

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS

SUGGESTED ANSWERS/HINTS

1. (a) **Compliance with Other Laws:** As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", the auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements including tax and labour laws.

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

If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management. If management does not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.

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

In the instant case, most of the labourers employed in Ajanta Ltd. are of the age between 11-12 years. While enquiring, management denied the fact of foundation on child labour and also contends that it was outside the scope of audit to look into the compliance with other laws. Here, it seems that the management is deliberately involved in the non-compliance of labor laws and hence precluding CA. Yusuf from obtaining sufficient appropriate audit evidence for further evaluation.

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

- (b) **Evaluation of Specific Work Done by Internal Auditor:** The statutory auditor should as a part of his audit, carry out general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor.

As per SA 610 "Using the Work of Internal Auditors", in order for the external auditor to use specific work of the internal auditors, the external auditor shall evaluate and perform audit procedures on that work to determine its adequacy for the external auditor's purposes. The external auditor shall evaluate whether-

- (i) The work was performed by internal auditors having adequate technical training and proficiency;
- (ii) The work was properly supervised, reviewed and documented;
- (iii) Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;
- (iv) Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and
- (v) Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.

Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is not independent of the entity as is required of the external auditor when expressing an opinion on financial statements. 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 auditors.

- (c) **AS 18 "Related Party Disclosures"** exempts parties being defined on the basis of significant influence in respect of providers of finance; trade unions; public utilities; etc. by virtue of only of those dealings. If an enterprise is completely dependent on an electricity distribution company because of monopoly in that region, but other than for this reason neither enterprises exercise control/significant influence, none of the transactions between them would be related party transactions for AS 18 purposes.

If a particular enterprise exercises control/significant influence on an electricity distribution company, for example, Pinch Ltd. holds 35% equity of Gujarat Electricity Ltd. (monopoly electricity distribution company) or vice-versa, all transactions (including the supply of electricity) between Pinch Ltd. and Gujarat Electricity Ltd. will be related party transactions and disclosure is necessary for the same as per AS 18.

Similarly, a provider of finance is not a related party by virtue of providing finance, however if the lender in addition to providing finance also holds equity of more than 20% in an enterprise, then it would be deemed to be exercising significant influence on that enterprise unless demonstrated otherwise.

Based on the above cited provisions of AS 18, Pinch Ltd. should disclose about Gujarat Electricity Ltd.

- (d) **Engagement to Report on Summary Financial Statements:** As per SA 810 "Engagements to Report on Summary Financial Statements", before accepting an engagement to report on summary financial statements, the auditor shall-
- (i) Determine whether the applied criteria are acceptable;
 - (ii) Obtain the agreement of management that it acknowledges and understands its responsibility:
 - (1) For the preparation of the summary financial statements in accordance with the applied criteria;
 - (2) To make the audited financial statements available to the intended users of the summary financial statements without undue difficulty (or, if law or regulation provides that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements, to describe that law or regulation in the summary financial statements); and
 - (3) To include the auditor's report on the summary financial statements in any document that contains the summary financial statements and that indicates that the auditor has reported on them.
 - (iii) Agree with management the form of opinion to be expressed on the summary financial statements.
2. (a) **Circulating Information Contained in Own Website:** As per clause (6) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.

However, the guidelines approved by the Council of the Institute of Chartered Accountants of India permit creation of own website by a chartered accountant in his or his firm name and no standard format or restriction on colours is there. The chartered accountant or firm, as per the guidelines, should ensure that none of the information contained in the website be circulated on their own or through E-mail or by any other mode except on a specific "Pull" request.

Further, members are not required to intimate the Website address to the Institute. Members are only required to comply with the Website Guidelines issued by the Institute in this regard.

In the given case, Mr. Chandan has circulated the information contained in the website through E-mail to public at large. Therefore, he is guilty of professional misconduct under clause (6) of Part I of the First Schedule to the said Act. However, there is no such misconduct for not intimating website address to the Institute.

