Standards on Auditing

1. While conducting the audit of Quantum Mechanics Limited, Mr. Manoj, the audit manager, identified significant payments made by the company for legal and retainership fees related to litigation. The litigation pertained to the Thirunelly manufacturing plant, situated on forest land reserved for the Elephant Corridor, which was declared illegally constructed.

The company had received a notice to decommission the plant by 31-05-2022, but it had challenged decommissioning order in the High Court and matter was still pending there. The company had not disclosed any information related to the litigation in its financial statements for Financial Year 2022-23. The Thirunelly plant accounted for over 75% of the company's annual production, and the audit team expressed concerns that decommissioning could significantly disrupt operations and potentially lead to bankruptcy. The audit was near to completion.

When Mr. Manoj sought advice from audit partner Mr. Shalabh on this matter, he suggested that no immediate action was necessary from the auditors, as the matter was still pending in Kerala High Court. However, Mr. Manoj feels that situation requires action from auditors and to be indicated in the report.

Whose view seems to be appropriate? Comment with reference to applicable Standards on Auditing.

In accordance with SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", if the auditor concludes that the noncompliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor shall in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report", express a qualified or adverse opinion on the financial statements.

In the specific case of Quantum Mechanics Limited, where significant legal and retainership fees have been paid related to a lawsuit concerning the Thirunelly manufacturing plant, the auditor needs to assess the impact of non-compliance on the financial statements.

Given that the Thirunelly plant constitutes over 75% of the company's annual production and the audit team believes that decommissioning the plant could potentially lead to bankruptcy, the non-disclosure of such a significant matter would have a material and pervasive impact on the financial statements.

Contrary to the audit partner's suggestion that no action is necessary as the matter is pending in the Kerala High Court, the requirements of SA 250 and SA 705 necessitate a different approach. The auditor should express either a qualified or an adverse opinion on the financial statements based on the level of impact of non-disclosure.

Further, above situation involves pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity may not be able to satisfy. It is an example of events or conditions that may cast a significant doubt on entity's ability to continue as a going concern.

However, no disclosure is made in financial statements about the material uncertainty.

SA 570, "Going Concern" also mandates auditor to express a qualified or an adverse opinion in accordance with SA 705, if adequate disclosure is not made about material uncertainty in financial statements.

As a non-disclosure of such a significant matter would have material and pervasive impact of financial statements, adverse opinion in this situation appears appropriate.

Therefore, Mr. Manoj's view seems to be proper.

2. While assessing the impact of uncorrected misstatements in the audit of Manhattan Constructions Private Limited, Mr. Sushil encountered a significant issue related to the calculation of materiality on Sales. The initial materiality calculation was based on estimated figures provided by the management. Notably, during the estimation of full-year sales, the management extrapolated from the actual amount of 11 months to derive the 12 months of sales.

However, given the nature of Manhattan Constructions as a company in the construction sector, where monthly sales exhibit substantial variations, a unique challenge emerged. The actual sales for the last month deviated significantly from the estimated sales due to an unforeseen increase in stamp duty rates imposed by the government in that region. As a result, the last month's actual sales represented only 25% of the estimated sales. Now, Mr. Sushil is confronted with a dilemma regarding the appropriate approach to evaluate uncorrected misstatements using the previously calculated materiality.

Kindly Guide Mr. Sushil in the light of relevant Standards on Auditing.

As per SA 450 "Evaluation of Misstatements Identified during the Audit", the auditor is required to reassess materiality, in accordance with SA 320 "Materiality in Planning and Performing an Audit", before evaluating the impact of uncorrected misstatements.

This reassessment is crucial to confirm appropriateness of materiality in light of the entity's actual financial results.

The determination of materiality under SA 320 often relies on estimates of the entity's financial results, given that the actual results may not be known during the early stages of the audit. Therefore, before the auditor proceeds to assess the effect of uncorrected misstatements, it becomes necessary to adjust the materiality calculated under SA 320 based on the now available actual financial results.

SA 320 outlines that, as the audit progresses, materiality may be revised for the financial statements as a whole or for specific classes of transactions, account balances, or disclosures.

This revision is prompted by the auditor's awareness of information that would have led to a different initial determination. Typically, significant revisions occur before the evaluation of uncorrected misstatements.

However, if the reassessment of materiality under SA 320 results in a lower amount, the auditor must reconsider performance materiality and the appropriateness of the audit procedures' nature, timing, and extent.

