

Ans.



(a) As per SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report"

- If the auditor considers it necessary to draw **users' attention to a matter presented or disclosed** in the financial statements that, in the auditor's judgment, is of such importance that it is **fundamental to users' understanding** of the financial statements,
- **The auditor shall include an Emphasis of Matter paragraph in the auditor's report provided:**
  - (i) The auditor would **not be required to modify the opinion** in accordance with SA 705 as a result of the matter; and
  - (ii) **When SA 701 applies**, the matter has **not been determined to be a key audit matter** to be communicated in the auditor's report.

(b) In the instant case: -

- Since Difficult Books Limited is **engaged in manufacturing of active pharmaceutical ingredients**, would now require **production capacity license** which will restrict the production of companies, due to change in laws and regulations.
- **Management of the Difficult Books Limited** assessed the **impact of the change in law** over the financial position of company and **appropriately disclosed** the same in the financial statement.
- **Audit team of the Difficult Books Limited** evaluated **management's disclosure** and found it appropriate and sufficient. **However, considering the said matter as most important and fundamental to users understanding** regarding financial statement the audit team decided to disclose the same.
- **The said matter is already disclosed and presented appropriately** in financial statement and is of such importance that is fundamental to the users understanding of the financial statement and hence, it required to be disclosed under **Emphasis of Matter paragraph**.

(c) **Conclusion:** -Therefore, **decision of audit team to disclose** the same in Other Matter Paragraph **is not in order**, it should be disclosed in Emphasis of Matter Paragraph.

### SA-710

### Comparative Information – Corresponding Figures and Comparative Financial Statements

214.

#### Auditor's Responsibilities- Comparatives:

You as a statutory auditor had audited the financial statements of A Ltd., a listed company, for F.Y. 2020-21. The company has included the comparative financial information in the financial statements prepared for the current F.Y. 2021-22. You as an auditor want to obtain sufficient appropriate audit evidence that comparative financial information has been presented, in all material aspects, in accordance with the requirements in the applicable financial reporting framework. List out audit procedures, as specified in relevant SA, which you are required to follow for the purpose.

(Dec-2021-Old)

OR

Auditor's responsibilities regarding comparatives.

(RTP-Nov-2018)

Ans.



(i) SA 710, "Comparative Information Corresponding Figures and Comparative Financial Statements",

- SA-710 Establishes standards on the **auditor's responsibilities regarding comparatives**.
- The auditor shall **determine whether the financial statements include the comparative information** required by the **applicable financial reporting framework** and
- Whether **such information is appropriately classified**.

(ii) **For the above purpose, the auditor shall evaluate whether:**

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

**(iii) Additional Audit Procedure:**

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

**(iv) Obtain Written Representation:**

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

215.

**Auditor's Responsibilities -Corresponding Figures:**

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

Ans.



**(i) As per SA 710 "Comparative Information—Corresponding Figures and Comparative Financial Statements",**

- In respect of corresponding figures, the auditor shall determine whether the **financial statements include the comparative information** required by the applicable financial reporting framework and whether such **information is appropriately classified**.

**(ii) For this purpose, the auditor shall evaluate whether:**

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

**(iii) Additional Audit Procedure:**

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

**(iv) Obtain Written Representation:**

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

216.

**Auditor's Responsibilities w.r.t. Corresponding Figures:**

For the year ended 31st March, 2021, the audit report of Avinash Ltd., contained a qualification regarding non-provision for diminution in the value of investments to the extent of ₹ 50 lacs. As an Auditor of the Company for the year 2021-22, how would you report, if:

- The Company does not make provision for diminution in the value of investments in the year 2021-2022.
- The Company makes adequate provision for diminution in the year 2020-2021. **(May-2018-Old)**

OR

The audit report of P Ltd. for the year 2020-21 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2021-22, how would you report, if:

- (i) The company does not make provision for doubtful debts in 2021-22?
- (ii) The company makes adequate provision for doubtful debts in 2021-22?