- (b) Issuing Certificate without having Certificate of Practice:** As per Clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council.

This clause requires every member of the Institute to act within the framework of the Chartered Accountants Act and the Regulations made thereunder. Any violation either of the Act or the Regulations by a member would amount to misconduct.

In the given case, CA. Kamal has issued a certificate in respect of a consumption statement of raw material to the manager of Norex (P) Ltd., as a Chartered Accountant in practice when he had not even applied for the CoP to the Institute, thereby contravening the provisions of section 6 of the Chartered Accountants Act, 1949.

Therefore, CA. Kamal will be held guilty of professional misconduct in terms of clause (1) of Part II of Second Schedule to the Chartered Accountants Act, 1949 for contravention of provisions of this Act.

- (c) Delegation of Authority to the Employee:** As per Clause (12) of Part I of the First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he allows a person not being a member of the Institute in practice or a member not being his partner to sign on his behalf or on behalf of his firm, any balance sheet, profit and loss account, report or financial statements.

However, the Council has clarified that the power to sign routine documents on which a professional opinion or authentication is not required to be expressed may be delegated and such delegation will not attract provisions of this clause like issue of audit queries during the course of audit, etc.

In the given case, CA. Raman proprietor of M/s R & Co., went to abroad and delegated the authority to another Chartered Accountant Mr. Raj, his employee, for taking care of routine matters of his office who is not a partner but a member of the Institute of Chartered Accountants. CA. Raj has issued audit queries which were raised during the course of audit.

Here CA. Raj is right in issuing the query, since the same falls under routine work which can be delegated by the auditor. Therefore, there is no misconduct in this case as per Clause (12) of Part I of First schedule to the Act.

- (d) **Submitting Wrong Information to the Institute:** As per Clause (3) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct if he includes in any information, statement, return or form to be submitted to the Institute, Council or any of its committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.

In the instant case, Mr. A and Mr. B, partners of M/s AB & Co., included the name of Mr. C, another Chartered Accountant, as partner in their firm, without his knowledge, in their application for empanelment as auditor of branches of Public Sector Banks submitted to the Institute. However, such a member was not a partner of the said firm as on the date of application submitted. Here, Mr. A and Mr. B have submitted wrong information to the Institute.

Therefore, Mr. A and Mr. B, both, would be held guilty of professional misconduct under Clause (3) of Part II of the Second Schedule to the Chartered Accountants Act, 1949.

3. (a) **Services Not to be Rendered by the Auditor:** Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:
- (i) accounting and book keeping services;
 - (ii) internal audit;
 - (iii) design and implementation of any financial information system;
 - (iv) actuarial services;
 - (v) investment advisory services;
 - (vi) investment banking services;
 - (vii) rendering of outsourced financial services;
 - (viii) management services; and
 - (ix) any other kind of services as may be prescribed.

In the given case, CA. Fanny was appointed as an auditor of Funtush Ltd. He was offered additional services of actuarial, investment advisory and investment banking which was also approved by the Board of Directors.

Therefore, the auditor is advised not to accept the services as these services are specifically notified in the services not to be rendered by him as an auditor as per section 144 of the Act.

- (b) Appointment of Relative of Director as an Auditor:** Section 141 of the Companies Act, 2013 deals with the eligibility, qualifications and disqualifications of Auditors. Sub-section (3)(f) of the section 141 of the said Act, explicitly disqualifies a person from being appointed as an auditor of a company whose relative is a director or is in employment of the company as a director or key managerial personnel. Further, the definition of the term “relative”, as defined under the Companies Act, 2013, includes son’s wife i.e. daughter-in-law.

Further, as per Council Guidelines 2008, a member of the Institute shall desist from expressing his opinion on financial statements of any business or enterprise in which one or more persons who are his relatives within the meaning of AS 18 have, either by way of themselves or in conjunction with such members, a substantial interest in the said business or enterprise. Therefore, if the director has substantial interest in the company then his relative should not accept the appointment of auditor of that company.