This is crucial for obtaining sufficient and appropriate audit evidence on which to base the audit opinion.

In the present case involving Manhattan Constructions Private Limited, it has been identified that the materiality calculated at the beginning of the audit for Sales was based on estimates provided by the management. The management extrapolated sales for the full year using the actual amount of 11 months, but since the company experiences significant monthly variations in sales, the actual sales for the last month were only 25% of the estimated figure. This discrepancy arose due to an unexpected increase in stamp duty rates by the government in that region.

In this audit scenario, Mr. Sushil, auditor, must review and re-assess the materiality initially determined under SA 320 to ensure its continued validity in light of the actual financial results.
If the re-assessed materiality is lower than the previously calculated amount, Mr. Sushil must reconsider performance materiality and the appropriateness of the nature, timing, and extent of further audit procedures.

This meticulous approach is essential to gather sufficient and appropriate audit evidence, enabling Mr. Sushil to form an independent and objective opinion on the financial statements of Manhattan Constructions Private Limited.

Standards on Related Services

1. Brown Enterprises Limited has huge funds locked up in its trade receivables standing at around ` 100 crores as on 31st December, 2023. The management of the company wants to evaluate validity of the trade receivables to ensure reliability of financial reporting at the year end. The accounts department has provided a list of trade receivables to the management containing about 1000 names, their balances and contact/communication details spread in different parts of the country.

The company's management has requested CA. Karuna to take up this assignment and prepare a report for management in accordance with professional standards. Despite not being statutory auditor of the company, she decides to accept above engagement.

a) By explaining nature of engagement described above, discuss whether it was proper for her to accept such engagement.
b) While reporting, which precautions should be taken by her so that readers of the report do not misunderstand its scope?

The above situation involves an engagement to perform agreed upon procedures.

In such an engagement, the auditor is engaged by the client to issue a report of factual findings based

- ✓ on specified procedures
- ✓ performed on specified subject matter
- ✓ of specified elements, accounts or items of a financial statement.

The management has requested CA. Karuna to take up the assignment and prepare report for management in accordance with professional standards. Such type of engagement and its reporting falls in purview of SRS 4400.

The reference to auditor in SRS 4400 does not imply that a person performing related services need necessarily be the auditor of entity's financial statements.

Hence, a person performing related services need not necessarily be auditor of entity's financial statements.

Therefore, it was proper for CA. Karuna to accept above engagement.

(b) While reporting, she should take following precautions so that readers of report do not misunderstand its scope: -

- ✓ A statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed.
- ✓ A statement that, had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported.
- ✓ A statement that the report is restricted to those parties that have agreed to the procedures to be performed.
- ✓ A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole.

Digital Audit

Certain studies have suggested that increase in cyber-attacks and rise in global payment processing cost have hit global banking and finance industries enormously. Therefore, such industries are going to place reliance on new technologies such as Blockchain. Blockchain is based on a decentralized and distributed ledger that is secured through encryption. Each transaction is validated by the blockchain participants, creating a block of information that is replicated and distributed to all participants. However, such technology comes with its weaknesses and associated risks.

What are common risks for Blockchain technology? Also discuss probable audit implications where such technology can be used.

Risks

The strengths of blockchain can also be its weaknesses.

- ✓ Contingency Plan: The inability to reverse transactions and to access data without the required keys make the system secure but also means that organisations need specific protocols and management processes to ensure that they are not locked out and have clear contingency plans.
- ✓ Security Issues: Operating through network nodes could also expose the organisation to cyber-attacks and data hacks, so security issues are important.

Audit Implications

Auditors should consider the appropriate governance and security around the transactions.

Although blockchain's core security premise rests on cryptography, there are risk factors associated with it.

As blockchain interacts with

- legacy systems and
- business partners,

concerns related to insecure application programming interfaces (APIs), data confidentiality and privacy cannot be ignored.

Weak blockchain application development protocols are something auditors cannot overlook.

Similarly, data privacy laws and regulations may be an area of concern as data are communicated across geographic boundaries. Auditors must be able to determine whether the data put on blockchain will expose the enterprise for non-compliance with applicable laws and regulations.