Ans.



**(i) Auditor's Responsibilities when modification resolved**

- In cases where **audit report for an earlier year is qualified** is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements".
- **As per SA 710**, When the auditor's report on the **prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion** and the matter **which gave rise to the modified opinion** is resolved and **properly accounted for** or disclosed in the financial statements in accordance with the **applicable financial reporting framework**, the auditor's opinion on the current period need not refer to the previous modification.

**(ii) When modification un-resolved**

- SA 710 further states that if the auditor's report on the prior period, as previously issued, included a **qualified opinion** and the matter which gave rise to the **modification is unresolved**, the **auditor shall modify the auditor's opinion on the current period's financial statements**.

**(iii) In the Basis for Modification paragraph** in the auditor's report, the auditor shall either:

- **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
- **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.

**(iv) Conclusion/Opinion:** -In the instant Case, **if P Ltd. does not make provision** for doubtful debts the auditor will have to **modify his report for both** current and previous year's figures as mentioned above. **If however, the provision is made**, the auditor **need not refer** to the earlier year's modification.

217.

**Impact of Modification in the Predecessor Auditor's Report**

It was observed from the modified audit report of the financial statements of ULFA Ltd. for the year ended 31st March, 2021 that depreciation of ₹ 4.25 crore for the year 2020-2021 had been charged off to the Statement of Profit and Loss instead of including it in "carrying value of asset under construction". State in relation to the audit for the year ended 31st March 2022, whether such modification in the previous year's audit report would have any audit implication for the current year i.e. FY 2021-22 and if yes, how the auditor is required to deal with the same in his audit report for the current year? **(MTP-Nov-2020)(Nov-2018-Old)**

Ans.



**(i) Auditor's Responsibilities when modification resolved**

- In cases where **audit report for an earlier year is qualified** is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements".
- **As per SA 710**, When the auditor's report on the **prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion** and the matter **which gave rise to the modified opinion** is resolved and **properly accounted for** or disclosed in the financial statements in accordance with the **applicable financial reporting framework**, the auditor's opinion on the current period **need not refer to the previous modification**.

**(ii) When modification un-resolved**

- SA 710 further states that if the auditor's report on the prior period, as **previously issued**, included a **qualified opinion** and the matter which gave rise to the **modification is unresolved**, the **auditor shall modify the auditor's opinion on the current period's financial statements**.

- (iii) In the **Basis for Modification paragraph** in the auditor's report, the auditor shall either:
- **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
  - **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**.
- (iv) **Conclusion:**
- In the instant case, **if Ulfa Ltd. does not correct the treatment of depreciation** extent of rupees 4.25 crore for previous year, the **auditor will have to modify his report for both current and previous year's figures** as mentioned above.
  - If however, **the figures and provisions are corrected**, the auditor **need not refer to the earlier year's modification**.

## SA-720

### The Auditor's Responsibility in Relation to Other Information

218.

#### Examples of Amounts or Other Items

LMP Associates, Chartered Accountants, conducting the audit of PQR Ltd., a listed Company for the year ended 31st March 2022 is concerned with the auditor's responsibilities relating to other information, both financial and non-financial, included in the Company's annual report. While reading other information, LMP Associates considers whether there is a material inconsistency between other information and the financial statements. As a basis for the consideration the auditor shall evaluate their consistency, compare selected amounts or other items in the other information with such amounts or other items in the financial statements. Guide LMP Associates with examples of "Amounts" or "other items" that may be included in the "other information" with reference to SA 720.

**(MTP-May-2021)(Study Material)(Nov-2019-New)(May-2019-Old)**

Ans.