In the instant case, Mr. Rajkamal is the director of Unite Ltd. and holding 25% shares of the company. Further, CA. Rani is his son’s wife i.e. a relative according to the definition of “relative” given under the Companies Act, 2013. Therefore, she should not accept the appointment as an auditor of that company. If she accepts such appointment, she would be guilty of professional misconduct and would also be liable for punishment for contravention of the provisions of the Companies Act.

- (c) Difference between Control Accounts and Subsidiary Records:** The huge differences found between control accounts and subsidiary records in the books of Alora Ltd. indicates that there may be material misstatements requiring detailed examination by the auditor to ascertain the cause. The contention of Chief Accountant cannot be accepted simply because the company has done huge volume of business. Such a phenomenon indicates that recording of transactions is not being done properly or the accounting system in the company which might have several branches spread over the country fails to capture all transactions in time. It would also be interesting to see whether it is a recurring phenomenon or such reconciliation could not be done at a subsequent date. Having regard to all these circumstances, it appears from the facts of the case that these differences indicate the possibility of some kind of material misstatements.

As per SA 240, “The Auditor’s Responsibilities relating to Fraud in an Audit of Financial Statements”, when the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor shall evaluate the implications for the audit.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government or Audit Committee/Board, as the case may be, within such time and in such manner as may be prescribed.

The auditor is also required to comment under clause (x) of Para 3 of CARO, 2016 whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

- (d) **Internal Controls in a CIS Environment:** The reliability of a component is a function of control that acts on the component. In a computer system following are the major types of controls that are used to enhance component reliability which the auditor must evaluate-
- (i) **Authenticity Control:** They are exercised to verify the identity of the individuals or process involved in a system (Password, digital signature etc.).
 - (ii) **Accuracy Control:** These attempts to ensure the correctness of the data and processes in a system (Programme validation check).
 - (iii) **Completeness Control:** This ensures that no data is missing and all processing is carried through to its proper conclusion.
 - (iv) **Privacy Control:** This ensures the protection of data from inadvertent or unauthorised disclosure.
 - (v) **Audit Trail Controls:** This ensures the traceability of all events occurred in a system.
 - (vi) **Redundancy Control:** It ensures that processing of data is done only once.
 - (vii) **Existence Control:** It attempts to ensure the ongoing availability of all system resources.

- (viii) **Asset safeguarding controls:** It attempts to ensure that all resources within a system are protected from destruction or corruption.
- (ix) **Effectiveness Control:** It attempts to ensure that the system achieves its goals.
- (x) **Efficiency Control:** It attempts to ensure that a system uses minimum resources to achieve its goals.

4. (a) **Donation to Charitable Institutions:** Section 181 of the Companies Act, 2013 provides that the Board of Directors of a company may contribute to bona fide charitable and other funds with prior permission of the company in general meeting for such contribution in case any amount the aggregate of which, in any financial year, exceed five per cent of its average net profits for the three immediately preceding financial years.

In the instant case, ABC Ltd. has given donation of Rs. 50,000 each to the two charitable organisations which amounts to Rs. 1,00,000. The average profit of the last 3 years is Rs. 15 lakhs and the 5% of this works out to Rs. 75,000. Hence the maximum of donation could be Rs. 75,000 only. For excess of Rs. 25,000 the company is required to take prior permission in general meeting which is not been taken.

By paying donations of Rs. 1,00,000 which is more than Rs. 75,000, the Board has contravened the provisions of Section 181 of the Companies Act, 2013. Hence, the auditor should qualify his report accordingly.

(b) **Reporting Under CARO, 2016**

- (i) **Utilisation of Term Loans:** According to clause (ix) of Para 3 of CARO, 2016, the auditor is required to comment whether term loans were applied for the purposes for which those are raised. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported.