Bank Audit

PDSJ & Associates are Statutory Auditors of a scheduled Commercial Bank for the year 2023-24. While evaluating internal control over advances, it came to their notice that classification of term loan borrower accounts into SMA as well as NPA is done in the system on the following lines:

- In case full dues are not received on a particular due date, a borrower account is immediately considered as overdue on the very next day. For example, if due date of loan account is 31st March, 2023 and dues are not received on 31st March, 2023, it shall be considered as overdue on 1st April, 2023.
- If it continues to remain overdue, then account is tagged as SMA-1 on 1st May, 2023.
- If it continues to remain overdue further, then account is tagged as SMA-2 on 31st May, 2023.
- If it continues to remain overdue even after being tagged as SMA-2, it is classified as NPA on 30th June, 2023.

Evaluate above control designed by bank in the system for the purpose of exercising control over such advances in compliance to regulatory guidelines. [RTP May-24]

The design of above control instituted by bank in its system is not in accordance with the regulatory guidelines.

Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date which is fixed by the bank, the borrower accounts are flagged as overdue by the banks as part of their day-end processes for the due date.

Classification of borrower accounts as SMA as well as NPA is done as part of day-end process for the relevant date. SMA or NPA classification date is the calendar date for which the day end process is run.

In other words, the date of SMA/NPA reflects the asset classification status of an account at the day-end of that calendar date.

In the given situation, due date of a loan account is March 31, 2023, and full dues are not received by the bank before it runs the day-end process for this date, the date of overdue shall be March 31, 2023 and not 1st April, 2023.

If it continues to remain overdue, then this account shall get tagged as SMA-1 upon running day-end process on April 30, 2023 [i.e. upon completion of 30 days of being continuously overdue].

Accordingly, the date of SMA-1 classification for that account shall be April 30, 2023.

Similarly, if the account continues to remain overdue, it shall get tagged as SMA-2 upon running day-end process on May 30, 2023 and if continues to remain overdue further, it shall get classified as NPA upon running day-end process on June 29, 2023.

PSU Audit

Comptroller & Auditor General appointed Saha & Associates, a Chartered Accountant firm, to conduct Performance audit of herbal Ltd., a public sector undertaking of Government of India. The firm conducted the audit with a view to check that all the expenses of the unit are in conformity with the public interest and publicly accepted customs. The audit report submitted by the audit firm was rejected by C&AG. Give your opinion on the action of C&AG.

In the provided scenario, Saha & Associates, a Chartered Accountant firm, was appointed by the Comptroller and Auditor General (C&AG) to conduct a Performance Audit of Herbal Ltd., a Public Sector Undertaking (PSU) of the Government of India.

The audit, however, primarily focused on verifying that all expenses of the unit were in conformity with public interest and publicly accepted customs, which does not align with the essence of a Performance Audit.

A Performance Audit is characterized as an impartial and systematic examination of evidence aimed at providing an independent assessment of the performance of a government organization, program, activity, or function. The ultimate goal is to furnish information that enhances public accountability and aids decision-making by entities responsible for oversight or corrective action.

In the context of PSUs, Performance Audits are conducted by the C&AG, specifically through various subordinate offices of the Indian Audit and Accounts Department (IAAD).

The auditing process adheres to manuals and standards set by the C&AG, guiding subordinate offices in evaluating the economy, efficiency, and effectiveness of policies, programs, organizations, and management.

The objectives of Performance Auditing encompass promoting accountability by aiding governance and oversight bodies in enhancing performance and fostering transparency by providing insights into the management and outcomes of diverse government activities.

The focus is on areas where adding value holds the greatest potential for development, thereby encouraging responsible parties to take appropriate actions.

Therefore, the rejection of the audit report submitted by Saha & Associates by the C&AG is warranted. This is because the audit conducted by the firm, which primarily aimed at checking the conformity of expenses to public interest and accepted customs, does not align with the comprehensive nature of Performance Audits, which evaluate various aspects of economy, efficiency, and effectiveness.

Internal Audit

CA. Sanjana has recently joined as Chief Internal Auditor of Up Scale Limited, a listed company. Her subordinate staff in internal audit department brings to her knowledge many prior audit issues highlighted in the previous internal audit reports which are still open. Does she have any responsibilities in this regard? How should she proceed in this situation?

In the given situation, CA. Sanjana has recently joined as Chief Internal Auditor in Up Scale Limited, a listed company. As a Chief Internal Auditor, CA. Sanjana is responsible for continuously monitoring the closure of prior audit issues through timely implementation of action plans included in past audits.

This shall be done with a formal monitoring process, elements of which are pre-agreed with management and those charged with governance.

The responsibility to implement the action plans remains with the management.

In monitoring and reporting of prior audit issues, the responsibility of the CA. Sanjana as internal auditor is usually in the form of an "Action Taken Report (ATR) of previous audits".