- (i) **As per SA 720 "The Auditor's Responsibility in Relation to Other Information"**  
The following are **examples of amounts and other items** that may be included in other information. **This list is not intended to be exhaustive.**
- (ii) **Examples of Amounts**
- Items in a **summary of key financial results**, such as **net income, earnings per share, dividends, sales** and other operating revenues, and purchases and operating expenses.
  - **Selected operating data**, such as **income from continuing operations** by major operating area, or sales by **geographical segment** or **product line**.
  - **Special items**, such as **asset dispositions, litigation provisions**, asset impairments, tax adjustments, environmental remediation provisions, and restructuring and reorganization expenses.
  - **Liquidity and capital resource information**, such as cash, cash equivalents and marketable securities; dividends; and debt, capital lease and minority interest obligations.
  - **Capital expenditures** by segment or division etc.
- (iii) **Examples of Other Items**
- Explanations of **critical accounting estimates** and related **assumptions**.
  - Identification of **related parties** and descriptions of **transactions** with them.
  - Articulation of the **entity's policies** or **approach to manage commodity, foreign exchange or interest rate risks**, such as through the use of forward contracts, interest rate swaps, or other financial instruments.
  - Descriptions of the **nature of off-balance sheet arrangements**.
  - **Descriptions of guarantees, indemnifications, contractual obligations**, litigation or environmental liability cases, and other contingencies, including management's qualitative assessments of the entity's related exposures etc.
  - Explanations of **specific factors influencing the entity's profitability** in specific segments

219.

#### Responding when the Auditor concludes that a Material Misstatement of the Other Information exists



ING Associates, Chartered Accountants, conducting the audit of XYZ Ltd., a listed Company for the year ended 31st March 2022 is concerned with the auditor's responsibilities relating to misstatements in other information, both financial and non-financial, included in the Company's annual report. While reading other information, ING Associates considers whether there is any material misstatement of the other information in the Company. After performing their procedures, the auditor concludes that a material misstatement of the other information exists. ING Associates discussed with the Management about the other information that appeared to be materially misstated to the auditor and also requested management to provide evidence for the basis of management's statements in the other information along with supporting documents. Guide ING Associates as to how to respond to that material misstatement of other information obtained prior to the date of auditor's report. Will your answer be different in case ING Associates conclude the same after the date of auditor's report? **(MTP-Nov-2020)**

Ans.



- (i) **Provision:** -As per SA 720, "The Auditor's Responsibility in Relation to Other Information", if the auditor concludes that a **material misstatement** of the **other information exists**, the auditor shall **request management to correct the other information**. If management:
- **Agrees to make the correction**, the auditor shall determine that the **correction has been made**; or
  - **Refuses to make the correction**, the auditor shall **communicate the matter** with TCWG and request that the **correction be made**.
- (ii) If the auditor concludes that a **material misstatement exists in other information** obtained prior to the date of the **auditor's report**, and the **other information is not corrected** after communicating with TCWG, the auditor shall take appropriate action, **including**:
- Considering the **implications for the auditor's report** and **communicating with TCWG** about how the auditor plans to **address the material misstatement** in the auditor's report;
  - **Withdrawing from the engagement**, where withdrawal is possible under **applicable law or regulation**.
- (iii) If the auditor concludes that a **material misstatement exists in other information** obtained after the date of the **auditor's report**, the auditor shall:
- If the other information is **corrected**, **perform the procedures necessary** in the circumstances; or
  - If the other information is **not corrected** after communicating with **those charged with governance**, take appropriate action considering the auditor's **legal rights and obligations**, to seek to have the **uncorrected material misstatement** appropriately brought to the attention of users for whom the auditor's report is prepared.

220.

**Responding when the Auditor concludes that a Material Misstatement of the Other Information exists**  
 GS & Co., Chartered Accountants, have been appointed Statutory Auditors of MAP Ltd. for the F.Y 2021-22. The audit team has completed the audit and is in the process of preparing audit report Management of the company has also prepared draft annual report. Audit in-charge was going through the draft annual report and observed that the company has included an item in its Annual Report indicating downward trend in market prices of key commodities/raw material as compared to previous year. However, the actual profit margin of the company as reported in financial statements has gone in the reverse direction. Audit Manager discussed this issue with partner of the firm who in reply said that auditors are not covered with such disclosures made by the management in its annual report, it being the responsibility of the management. Do you think that the partner is correct in his approach on this issue. Discuss with reference to relevant Standard on Auditing the Auditor's duties with regard to reporting. **(Nov-2020-New)(MTP-Dec-2021)**

Ans.