The auditor should examine the terms and conditions of the term loan with the actual utilisation of the loans. If the auditor finds that the fund has not been utilized for the purpose for which they were obtained, the report should state the fact.

In the instant case, term loan taken for the purpose of R&D equipment has been utilized for the purchase of car which has no relation with R&D equipment.

Therefore, car though used for R&D Director cannot be considered as R&D equipment. The auditor should state the fact in his report that out of the term loan taken for R&D equipment, Rs. 15 lakh was not utilised for the purpose of acquiring R&D equipment.

- (ii) **Physical Verification of Inventory:** Clause (ii) of Para 3 of CARO, 2016 requires the auditor to report on whether physical verification of inventory has been conducted at reasonable intervals by the management and whether any material discrepancies were noticed and if so, whether they have been properly dealt with in the books of account.

Physical verification of inventory is the responsibility of the management which should verify all material items at least once in a year and more often in appropriate cases. The auditor in order to satisfy himself about verification at reasonable intervals should examine the adequacy of evidence and record of verification.

In the given case, the above requirement of CARO, 2016 has not been fulfilled as such and the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable. He may consider the impact on financial statement and report accordingly.

- (c) **Reporting for Default in Repayment of Dues:** As per the general instructions for preparation of Balance Sheet, provided under Schedule III to the Companies Act, 2013, terms of repayment of term loans and other loans is required to be disclosed in the notes to accounts. It also requires specifying the period and amount of continuing default as on the balance sheet date in repayment of loans and interest, separately in each case.

Further, as per clause (viii) of Para 3 of CARO, 2016, the auditor of a company has to state in his report whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders and if yes, the period and the amount of default to be reported

In the given case, Zed Ltd. has defaulted in repayments of dues to a financial institution during the financial year 2015-16 which remain outstanding as at March 31, 2016. However, the company has settled the total outstanding dues including interest in April, 2016 but, the dues were outstanding as at March 31, 2016. Therefore, it needs to be reported in the notes to accounts.

The draft report for above matter is as under:

“The company has taken a loan during the year, from a financial institution amounting to Rs. XXXX @ X% p.a. which is repayable by monthly installment of Rs. XXXX for XX months.

The company has defaulted in repayment of dues including interest to a financial institution during the financial year 2015-16 amounting to Rs. XXXX which remained outstanding as at March 31, 2016. The period of default is XXX days. However, the outstanding sum was settled by the company in April, 2016.”

5. (a) **Classification of Non-Performing Assets:** An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.

Criteria for the classification of a Non Performing Asset (NPA) is a loan or an advance where-

- (i) Interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan.
- (ii) The account remains "out of order" in respect of an Overdraft/Cash Credit (OD/CC).
- (iii) The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
- (iv) The instalments of principal or interest thereon remain overdue for two crop seasons for short duration crops.
- (v) The instalment of principal or interest thereon remains overdue for one crop season for long duration crops.
- (vi) The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitisation transaction undertaken in terms of guidelines on securitization dated 1st February, 2006.
- (vii) In respect of derivative transactions, the overdue receivables representing positive mark to Market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

- (b) **Audit of a Loan Financing Company:** Special points to be kept in mind while auditing a loan financing company, an NBFC, are given below-

- (i) Auditor should examine whether each loan or advance has been properly sanctioned. He should verify the conditions attached to the sanction of each loan or advance i.e. limit on borrowings, nature of security, interest, terms of repayment, etc.
- (ii) Auditor should verify the security obtained and the agreements entered into, if any, with the concerned parties in respect of the advances given. He must ascertain the nature and value of security and the net worth of the borrower/guarantor to determine the extent to which an advance could be considered realisable.
- (iii) Obtain balance confirmations from the concerned parties.
- (iv) As regards bill discounting, verify that proper records/documents have been maintained for every bill discounted/rediscouted by the NBFC. Test check some transactions with reference to the documents maintained and ascertain whether the discounting charges, wherever, due, have been duly accounted for by the NBFC.

