AG prescribe.

2. According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Correct/Incorrect.

Answer:

Correct. According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations.

3. The Comptroller and Auditor General does not have any authority to audit the accounts of stores and inventory kept in any office or department of the Union or of a State. Correct/Incorrect.

Answer:

Incorrect- The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

4. Explain in detail the duties of Comptroller and Auditor General of India.

Answer: Write Point J

5. Define Government Audit & explain its objectives.

Answer: Write Point A

TEST YOUR UNDERSTANDING

1. **It is the duty of Comptroller and Auditor General of India to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it. Discuss, in above context, what is understood by "Consolidated Fund of India"? What is its importance?**

Answer:

Consolidated Fund of India consists of all the revenue received from direct and indirect taxes, all the loans taken by the Govt. of India and all the amount of repayment of loans received by the Govt. of India. Its importance lies in the fact that all government expenditure is incurred from this fund. No moneys out of the Consolidated Fund of India shall be appropriated except in accordance with law and for the purposes and in the manner provided in the Constitution.

15. AUDIT OF VARIOUS ENTITIES

Q.NO.1 WRITE ABOUT AUDIT OF A SOLE TRADER.

ANSWER:

1. A sole trader is under no legal obligation to have his accounts audited.
2. However, many such individuals get their financial statement audited due to regulatory requirements, such as inventory brokers or on a specific instruction of the bank for approval of loans, etc.
3. Auditors of sole- proprietary concern shall be appointed by the sole proprietor himself.
4. As such, sole proprietor can determine the scope of the audit as well as the conditions under which it will be carried out.
5. it is desirable that the contract of appointment of auditor in such a case should be in writing. Also, that it should clearly define the scope of the work which the auditor is expected to carry out. This helps to prevent misunderstanding.
6. Advantages of Audit of sole trader – Refer the **Question no 6 from chapter 2**

Q.NO.2 WRITE ABOUT AUDIT OF A PARTNERSHIP FIRM.

ANSWER:

A. APPOINTMENT OF AUDITOR:

1. The auditor to a firm is usually appointed by the partners either on the basis of a decision taken by them or to comply with a condition in the partnership agreement.
2. His remuneration is also fixed by the partners.
3. It is important that the letter of appointment should clearly state the nature and scope of audit which is to be carried out and particulars of limitations, if any, under which he would have to function.

B. MATTERS TO BE CONSIDERED BEFORE STARTING AUDIT: Before starting the audit, he should examine the partnership agreement and note the provisions therein as regards the following matters:

1. The name and style under which the business shall be conducted.
2. The duration of the partnership, if any, that has been agreed upon.
3. The amount of capital that shall be contributed by each partner.
4. The period at the end of which the accounts of the partnership will be closed.
5. The proportions in which the profit shall be divided among the partners or losses shall have to be contributed by them.
6. The provisions as regards maintenance of books of account and the matters which must be taken into account for determining the profits of the firm available for division among the partners.
7. Borrowing capacity of the partnership.

8. The rate at which interest will be allowed on the capitals and loans provided by partners and the rate at which it will be charged on their drawings and current accounts.
9. Whether any salaries are payable to the partners or withdrawals are permitted against shares of profits and, if so, to what extent?
10. Duties of the partners as regards the management of business of the firm; also, the partners who shall act as managing partners.
11. Who shall operate the bank account of the firm? How will the surplus funds of the partnership be invested?

C. MATTERS WHICH SHOULD BE SPECIALLY CONSIDERED IN THE AUDIT OF ACCOUNTS OF A PARTNERSHIP:

1. **Letter of Appointment:** Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, especially the limitation, if any, under which the auditor shall have to function.
2. **Partnership Documents:** Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans; purchase of assets, extraordinary contracts entered into and other such matters as are not of a routine nature.
3. **Objects of Partnership:** Verifying that the business in which the partnership is engaged is authorised by the partnership agreement.
4. **Books of Account:** Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.
5. **Mutual Interest :** Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.
6. **Provision for Taxes:** Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.
7. **Division of Profits:** Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

D. ADVANTAGES OF AUDIT OF PARTNERSHIP FIRM: Refer the **Question no 6 from chapter 2**

Q.NO.3 WRITE ABOUT AUDIT OF A LIMITED LIABILITY PARTNERSHIP.

ANSWER:

A. MAINTENANCE OF BOOKS OF ACCOUNTS: An LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. LLP's are required to maintain books of accounts which shall contain

1. Particulars of all sums of money received and expended by the LLP and the matters in respect of which the receipt and expenditure takes place,
2. A record of the assets and liabilities of the LLP,

3. Statements of costs of goods purchased, inventories, work-in-progress, finished goods and costs of goods sold,
4. Any other particulars which the partners may decide.