- (i) As per SA 720, "The Auditor's Responsibility in Relation to Other Information", Descriptions of trends in market prices of key commodities or raw materials is an example of amounts or other Items that may be Included in the other information.
- The **auditor's discussion with management** about a **material inconsistency** (or other information that appears to be materially misstated) may include **requesting management to provide support** for the basis of management's statements in the other information.
  - **Based on management's further information or explanations**, the auditor may be **satisfied** that

the other information is **not materially misstated**.

- **For example, management explanations** may indicate **reasonable and sufficient** grounds for valid differences of judgment.

**(ii) Auditor's duties with regard to reporting in the given case are given hereunder:**

As per SA 720, "The Auditor's Responsibility in Relation to Other Information", if the auditor concludes that a **material misstatement of the other information exists**, the auditor shall request management to **correct the other information**. If management:

- Agrees to **make the correction**, the auditor shall **determine that the correction** has been made; or
- **Refuses to make the correction**, the auditor shall **communicate the matter** with TCWG and request that the correction be made. Contention of the partner of the firm that auditors are not concerned with such disclosures made by the management in its annual report, is incorrect.

221.

**Reporting of Supplementary Information in Audit Report**

CA. S has been appointed as Statutory Auditor of SRT Ltd. for the financial year 2021-2022. The Company while preparing financial statements for the year under audit prepared one additional profit and loss account that disclosed specific items of expenditure and included the same as an appendix to the financial statements. CA. S has not been able to understand this as the additional profit and loss account is not covered under applicable financial reporting framework. Guide him as to how he should deal with his issue while reporting on the financial statement of SRT Ltd.

**(July-2021-New)**

Ans.

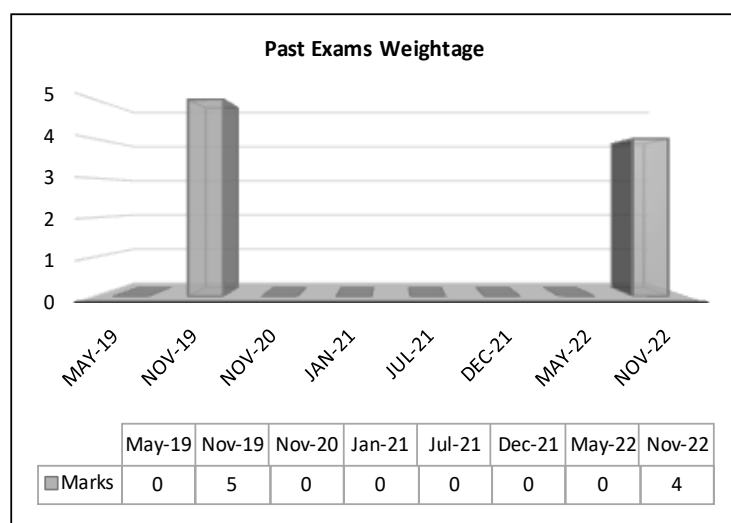


- ❖ If supplementary information that is **not required by the applicable financial reporting framework** is presented with the audited financial statements, the **auditor shall evaluate whether**, in the auditor's professional judgment, supplementary information is **nevertheless an integral part of the financial statements** due to its nature or how it is presented.
- ❖ **When it is an integral part of the financial statements**, the supplementary information shall be covered by the auditor's opinion.
- ❖ **If supplementary information that is not required by the applicable financial reporting framework** is not considered an integral part of the audited financial statements, the auditor shall evaluate **whether such supplementary information** is presented in a way that **sufficiently and clearly differentiates** it from the audited financial statements.
- ❖ If this is not the case, then the **auditor shall ask management to change how the unaudited supplementary information is presented**.
- ❖ **If management refuses to do so**, the auditor shall identify the **unaudited supplementary information** and **explain in the auditor's report** that such supplementary information **has not been audited**.
- ❖ **When an additional profit and loss account that discloses specific items of expenditure** is disclosed as a separate schedule, included as an appendix to the financial statements, the **auditor may consider this to be supplementary information** that can be clearly **differentiated from the financial statements**.