- (v) Check whether the NBFC has not lent/ invested in excess of the specified limits to any single borrower or group of borrowers as per NBFC Prudential Norms Directions.
 - (vi) Check whether the NBFC has not advanced any loans against the security of its own shares.
 - (vii) In case of companies which are engaged in the business of providing short term funds in the ICD market, the auditor should ascertain whether the NBFC has a regular system for ascertaining the credit worthiness of the clients prior to placed by the company are being rolled over and whether there is any risk of non-recovery. In addition, he should ascertain that the NBFC is receiving interest regularly in respect of these ICDs. Roll over of ICDs and non-realisation of interest and principal amounts should be thoroughly checked to determine whether the ICD is required to be treated as a NPA.
 - (viii) Auditor should verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances. In addition, he may analyze the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.
 - (ix) Check the classification of loans and advances (including bills purchased and discounted) made by an NBFC into Standard Assets, Sub-Standard Assets, doubtful assets and loss assets and the adequacy of provision for bad and doubtful debts as required by NBFC Prudential Norms Directions.
 - (x) An auditor should also verify whether provision for bad and doubtful debts has been disclosed separately in the Balance Sheet and the same have not been netted off against the income or against the value of assets as required by the NBFC Prudential Norms Directions.
- (c) **Key Functions of Energy Auditor:** Energy auditing is defined as an activity that serves the purposes of assessing energy use pattern of a factory or energy consuming equipment and identifying energy saving opportunities. In that context, energy management involves the basis approaches reducing avoidable losses, improving the effectiveness of energy use, and increasing energy use efficiency. The function of an energy auditor could be compared with that of a financial auditor. The energy auditor is normally expected to give recommendations on efficiency improvements leading to monetary benefits and also advise on energy management issues. Generally, energy auditor for the industry is an external party. The following are some of the key functions of the energy auditor:
- (i) Quantify energy costs and quantities.
 - (ii) Correlate trends of production or activity to energy costs.

- (iii) Devise energy database formats to ensure they depict the correct picture – by product, department, consumer, etc.
 - (iv) Advise and check the compliance of the organisation for policy and regulation aspects.
 - (v) Highlight areas that need attention for detailed investigations.
 - (vi) Conduct preliminary and detailed energy audits which should include the following:
 - (a) Data collection and analysis.
 - (b) Measurements, mass and energy balances.
 - (c) Reviewing energy procurement practices.
 - (d) Identification of energy efficiency projects and techno-economic evaluation.
 - (e) Establishing action plan including energy saving targets, staffing requirements, implementation time requirements, procurement issues, details and cost estimates.
 - (f) Recommendations on goal setting for energy saving, record keeping, reporting and energy accounting, organisation requirements, communications and public relations.
- (d) Instances of Capital Receipts to be Stated Under Clause 16(e):** The following is an illustrative list of capital receipts which, if not credited to the statement of profit and loss, are to be stated under clause 16(e) of Form 3CD-
- (i) Capital subsidy received in the form of government grants, which are in the nature of promoters' contribution i.e., they are given with reference to the total investment of the undertaking or by way of contribution to its total capital outlay. For example, Capital Investment Subsidy Scheme.
 - (ii) Government grant in relation to a specific fixed asset where such grant is shown as a deduction from the gross value of the asset by the concern in arriving at its book value.
 - (iii) Compensation for surrendering certain rights.
 - (iv) Profit on sale of fixed assets/investments to the extent not credited to the statement of profit and loss.
- 6. (a) Behavioural Aspects Encountered in Management Audit:** Financial auditors deal mainly with figures. Management auditors deal mainly with people. There are many causes for behavioural problems arising in the review function of management audit. Particularly, when management auditors performs comprehensive audit of operations, they cannot be as well informed about such operations as a financial

auditor in a financial department. Operating processes may be unfamiliar and complex. The operating people may be speaking a language and using terms that are foreign to the auditor's experience. The nature and causes of behavioural problems that the management auditor is likely to face in the discharge of the review function that is expected of him and possible solutions to overcome these problems are discussed below-