The term "Monitoring and Reporting" refers to the periodic tracking of issues raised during prior audits and evaluation of the corrective actions undertaken by the auditee to resolve them and to report any open and pending matters to the management and those charged with governance.

CA. Sanjana should review whether follow-up action is taken by the management on the basis of his report.

- If no action is taken within a reasonable time, she should draw the management's attention to it.
- Where the management has not acted upon the suggestions or not implemented the prescribed recommendations, she should ascertain the reasons thereof.
- Where the management has accepted recommendations of the CA. Sanjana and initiated the necessary action, she should periodically review the manner and the extent of implementation of the recommendations and
- report to the management highlighting the recommendations which have not been implemented fully or partly.

Emerging Areas

SEBI has made Business Responsibility and Sustainability Report (BRSR) mandatory for certain listed companies. It is an evolutionary step in Environment, Social and Governance (ESG) reporting. Discuss the nature of ESG reporting. How can corporates contribute to Sustainable Development Goals (SDGs)?

Environment, Social and Governance (ESG) reporting is all about disclosure of information, data, metrics that explain the added value in following three areas:

Environment

Environmental stands for corporate climate policies, energy use, waste, pollutions, natural resource conservation, and treatment of animals. It includes the natural resources that every entity absorbs for its functioning like that of coal, electricity, water and so on. Processing this energy into products / services which will leave behind certain wastes like that of carbon emissions, water discharges, e-wastes and so on. Thus, one is dependent on the environment for carrying out its operations.

Social

It addresses the relationships the entity has and the reputation it fosters with people and institutions in the communities where you do business and the value chain involved. It further includes labour relations, diversity, and inclusions. Every company operates within a broader and diverse society.

Governance

It is the internal system of practices, controls, and procedures entity adopts in order to govern itself, make effective investment decisions, comply with the law, and meet the needs of all stakeholders. Every entity, which is itself a legal creation, requires governance.

Nature of Reporting:

ESG reporting can be both quantitative and qualitative in nature. Qualitative reports tend to describe a company's strategy or policy around the relevant topics, while a quantitative approach includes metrics, and key performance indicators (KPIs) linked to each area in order to measure progress against goals and report on achievements.

Naturally, a mixed approach that makes use of both qualitative and quantitative information tends to add the maximum value to the quality of disclosures.

How can corporates contribute to SDGs?

United Nations members states adopted Sustainable Development to provide a blueprint which mentioned the Sustainable Development Goals (SDGs).

They recognized that ending poverty and other deprivations must go hand in hand with strategies that improve health and education, reduce inequality, and spur economic growth – all while tackling climate change and working to preserve our oceans and forests.

Corporates can contribute to SDGs due to their capacity to provide solutions necessary for meeting SDGs. Companies can lead in innovation and contribute to achievement of Sustainable Development Goals.

Professional Ethics

1. Comment on the following with reference to the provisions of the Chartered Accountant Act 1949:
   a) CA. Pankaj accepted professional work of acting as valuer under direct taxes. He charges fees on a percentage of the property valued.
   b) CA. Anita joined as an audit executive in a CA firm on April 1, 2023. Despite receiving multiple reminders from ICAI, she has failed to respond with her appointment date and submit her membership certificate.

a) Restriction on fees based on a Percentage: According to Clause (10) of Part I of First Schedule to the Chartered Accountants Act, 1949, a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he charges or offers to charge, accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulations made under this Act.

However, Regulation 192 exempts Chartered Accountants in practice to charge fees based on a percentage of profits or contingent upon findings or results for professional work for certain professional services. Regulation 192 specifically states that in the case of a valuer for the purposes of direct taxes and duties, the fees may be based on a percentage of the value of the property valued.

Conclusion: Consequently, CA. Pankaj shall not be deemed to be guilty of professional misconduct, as he is within the permissible scope of charging fees based on a percentage of the property valued.

b) Failed to Supply Information Called For: In accordance with Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949, a member, whether in practice or not, is considered to be engaged in professional misconduct if he fails to provide the information requested or does not comply with the requirements set forth by the Institute, Council, or any of its Committees, including the Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board, or the Appellate Authority.

Conclusion: Therefore, in the given scenario, CA. Anita has neglected to respond to the Institute's letters seeking confirmation of her appointment date and has not submitted her membership certificate. Consequently, she is deemed to be guilty of professional misconduct as given in Clause (2) of Part III of the First Schedule to the Chartered Accountants Act, 1949.