**Conclusion:** -Thus, **additional profit and loss account is not considered an integral part of the audited financial statements** and the auditor shall evaluate that **supplementary information** is presented in a way that **sufficiently and clearly differentiates** it from the audited financial statements.

## Chapter 2

# AUDIT PLANNING, STRATEGY & EXECUTION



| Topics  | Unique Qs | Total Qs |
|---|-----------|----------|
| 2.1 - Audit Planning - Content & Objective            | 5         | 6        |
| 2.2 - Audit Strategy- Formulation, Factors & Benefits | 5         | 6        |
| 2.3 - Audit Programme - Drafting                      | 3         | 6        |
| 2.4 - Audit Execution -Key phases                     | 1         | 2        |

### 2.1 - Audit Planning -Content & Objective

**1. Audit Plan- Contents**  
**Write a short note:** Contents of an audit plan. (RTP-May-2021)

**Ans.**



**The auditor shall develop an audit plan that shall include a description of-**

- The nature, timing and extent of **planned risk assessment procedures**, as determined under SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment".
- The nature, timing and extent of **planned further audit procedures** at the **assertion level**, as determined under SA 330 "The Auditor's Responses to Assessed Risks".
- Other planned audit procedures** that are required to be carried out so that the **engagement complies with SAs**.
  - The audit plan is **more detailed than the overall audit strategy** that includes the nature, timing and extent of audit procedures to be performed by engagement team members.
  - Planning for these audit procedures takes place **over the course of the audit** as the audit plan for the engagement develops.
  - For example:** Planning of the **auditor's risk assessment procedures** occurs **early** in the audit process. However, planning the **nature, timing and extent** of specific **further audit procedures** **depends** on the **outcome of those risk assessment procedures**.
  - In addition, the auditor **may begin the execution of further audit procedures** for some classes of transactions, account balances and disclosures before planning all remaining further audit procedures.

**2. Audit Plan - Development**  
 A & Co. was appointed as auditor of Great Airways Ltd. As the audit partner what factors shall be considered in the development of overall audit plan? (Study Material)

**Ans.**

**Factors to be considered in development of overall audit plan**  
 Overall plan is basically intended to provide **direction for audit work programming** and includes the determination of **timing, manpower development and co-ordination** of work with the client, other auditors and other experts. The auditor should consider the **following matters** in developing his overall plan



for the expected scope and conduct of the audit:

1. **Terms of his engagement** and any statutory responsibilities.
2. **Nature and timing** of reports or other communications.
3. Applicable **Legal or Statutory** requirements.
4. **Accounting policies** adopted by the clients and changes, if any, in those policies.
5. The effects of **new accounting and auditing pronouncement** on the audit.
6. **Identification** of significant audit areas.
7. Setting of **materiality levels** for the audit purpose.
8. Conditions requiring **special attention** such as the possibility of **material error or fraud** or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
9. **Degree of reliance** to be placed on the accounting system and internal control.
10. Possible rotation of **emphasis** on specific audit areas.
11. Nature and extent of **audit evidence** to be obtained.
12. Work of the **internal auditors** and the extent of reliance on their work, if any in the audit.
13. Involvement of **other auditors** in the audit of subsidiaries or branches of the client and involvement of experts.
14. **Allocation of works** to be undertaken between **joint auditors** and the procedures for its control and review.
15. Establishing and **coordinating staffing requirements**.