- (1) **Staff / Line conflict:** Management auditors are staff people while the members of other departments are line people. Management auditors tend to discount the difficulties the line staff may face, if called on to act on the ideas of management auditors. Management auditors are specialists in their field and they may think their approach and solutions are the only answers.
- (2) **Control:** The management auditor is expected to evaluate the effectiveness of controls, there is an instinctive reaction from the auditee that the report of the auditor may affect them. There is a fear that the action taken based on the management audit report will affect the line people. It breeds antagonism. The causes are under:
 - (i) Fear of criticism stemming from adverse audit findings.
 - (ii) Fear of change in day to day working habits because of changes resulting from audit recommendations.
 - (iii) Punitive action by superior prompted by reported deficiencies.
 - (iv) Insensitive audit practices.
 - (v) Hostile audit style.

Solution to Behavioural Problems: The following steps may be taken to overcome the aforesaid problems-

- (i) To demonstrate that audit is part of an overall programme of review for protective and constructive benefit.
- (ii) To demonstrate the objective of review is to provide maximum service in all feasible managerial dimensions.
- (iii) To demonstrate the review will be with minimum interference with regular operation.
- (iv) The responsible officers will be involved in the process of review of the findings and recommendations before the audit report is formally released.

It is essential to create an atmosphere of trust and friendliness so that audit reports will be understood in their proper perspective.

Finally, it needs hardly any emphasis that there should be right management culture, enlightened auditees and auditors of the right calibre. May be to expect a

combination at all times of all the three is asking for the impossible. But, a concerted effort by the management, auditors and auditees to achieve a more acceptable climate would go a long way to achieve the goal.

- (b) **Reliance on Audited Statement of Accounts by Investigator:** If the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited statement of account arises. However, if the investigator has been requested to establish value of a business or a share or the amount of goodwill payable by an incoming partner, ordinarily the investigator would be entitled to put reliance on audited materials made available to him unless, in the course of his test verification, he finds the audit to have been carried on very casually or unless his terms of appointment clearly require to test everything afresh. It is, therefore, desirable for the investigator to ascertain from the client, in advance, in writing, whether the audited statements of account produced to him should be taken as correct.

If the statements of account produced before the investigator were not audited by a qualified accountant, then of course there arises a natural duty to get the figures in the accounts properly checked and verified. However, when the accounts produced to the investigator have been specially prepared by a professional accountant, who knows or ought to have known that these were prepared for purposes of the investigation, he could accept them as correct relying on the principle of liability to third parties. Nevertheless, it would be prudent to see first that such accounts were prepared with objectivity and that no bias has crept in to give advantage to the person on whose behalf these were prepared.

(c) **Powers of Comptroller and Auditor-General of India**

- (i) **Supplementary audit under section 143(6)(a) of the Companies Act, 2013:** The Comptroller and Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct.

Comment upon or supplement such Audit Report under section 143(6)(b) of the Companies Act, 2013: Any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 of the said Act i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such

member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

- (ii) **Test audit under section 143(7) of the Companies Act, 2013:** Without prejudice to the provisions relating to audit and auditor, the Comptroller and Auditor-General of India may, in case of any company covered under sub-section (5) or sub-section (7) of section 139 of the said Act, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of 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.

7. (a) Objectives of the Internal Check System: Following are the objectives of the internal check system-

- (i) To detect error and frauds with ease.
- (ii) To avoid and minimize the possibility of commission of errors and fraud by any staff.
- (iii) To increase the efficiency of the staff working within the organization.
- (iv) To locate the responsibility area or the stages where actual fraud and error occurs.
- (v) To protect the integrity of the business by ensuring that accounts are always subject to proper scrutiny and check.
- (vi) To prevent and avoid the misappropriation or embezzlement of cash and falsification of accounts.