B. AUDIT OF THE ACCOUNTS OF AN LLP: The accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009.

Such rules, inter-alia, provides that any LLP, whose **turnover does not exceed**, in any financial year, **forty lakh rupees**, or whose **contribution does not exceed twenty five lakh rupees**, is not required to get its accounts audited.
However, if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rule.

C. APPOINTMENT OF AUDITOR: The auditor may be appointed by the designated partners of the LLP –

1. At any time for the first financial year but <u>before the end of first financial year</u> (First auditor)
2. At least <u>thirty days prior to the end of each financial year</u>(other than the first financial year)
3. To fill the <u>causal vacancy</u> in the office of auditor (by any reason),

The partners may appoint the auditors if the designated partners have failed to appoint them.

D. AUDITOR'S DUTY REGARDING AUDIT OF LLP:

1. **Engagement Letter:** The auditor should get definite instructions in writing as to the work to be performed by him.
2. **Minutes Book:** If partners maintain minute book he shall refer it for any resolution passed regarding the accounts
3. **LLP Agreement:** The auditor should read the LLP agreement & note the following provisions
   a. Nature of the business of the LLP.
   b. Amount of capital contributed by each partner.
   c. Interest – in respect of additional capital contributed.
   d. Duration of partnership.
   e. Drawings allowed to the partners.
   f. Salaries, commission etc payable to partners.
   g. Borrowing powers of the LLP
   h. Rights & duties of partners.
   i. Method of settlement of accounts between partners at the time of admission, retirement, admission etc.
   j. Any loans advanced by the partners.
   k. Profit sharing ratio
4. **Reporting:** The auditor should mention
   a. Whether the records of the firm appear to be correct & reliable.
   b. Whether he was able to obtain all information & explanation necessary for his work.

c. Whether any restriction was imposed upon him

E. **ADVANTAGES OF AUDIT OF LLP:** Refer the **Question no 6 from chapter 2**

F. **RETURNS TO BE MAINTAINED AND FILED BY AN LLP:**

1. Every LLP would be required to file **annual return in Form 11** with ROC **within 60 days of closer of financial year**. The annual return will be available for public inspection on payment of prescribed fees to Registrar.
2. Every LLP is also required to submit **Statement of Account and Solvency in Form 8** which shall be filed within a period of **thirty days from the end of six months the financial year** to which the Statement of Account and Solvency relates.

G. **POWERS OF THE REGISTRAR:**

1. Registrar would have power to obtain such information which he may consider necessary for the purposes of carrying out the provisions of the Act, from any designated partner, partner or employee of the LLP.
2. He would also have power to summon any designated partner, partner or employee of any LLP before him for any such purpose, in case the information has not been furnished to him or in case the Registrar is not satisfied with the information furnished to him.

H. **DOCUMENTS AVAILABLE FOR PUBLIC INSPECTION:** The following documents/information will be available for inspection by any person:-

1. Incorporation document
2. Names of partners and changes, if any, made therein
3. Statement of Account and Solvency
4. Annual Return

The fees for such inspection of an LLP is **₹ 50/-** and fees for **certified copy or extract of any document u/s 36 shall ₹ 5/- per page.**

Q.NO.4 WRITE ABOUT AUDIT OF A LOCAL BODIES.

ANSWER:

A. **BACKGROUND:**

1. **Meaning:** A Municipality can be defined as a unit of local self-government in an urban area. By the term 'local self-government' is ordinarily understood the administration of a locality
   a. a village, a town, a city or any other area smaller than a state
   b. by a body representing the local inhabitants, possessing fairly large autonomy,
   c. raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.
2. **Municipal government in India covers five distinct types of urban local authorities-**
   a. the municipal corporations,

b. the municipal councils,
c. the notified area committees,
d. the town area committees and
e. the cantonment committees.

3. **Municipal authorities are endowed with specific local functions covering:**
   a. regulatory,
   b. maintenance and
   c. development activities.
4. **Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads:**
   a. general administration and revenue collection,
   b. public health,
   c. public safety,
   d. education,
   e. public works, and
   f. others such as interest payments, etc
5. **Sources of revenue for a local body:**
   a. Property taxes and octroi are the major sources of revenue of the municipal authorities.
   b. Other municipal taxes are profession tax, non-mechanised vehicles tax, taxes on advertisements, taxes on animals and boats, tolls, show-tax, etc.
   c. Local bodies may receive different types of grants from the state administration as well. Broadly, the revenue grants are of three categories:
      a. **General purpose grants:** These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.
      b. **Specific purpose grants:** These grants which are tied to the provision of certain services or performance of certain tasks.
      c. **Statutory and compensatory grants:** These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

B. FINANCIAL ADMINISTRATION:

1. **Budgetary Procedure:**
   a. Budgetary procedures in local bodies ensures financial accountability and control of expenditure.
   b. The main objective is to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the legislature or council.
   c. Budget preparation is usually the occasion for determining the levels of taxation and rates and the ceilings on expenditure.
2. **Expenditure Control:**
   a. At the state and central government level is conditioned by the fact that there is a clear demarcation between the legislature and executive.

b. The integration of legislation and executive powers in the municipal council makes it difficult the existence of an independent finance officer responsible to the municipal council or its executive committee.
c. This leaves the system of external audit by state government as the only instrument of controlling municipal expenditure.