**SJ Note: Any eight points may be answered in Exam**

3. **Benefits/Advantages of Audit Planning**  
 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. Briefly discuss the usefulness of careful and adequate audit planning **(July-2021-Old)**

OR

**Write short notes on:** Usefulness of careful and adequate audit planning.

**Ans.**



**Benefits/Advantages of Planning in an Audit of Financial Statements:** 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 described hereunder-**

- (i) **Attention to Important Areas** - Planning would help the auditor to devote appropriate attention to important areas of the audit.
- (ii) **Timely resolution of Potential Problems** - It would also help the auditor identify and resolve potential problems on a timely basis.
- (iii) **Proper Organisation and Management of Audit Engagement** - Adequate planning would help the auditor in properly organizing and managing the audit engagement so that it is performed in an effective and efficient manner.
- (iv) **Proper Selection of Engagement Team** - Planning would assist the auditor 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.
- (v) **Direction and Supervision of Engagement Team** - It would further facilitate the direction and supervision of engagement team members and the review of their work.
- (vi) **Easy Coordination** - Also, planning would be helpful to the auditor in coordination of work done by auditors of components and experts.

4. **Audit Plan - Abnormal Wastage of Raw Material**  
 Darshan Ltd. is a manufacturing company, provided following details of wastages of raw materials in percentage, for various months. You have been asked to enquire into causes of abnormal wastage of raw materials. Draw out an audit plan.



**Wastage percentage are:**

July 2021 - 1.5%

Aug 2021 - 1.7%

Sep 2021 - 1.4%

Oct 2021 - 4.1%

(MTP-May-2022)(MTP-May-2018)

**Ans.****Audit Plan to inquire causes of abnormal wastage of raw material:**

Before planning for detailed investigation, the auditor is required to understand the manufacturing operations from the initial stage of purchase of materials, issue of material, consumption of material and conversions into finished goods.

**To locate the reasons for the abnormal wastage, the audit plan may include the following:**

- (i) **Obtain a list of raw materials used** in the production process mentioning therein the names and detailed characteristics of each raw material.
- (ii) **Ascertain the basis of computation** of normal wastage figures and its consistency as compared to previous months.
- (iii) **Obtain internal control reports** in respect of manufacturing costs incurred with reference to predetermined standards or budgets.
- (iv) **Examine the stock records** so as to determine the raw material purchased, material issued to production.
- (v) **Examine the production records** so as to determine the material received from the stores and actual material consumed in the production and waste produced in the production process.
- (vi) **Study the Maintenance Programme** of machinery to ensure that the machinery does not consume more raw material and quality of goods manufacture is not of sub-standard nature.
- (vii) **Employees training ascertain** whether employees engaged in production are properly trained and working efficiently.
- (viii) **Examine inventory controls** in respect of storage, pilferage, issues etc.
- (ix) **Obtain a statement showing break up** of wastage figures in storage, handling and production for the period under reference and compare the results of the analysis for each of the month.
- (x) **Consider the existence of following situations that may also cause the abnormal wastage:**
  - Purchase of **poor quality** of raw materials.
  - **Machinery breakdown** or power failure.
  - **High rate of rejections** of finished goods
  - **Deterioration** of raw material lying in godowns
  - **Abnormal wastages** in storage and handling.
  - Commencing **new production line**.

## 2.2 - Audit Strategy-Formulation, Factors &amp; Benefits

**5.****Audit Strategy- Factors**



You have been appointed as an auditor of Bahubali Ltd. for the first time. Enumerate the factors to be considered while establishing an overall audit strategy and its benefits. (May-2018-Old)


**Ans.****SA 300 "Planning an Audit of Financial Statements":-**

Requires that 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.