- (b) Factors Relevant in Evaluation of Inherent Risk:** While developing an overall audit plan, the auditor is required to assess inherent risk at financial statement level and is then required to relate his assessment to material account balances and the class of transactions. To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Normally an auditor evaluates inherent risk by assessing factors such as integrity of the management, experience and knowledge of the management, turnover of key management personnel, circumstances which may motivate the management to misstate the financial statement when its financial performance is not satisfactory, nature of entity's business prone to rapid technological obsolescence, dealing with large number of related parties etc.

(c) **Frauds Committed Through Supplier's Ledger:** Fraud through supplier's ledger could be made in any of the following ways, which the auditor has to take care of-

- (i) Inflating supplier's account with fictitious or duplicate invoices and subsequent misappropriations as if payments are made to the supplier.
- (ii) Suppressing credit notes issued by the suppliers and withdrawing the corresponding amount not claimed by them.
- (iii) Withdrawing amounts which remain unclaimed for more than the normal time limit for one reason or other by showing the same have been paid to the parties.
- (iv) Inflating values of items purchased and collecting the excess from suppliers i.e. accepting invoices at prices considerably higher than the market price and collecting the excess claim from the suppliers directly.

(d) **Areas Excluded from the Scope of Peer Reviewer:**

- (i) Management Consultancy Engagements;
- (ii) Representation before various Authorities;
- (iii) Engagements to prepare tax returns or advising clients in taxation matters;
- (iv) Engagements for the compilation of financial statements;
- (v) Engagements solely to assist the client in preparing, compiling or collating information other than financial statements;
- (vi) Testifying as an expert witness;
- (vii) Providing expert opinion on points of principle, such as Accounting Standards or the applicability of certain laws, on the basis of facts provided by the client; and
- (viii) Engagement for Due diligence.

(e) **General Steps in the Conduct of Risk-Based Audit:** Risk-based audit (RBA) is an approach to audit that analyzes audit risks, sets materiality thresholds based on audit risk analysis and develops audit programmes that allocate a larger portion of audit resources to high-risk areas.

RBA consists of four main phases starting with the identification and prioritization of risks, to the determination of residual risk, reduction of residual risk to acceptable level and the reporting to auditee of audit results. These are achieved through the following:

- (i) Understanding auditee operations involves processes for reviewing and understanding the audited organization's risk management processes for its strategies, framework of operations, operational performance and information

process framework, in order to identify and prioritize the error and fraud risks that impact the audit of financial statements. The environment in which the auditee operates, the information required to monitor changes in the environment, and the process or activities integral to the audited entity's success in meeting its objectives are the key factors to an understanding of agency risks. Likewise, a performance review of the audited entity's delivery of service by comparing expectations against actual results may also aid in understanding agency operations.

- (ii) Assessment of management risk strategies and controls is the determination as to how controls within the auditee are designed. The role of internal audit in promoting a sound accounting system and internal control is recognized, thus the SAI should evaluate the effectiveness of internal audit to determine the extent to which reliance can be placed upon it in the conduct of substantive tests.
- (iii) Management of residual risk requires the design and execution of a risk reduction approach that is efficient and effective to bring down residual audit risk to an acceptable level. This includes the design and execution of necessary audit procedures and substantive testing to obtain evidence in support of transactions and balances. More resources should be allocated to areas of high audit risks, which were earlier known through the analytical procedures undertaken.
- (iv) The results of audit shall be communicated by the auditor to the audited entity. The auditor must immediately communicate to the auditee reportable conditions that have been observed even before completion of the audit, such as weaknesses in the internal control system, deficiencies in the design and operation of internal controls that affect the organization's ability to record, process, summarize and report financial data.