3. **Accounting System:**
    a. Municipal accounting and budget format have been criticised as neither simple nor comprehensible, sometimes providing inadequate information.
    b. Both these situations do not support to a proper system of management information.

C. OBJECTIVE OF AUDIT OF LOCAL BODIES: The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. However , the municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit. The important objectives of audit are:

1. Reporting on the fairness of the content and presentation of financial statements;
2. Reporting upon the strengths and weaknesses of systems of financial control;
3. Reporting on the adherence to legal and/or administrative requirements;
4. Reporting upon whether value is being fully received on money spent; and
5. Detection and prevention of error, fraud and misuse of resources.

D. AUDIT PROGRAMME FOR LOCAL BODIES:

1. **Appointment:** The Local Fund Audit Wing of the State Govt. is generally in charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g., Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So, the auditor should ensure his appointment.
2. **Auditor's Reporting:** The auditor while auditing the local bodies should report on the
    a. fairness of the contents and presentation of financial statements,
    b. the strengths and weaknesses of system of financial control,
    c. the adherence to legal and/or administrative requirements;
    d. whether value is being fully received on money spent.
    e. to detect errors and fraud and misuse of resources.
3. **Rules & regulations:** The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.
4. **Sanctions:** He should ensure that all types of sanctions, either special or general, accorded by the competent authority.
5. **Provision of funds**: He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.
6. **Performance Audit:** The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

Q.NO.5 WRITE ABOUT AUDIT OF NON-GOVERNMENT ORGANISATIONS (NGO).

ANSWER:

A. MEANING: NGOs can be defined as non-profit making organisations

1. which raise funds from members, donors or contributors and
2. also receive donation of time, energy and skills for achieving their social objectives.

Note: Non-Governmental Organisations are generally incorporated as societies under the Societies Registration Act, 1860 or as a trust under the India Trust Act, 1882 or incorporated as a company under section 8 of the Companies Act, 2013.

B. SOURCES AND APPLICATIONS OF FUNDS: The main sources of funds include grants and donations, fund raising programmes, advertisements, fees from the members, technical assistance fees / fee for services rendered, subscriptions, gifts, sale of produce or publications, etc:

1. Donations and grants received in the nature of promoter's contribution are in the nature of capital receipts and shown as liabilities in the Balance Sheet of NGO. These may either be in the form of corpus contribution or a contribution towards revolving fund. A contribution made towards the capital or the corpus of an NGO is known as corpus contribution. The donors are generally required to specify whether the donation/grant given by him shall form part of the corpus of the NGO. Such contributions are generally given with reference to the total funds required by an NGO.
2. Section 11(1)(d) of the Income Tax Act 1961 also states that income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution shall not be included in the computation of total income.
3. The objective of a contribution or grant towards a Revolving Fund is to rotate the amount by giving temporary loans from the fund to other NGO or beneficiaries for their projects and then recover the loan so as to give temporary loans again and so on. However, any interest earned from the beneficiary on such temporary loans from the revolving fund could be either added back to the fund or credited to the Income and Expenditure Account depending on restrictions laid down by the authority providing the contribution (for the revolving fund) or by the rules and regulations laid down by the concerned NGO in this regard.
4. Donations and grants received for acquisition of specific fixed assets are those grants whose primary condition is that an NGO accepting them should purchase, construct or otherwise acquire the assets for which the grant is given.
5. Many a times NGOs receive contributions in kind. These contributions include assets such as land, buildings, vehicles, office equipment, etc. and articles related to programmes / projects such as food, books, building materials, clothes, beds, and raw material for training purposes, e.g., Wool, reeds, cloth, etc.
6. The areas of application of funds for an NGO include Establishment Costs, Office and Administrative Expenses, Maintenance Expenses, Programme / Project Expenses, Charity, Donations and Contributions given, etc.

C. POINTS THE AUDITOR SHALL CONCENTRATE WHILE CONDUCTING THE AUDIT OF NGO:

1. Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operates.
2. Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 1976, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.
3. Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.
4. Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.
5. Examination of minutes of the Board/Managing Committee/Governing Body/ Management and Committees thereof to ascertain the impact of any decisions on the financial records.
6. Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.
7. Setting of materiality levels for audit purposes.
8. The nature and timing of reports or other communications.
9. The involvement of experts and their reports.
10. Review the previous year's Audit Report.

D. AUDIT PROGRAMME: The audit programme should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted.

1. **Corpus Fund:** The contributions / grants received towards corpus be vouched with special reference to the letters from the donor(s). The interest income be checked with Investment Register and Physical Investments in hand.
2. **Reserves:** Vouch transfers from projects / programmes with donors letters and board resolutions of NGO.
3. **Ear-marked Funds:** Check requirements of donors institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.
4. **Loans:** Vouch loans with loan agreements, counterfoil of receipt issued.
5. **Fixed Assets:** Vouch all acquisitions / sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/ agreements for the grant. In the case of immovable property check title, etc.
6. **Investments:** Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis- investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.
7. **Cash in Hand:** Physically verify the cash in hand and imprest balances, at the close of the year and whether it tallies with the books of account.
8. **Bank Balance:** Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.
9. **Inventory:** Verify inventory in hand and obtain certificate from the management for the quantities and valuation of the same.

10. **Programme and Project Expenses:** Verify agreement with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme/project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.
11. **Establishment Expenses:** Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

E. **AUDIT OF RECEIPTS OF NGO:** The receipt of income of NGO may be checked on the following lines:

1. **Contributions and Grants for projects and programmes:**
   a. Check agreements with donors and grants letters to ensure that funds received have been accounted for.
   b. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.
2. **Receipts from fund raising programmes:** Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.
3. **Membership Fees:**
   a. Check fees received with Membership Register.
   b. Ensure proper classification is made between entrance and annual fees and life membership fees.
   c. Reconcile fees received with fees to be received during the year.
4. **Subscriptions:**
   a. Check with subscription register and receipts issued.
   b. Reconcile subscription received with printing and dispatch of corresponding magazine / circulars / periodicals. Check the receipts with subscription rate schedule.
5. **Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.

TEST YOUR KNOWLEDGE:

1. You have been appointed as an auditor of an NGO, briefly state the points on which you would concentrate while planning the audit of such an organisation?

Answer: Refer above answer

2. An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit

programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations.

Answer: Refer Point D from above answer

Q.NO.6 WRITE ABOUT AUDIT OF CHARITABLE INSTITUTION.

ANSWER:

A. GENERAL POINTS:

1. Studying the constitution under which the charitable institution has been set up.
2. Verifying whether the institution is being managed in the manner contemplated by the law under which it has been set up.
3. Examining the system of internal check, especially as regards accounting of amounts collected.
4. Verifying in detail the income and confirming that the amounts received have been deposited in the bank regularly and promptly.
5. Examine the Trust Deed or the Regulations as laid down.

B. AUDIT OF RECEIPTS:

1. **Subscriptions and donations:**
   a. Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.
   b. Whether official receipts are issued;
      i. Confirming that adequate control is imposed over unused receipt books;
      ii. Obtaining all receipt books covering the period under review;
      iii. Test checking the counterfoils with the cash book; any cancelled receipts being specially looked into.
      iv. obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;
      v. verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.
2. **Legacies:** Verifying the amounts received by reference to correspondence with any figures and other available information.
3. **Grants:**
   a. Vouching the amount received with the relevant correspondence, receipts and minute books.
   b. Obtaining a certificate from a responsible official showing the amount of grants received.
4. **Investments Income:**
   a. Vouching the amounts received with the dividend and interest counterfoils.
   b. Checking the calculations of interest received on securities bearing fixed rates of interest.
   c. Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.

d. Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

5. **Rent:** Examining the rent roll and inspecting tenancy agreements, noting in each case:
   a. the amounts of the rent and the due dates.
   b. Vouching the rent on to the rent roll from the counterfoils of receipt books and checking the totals of the cash book.
6. **Special function:**
   a. Vouching gross receipts and outgoings in respect of any special functions, e.g. concerts, dramatic performance, etc., held in aid of the charity with such vouchers and cash statements as are necessary.
   b. In particular, verifying that the proceeds of all tickets issued have been accounted for, after making the allowance for returns.
7. **Income Tax Refunds:** Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax.

C. AUDIT OF EXPENDITURE:

1. Vouching payment of grants, also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and that no trustee, director or member of the Managing Committee has benefited there from either directly or indirectly.
2. Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test- basis.
3. Verifying the cash and bank payments.
4. Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.

TEST YOUR KNOWLEDGE:

1. **Mention the special points to be examined by the auditor in the audit of a charitable institution running hostel for students pursuing the Chartered Accountancy Course and which charges only Rs. 500 per month from a student for his lodging/boarding.**

Answer: Refer above answer

Q.NO.7 WRITE ABOUT AUDIT OF EDUCATIONAL INSTITUTION.

ANSWER:

A. GENERAL POINTS:

1. Examine the Trust Deed or Regulations, in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulation framed thereunder.

2. Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, especially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

B. FEES FROM STUDENTS:

1. Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged.
2. Verify that there operates a system of internal check which ensures that demands against the students are properly raised.
3. Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.
4. Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
5. Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.
6. See that free studentship and concessions have been granted by a person authorised to do so, having regard to the Rules prepared by the Managing Committee.
7. Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.
8. Confirm that hostel dues were recovered before student's accounts were closed and their deposits of caution money refunded.
9. Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.
10. Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet not transferred to revenue, unless they are not refundable.

8. **Legacies:** Verifying the amounts received by reference to correspondence with any figures and other available information.
9. **Grants:**
   a. Vouching the amount received with the relevant correspondence, receipts and minute books.
   b. Obtaining a certificate from a responsible official showing the amount of grants received.
10. **Investments Income:**
   a. Vouching the amounts received with the dividend and interest counterfoils.
   b. Checking the calculations of interest received on securities bearing fixed rates of interest.
   c. Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.

d. Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

11. **Income Tax Refunds:** Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax.

C. AUDIT OF EXPENDITURE:

1. Verify that the Provident Fund money of the staff has been invested in appropriate securities.
2. Vouch donations, if any with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.
3. Vouch, all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.
4. Vouch, in the usual manner, all establishment expenses and enquire into any unduly heavy expenditure under any head. If there was any annual budget prepared, see that any excess under any head over the budgeted amount was duly sanctioned by the Managing Committee. If not, bring it to the Committee's notice in your report.
5. See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.
6. Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
7. Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Inventory Register or corresponding inventories of the previous year and values applied to various items should be test checked.

Q.NO.8 WRITE ABOUT AUDIT OF HOSPITALS.

ANSWER:

The special steps involved in the audit of hospital are:

1. REGISTER OF PATIENTS:

a. Vouch the Register of patients with copies of bills issued to them.

b. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared.

c. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

2. COLLECTION OF CASH: Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

3. INVESTMENTS INCOME:

a. Vouching the amounts received with the dividend and interest counterfoils.

b. Checking the calculations of interest received on securities bearing fixed rates of interest.

c. Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.
d. Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

4. **LEGACIES AND DONATIONS:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
5. **RECONCILIATION OF SUBSCRIPTIONS:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).
6. **AUTHORISATION AND SANCTIONS:** Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.
7. **INCOME TAX REFUNDS:** Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax.
8. **BUDGETS:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee, significant variations which have taken place.
9. **INTERNAL CHECK:** Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Inventory Register and that issues have been made only against proper authorisation.
10. **DEPRECIATION:** See that depreciation has been written off against all the assets at the appropriate rates.
11. **INVENTORIES:** Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.
12. **MANAGEMENT REPRESENTATION AND CERTIFICATE:** Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

TEST YOUR KNOWLEDGE

1. ***The general transactions of a hospital include patient treatment, collection of receipts, donations, capital expenditures. You are required to mention special points of consideration while auditing such transactions of a hospital?***

__Answer:__ Refer above answer

Q.NO.9 WRITE ABOUT AUDIT OF CLUB.

__**ANSWER:**__

The special steps involved in such an audit are stated below-

1. **ENTRANCE FEE:** Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes of the Managing Committee.

2. **SUBSCRIPTIONS:**
    a. Vouch members' subscriptions with the <u>counterfoils of receipt</u> issued to them, trace receipts for a selected period to the Register of Members.
    b. Also <u>reconcile</u> the amount of total subscriptions due with the amount collected and that outstanding.
3. **ARREARS OF SUBSCRIPTIONS:** Ensure that arrears of subscriptions for the previous year have been <u>correctly brought over</u> and arrears for the year under audit and <u>subscriptions received in advance have been correctly adjusted</u>.
4. **ARITHMETICAL ACCURACY:** Check totals of various columns of the Register of members and tally them across.
5. **IRRECOVERABLE MEMBER DUES:** See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether <u>necessary steps have been taken for their recovery</u>; the amount considered irrecoverable should be mentioned in the Audit Report.
6. **PRICING:** Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.
7. **MEMBER ACCOUNTS:** Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services to members to confirm that the account of every member has been debited with amounts recoverable from him.
8. **PURCHASES:** Vouch purchase of <u>sports items, furniture, crockery, etc</u>. and trace their entries into the respective inventory registers.
9. **MARGINS EARNED:** Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the <u>normal rates of gross profit</u> have been earned on their sales. The inventory of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.
10. **INVENTORIES:** Check the inventory of furniture, sports material and other assets physically with the respective inventory registers or inventories prepared at the end of the year.
11. **INVESTMENTS:** Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts; also ascertain that the arrangements for their safe custody are satisfactory.

Q.NO.10 WRITE ABOUT AUDIT OF CINEMA HALL.

<u>ANSWER:</u>

A. AUDIT OF INCOMES:

1. Verify the internal control mechanism-
    a. That <u>entrance</u> to the cinema-hall during show is only through <u>printed tickets.</u>
    b. That they are <u>serially numbered</u> and bound into books.
    c. That the number of <u>tickets issued for each show and class, are different</u> though the numbers of the same class for the show on the same day, each week, run serially.
    d. That for <u>advance booking a</u> separate series of tickets is issued; and
    e. That the <u>inventory of tickets is kept in the custody</u> of a responsible official.

2. Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.
3. Verify that a record is kept of the 'free passes' and that these are issued under proper authority.
4. Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class and vouch and verify the entertainment tax returns filed each month.
5. Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.
6. Verify the charges collected for advertisement slides and shorts by reference to the Register of Slides and Shorts Exhibited kept at the cinema as well with the agreements, entered into with advertisers in this regard.
7. **Restaurant income:**
   a. The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually.
   b. In case the restaurant is run by the Cinema, its accounts should be checked.
   c. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, etc. as in the case of club.

B. AUDIT OF EXPENDITURE:

1. Vouch the expenditure incurred on advertisement, repairs and maintenance. No part of such expenditure should be capitalized.
2. Confirm that depreciation on machinery and furniture has been charged at an appropriate rate.
3. Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.
4. Examine unadjusted balance out of advance paid to the distributors against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.

TEST YOUR KNOWLEDGE:

1. You are auditing the Books of accounts of Karla Multiplex which runs 15 Film shows every day. One of the major issues which are of concern to you as an auditor is the Agreement entered into the Multiplex owners with the Film Distributors. State what points would you check as an auditor in this respect.

Answer: Refer above answer

Q.NO.11 WRITE ABOUT AUDIT OF HOTEL.

ANSWER:

A. INTERNAL CONTROLS: Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be undermined. It is the responsibility of management to introduce controls which will minimise the leakage as far as possible.

B. ROOM SALES & HALL BOOKINGS:

1. The charge for room sales should be compared with guest register and audit tests should be carried out to ensure that the correct numbers of guests are charged for the correct period.
2. Any difference between the charged rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.
3. In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room, which are required to be verified by the auditor.
4. The auditor should ensure that proper records are maintained for booking of halls and other premises for special parties and recovered on the basis of the tariff.
5. **Travel Agents & Shops :**
   a. For ledgers coming through travel agents or other booking agencies the bills are usually made on the travel agents or booking agencies. The auditor should ensure that money are recovered from the travel agents or booking agencies as per the terms of credit allowed.
   b. Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.
6. The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts for proper recording of closing and opening entries and maintenance of accounts on Accrual basis as per the Matching concept.

C. INVENTORIES:

1. The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories.
2. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores areas and sales point.
3. Areas where large quantities of inventory are held should be kept locked, the key being retained by the departmental manager.
4. The key should be released only to trusted personnel and unauthorised persons should not be permitted in the stores areas except under constant supervision.
5. In order to satisfy himself, the auditor should consider attending the physical inventory taking and carrying out certain pricing and calculation tests.

D. FIXED ASSETS: The auditor should see that costs of repairs and minor renovation and redecoration are treated as revenue expenditure, whereas costs of major alterations and additions to the hotel building and facilities capitalised.

E. CASUAL LABOUR:

1. The hotel trade operates to very large extent on casual labour.

2. The records maintained of such wage payments are frequently inadequate.
3. The auditor should ensure that defalcation on this account does not take place by suggesting proper controls to the management.

TEST YOUR KNOWLEDGE

1. As an auditor, what would be your areas of consideration while auditing the element of ROOM SALES during the audit of a 5-Star Hotel.

Answer: Refer Point B from above answer

Q.NO.12 WRITE ABOUT AUDIT OF HIRE PURCHASE AND LEASING COMPANIES.

ANSWER:

A. AUDIT OF HIRE PURCHASE COMPANIES:

1. **Hire Purchase agreement:** A Hire-purchase agreement means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which-
   (i) Possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalments,
   (ii) The property in the goods is to pass to such person on the payment of the last of such instalments, and
   (iii) such person has a right to terminate the agreement at any time before the property so passes.
2. **Hirer:** Hirer means the person who obtains or has obtained possession of goods from an owner under a hire- purchase agreement.
3. **Owner:** Owner means the person who lets or has let, delivers or has delivered possession of goods to a hirer under a hire purchase agreement.
4. While checking the hire- purchase transaction, the auditor may examine the following:
   (i) Hire purchase agreement is in writing and is signed by all parties.
   (ii) Hire purchase agreement specifies clearly-
      (a) The hire-purchase price of the goods to which the agreement relates;
      (b) The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;
      (c) The date on which the agreement shall be deemed to have commenced;
      (d) The number of instalments by which the hire- purchase price is to be paid, the amount of each of those instalments, and the date, or the mode of determining the date, upon which it is payable, and the person to whom and the place where it is payable; and
      (e) The goods to which the agreement relates, in a manner sufficient to identify them.
   (iii) Ensure that instalment payments are being received regularly as per the agreement.

B. **AUDIT OF LEASING COMPANIES:** In respect of leasing transaction entered into by the leasing company, the following procedures may be adopted by the auditor:

1. The object clause of leasing company to see that the goods like capital goods, consumer durables etc. in respect of which the company can undertake such activities. Further, to ensure that whether company can undertake financing activities or not.
2. Whether there exists a procedure to ascertain the credit analysis of lessee like lessee's ability to meet the commitment under lease, past credit record, capital strength, availability of collateral security, etc.
3. The lease agreement should be examined and the following points may be noted:
   (i) the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).
   (ii) the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.
   (iii) whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.
   (iv) whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.
4. Examine the lease proposal form submitted by the lessee requesting the lessor to provide him the equipment on lease.
5. Ensure that the invoice is retained safely as the lease is a long-term contract.
6. Examine the acceptance letter obtained from the lessee indicating that the equipment has been received in order and is acceptable to the lessee.
7. See the Board resolution authorising a particular director to execute the lease agreement has been passed by the lessee.
8. See that the copies of the insurance policies have been obtained by the lessor for his records.

TEST YOUR UNDERSTANDING

1. **CA Akash Virmani is auditor of a partnership firm consisting of 4 partners. During the year, one of the partners has retired and another partner has joined the next day. Discuss, any one point, which shall be considered by you to ensure that financial statements of firm are not misstated due to change of constitution of firm.**

Answer:

The auditor shall consider provisions of retirement deed/partnership deed for date of retiring and joining of partners. It should be ensured that profits are appropriately distributed up to date of retirement. Further, profits after retirement should have been distributed among partners as per terms of new partnership deed.

2. **You are auditor of a school operating in your city. During audit of a year, it is noticed that fees concessions to students have been provided in substantial number of cases. Discuss, how, you as an auditor, would proceed to verify the same?**

Answer:

The fees concessions have to be under proper authority of school management. The auditor would verify internal controls in this regard.

Besides, detailed checking of few cases needs to be undertaken to ensure genuineness of fees concessions and proper management approvals.

16. MISACALLNEOUS

NATURE, OBJECTIVE AND SCOPE OF AUDIT

A. ORIGIN OF AUDITING:

1. Auditing has existed even in ancient times in many societies of world including India. The reference to auditing is found in Kautilya's Arthshastra even in 4th century BC.
2. It talks about fixed accounting year, a process for closure of accounts and audit for the same.
3. Concepts of periodical checking and verification existed even in those times. Even there are references in his monumental work to misstatements in financial statements due to abuse of power.
4. The word "audit" originates from Latin word "audire" meaning "to hear".
5. Coming to more recent history, the first Auditor General of India was appointed in British India in 1860 having both accounting and auditing functions.
6. Later on, office of Auditor General was given statutory recognition.
7. Presently, Comptroller and Auditor General of India is an independent constitutional authority responsible for auditing government receipts and expenditures.
8. The Institute of Chartered Accountants of India was established as a statutory body under an Act of Parliament in 1949 for regulating the profession of Chartered Accountancy in the country.

B. NATURE OF AUDITING: "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"

An incisive analysis of above meaning of auditing brings out following points clearly: -

1. **Audit is an independent examination of financial information.**
   a. Independence, here, implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him.
   b. The auditor should be independent of entity whose financial statements are subject to audit so that he can form an opinion without being affected by any influence.
   c. Independence increases auditor's ability to act objectively without creeping in of any biases.
2. **Irrespective of profit oriented, size or legal form:**
   a. The entity whose financial information is examined need not necessarily be profit oriented like in case of a business. It can be a non-profit organization like an NGO or a charitable trust.
   b. Audit can be undertaken in respect of any organization be it a small, medium or large.
   c. Further, it can be conducted for any entity irrespective of its legal structure i.e. such an entity may be a proprietary concern, a partnership firm, a LLP, a private company, a public company, a society or a trust.
3. **The purpose of audit is to express an opinion on the financial statements:** Understand that preparation and presentation of financial statements of an entity is responsibility of

management of entity. The auditor expresses an opinion on financial statements by means of written audit report.

C. WHAT IS NOT INCLUDED IN AUDITOR'S SCOPE:

1. Auditor is not expected to perform duties which fall outside domain of his competence.
   For example, physical condition of certain assets like that of sophisticated machinery cannot be determined by him. Similarly, it is not expected from an auditor to determine suitability and life of civil structures like buildings. These require different skillsets which may be performed by qualified engineers in their respective fields.
2. An auditor is not an expert in authentication of documents. The genuineness of documents cannot be authenticated by him because he is not an expert in this field.
3. An audit is not an official investigation into alleged wrong doing. He does not have any specific legal powers of search or recording statements of witness on oath which may be necessary for carrying out an official investigation. Audit is distinct from investigation.
   a. Audit is distinct from investigation.
   b. Investigation is a critical examination of the accounts with a special purpose.
      For example, if fraud is suspected and it is specifically called upon to check the accounts whether fraud really exists, it takes character of investigation.
   c. The objective of audit, on the other hand, as has already been discussed, is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion.
   d. The scope of audit is general and broad whereas scope of investigation is specific and narrow.

D. MEANING OF ETHICS – A STATE OF MIND:

1. The term "Ethics" means moral principles which govern a person's behaviour or his conducting of an activity.
2. It is the branch of knowledge that deals with moral principles.
3. Ethics is something which comes from an individual intrinsically. It has to be inculcated in the habit and temperament of an individual, so that there is an overall culture of ethics, the force has to be strong enough to withstand any selfish motive or temptation.
4. It is a state of mind to act and perform in accordance with moral principles.
5. Ethics is the science of morals in human conduct. Such moral principles and rules of conduct impose obligations upon individuals.

E. NEED FOR PROFESSIONAL ETHICS:

1. Professions like law, medicine have their code of ethics. Auditing profession is no exception. Rather, in the profession of auditing, requirement of ethics is manifold.
2. It is due to the reason that society in general, governments, clients, taxing authorities, employees, investors, the business and financial community in particular, have reposed tremendous trust in services rendered by Chartered Accountants.

3. The purpose of assurance engagements is to enhance confidence of the intended users. Therefore, users need to trust the person who is providing such services.
4. A distinguishing feature of the accountancy profession is its acceptance of the responsibility to act in the public interest. Professional ethics seek to protect the interests of the profession as a whole and act as a shield that enables us to command respect.
5. A Chartered Accountant, either in practice or in service, has to abide by ethical behaviours. They are expected to follow the fundamental principles of professional ethics while performing their duties.
6. Service users of professionals should be able to feel secure that there exists a framework of professional ethics which governs the provision of those services.
7. It is in this spirit of things that the ICAI requires its members to comply with the principles of ethics while performing their duties.
8. Any deviation from the ethical responsibilities brings the disciplinary mechanism into action against the Chartered Accountants which may result into fines, suspension of membership, removal from membership or other disciplinary actions.

AUDIT STRATEGY, PLANNING AND PROGRAMME

A. DETERMINATION OF MATERIALITY- A MATTER OF PROFESSIONAL JUDGMENT: 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.
d. Make reasonable economic decisions on the basis of the information in the financial statements.

STANDARDS ON AUDIT

SA 550 – RELATED PARTIES

A. MEANING OF CONTROL AND SIGNIFICANT INFLUENCE IN REFERENCE TO RELATED PARTY CONTROL OR SIGNIFICANT INFLUENCE: Many financial reporting frameworks discuss the concepts of control and significant influence. They generally explain that:

1. **Control** is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities; and
2. **Significant influence** (which may be gained by share ownership, statute or agreement) is the power to participate in the financial and operating policy decisions of an entity, but is not control over those policies

3. The existence of the following relationships may indicate the presence of control or significant influence:
   a. Direct or indirect equity holdings or other financial interests in the entity.
   b. The entity's holdings of direct or indirect equity or other financial interests in other entities.
   c. Being part of those charged with governance or key management (i.e., those members of management who have the authority and responsibility for planning, directing and controlling the activities of the entity).
   d. Being a close family member of any person referred to in subparagraph (iii).
   e. Having a significant business relationship with any person referred to in subparagraph (iii).

B. CONSIDERATIONS SPECIFIC TO SMALLER ENTITIES BY THE AUDITOR:

1. Control environment in smaller entities is likely to be different from larger entities.
2. In particular those charged with governance may not include an outside member, and the role of governance may be undertaken directly by the owner-manager where no other owner exists.
3. Control activities in smaller entities are likely to be less formal and smaller entities may have no documented processes for dealing with related party relationships and transactions.
4. An owner-manager may mitigate some of the risks arising from related party transactions, or potentially increase those risks, through active involvement in all the main aspects of the transactions.
5. For such entities, the auditor may obtain an understanding of the related party relationships and transactions, and any controls that may exist over these, through inquiry of management combined with other procedures, such as observation of management's oversight and review activities, and inspection of available relevant documentation.

SA 570 – GOING CONECRN

MEANING OF GOING CONCERN AND ITS SIGNIFICANCE:

1. Going concern is one of the fundamental accounting assumptions.
2. The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.
3. General purpose financial statements are prepared using the going concern basis of accounting, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.
4. The significance of Going Concern is due to its effect on preparation of financial statements. Ability or otherwise of an enterprise to be viewed as going concern affects its preparation of financial statements.
5. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

6. When an enterprise is not viewed as a going concern, the financial statements are prepared on liquidation basis. For example, inventories may need to be written down as these may be sold for a lower price. Assets may have to be recorded at the likely prices they will fetch.

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