**In establishing the overall audit strategy, the auditor shall:**

- a) **Determination of Characteristics of Audit:** Identify the **characteristics of the engagement** that define its scope;
- b) **Reporting Objectives:** Ascertain the **reporting objectives of the engagement** to plan the timing of the audit and the nature of the communications required;
- c) **Team's Efforts:** Consider the **factors that are significant** in directing the engagement team's efforts;
- d) **Preliminary Work:** Consider the **results of preliminary engagement activities** and, where applicable, whether knowledge gained on **other engagements performed** by the engagement partner for the entity is relevant; and
- e) **Nature, timing and Extent of Resources:** Ascertain the **NTE of procedures** necessary to perform.

|   |  |
|---|--|
| <p>6.</p>   | <p><b>Audit Strategy- Formulation &amp; Specific factors for Online Shopping Venture</b></p> <p>As an auditor of garment manufacturing company for the last five years, you have observed that new venture of online shopping has been added by the company during current year. What factors would be considered by you in formulating the audit strategy of the company? <b>(Study Material)</b></p>   |
| <p><b>Ans.</b></p>    | <p><b>Formulation of Audit Strategy &amp; Specific factors for Online Shopping Venture</b></p> <p>(i) <b>Factors to be considered in establishing audit strategy SA 300 “Planning an Audit of Financial Statements”</b>:-Requires that the auditor shall establish an <b>overall audit strategy</b> that sets the <b>scope, timing and direction</b> of the audit, and that <b>guides</b> the development of the audit plan.</p> <p><b>In establishing the overall audit strategy, the auditor shall:</b></p> <ol style="list-style-type: none"> <li>Identify the <b>characteristics of the engagement</b> that define its scope;</li> <li>Ascertain the <b>reporting objectives of the engagement</b> to plan the timing of the audit and the nature of the communications required;</li> <li>Consider the <b>factors that are significant</b> in directing the engagement team’s efforts;</li> <li>Consider the <b>results of preliminary engagement activities</b> and, where applicable, whether knowledge gained on <b>other engagements performed</b> by the engagement partner for the entity is relevant; and</li> <li>Ascertain the <b>NTE of procedures</b> necessary to perform.</li> </ol> <p>(ii) <b>Specific Factors for Online Shopping:</b> The auditor shall also obtain an understanding of the information system including the related business processes due to new venture of online shopping in the following areas:</p> <ol style="list-style-type: none"> <li>Nature of transactions <b>significant</b> to the financial statements;</li> <li>Procedures, within <b>both information technology and manual systems</b>, by which transactions are <b>initiated, recorded, processed, corrected</b> (if necessary), transferred to the general ledger and reported in the financial statements;</li> <li>System by which the information system <b>captures events and conditions</b>, other than transactions, that are significant to the financial statements;</li> <li><b>Controls used</b> to record non-recurring, unusual transactions or adjustments.</li> </ol> |
| <p>7.</p>   | <p><b>Audit Strategy - Team Resources</b></p> <p>The process of establishing the overall audit strategy assists the auditor to determine certain matters with respect of team resource. Explain those matters.</p>   |
| <p><b>Ans.</b></p>  | <p><b>Matters determined by Audit Strategy with respect to team resources</b></p> <p>(i) <b>Employment of Qualitative Resources:</b></p> <ul style="list-style-type: none"> <li>Audit strategy helps in deploying the <b>appropriate resources for specific audit areas</b>,</li> <li>Such as the use of <b>experienced team members</b> for high risk areas or the <b>involvement of experts</b> on complex matters like review of valuation, hedging transactions. .</li> </ul> <p>(ii) <b>Allocation of Quantity of Resources:</b></p> <ul style="list-style-type: none"> <li>Audit strategy helps in allocating the <b>appropriate number of resources</b> to specific audit areas</li> <li>Such as the <b>number of team members assigned</b> to observe the <b>inventory count</b> at material locations.</li> </ul> <p>(iii) <b>Timing of Deployment of Resources:</b></p> <ul style="list-style-type: none"> <li>Audit strategy helps in determining the timing of deploying the resources</li> <li>Such as <b>whether at an interim audit stage</b> or at <b>key cut-off dates</b>.</li> </ul> <p>(iv) <b>Management of Resources:</b></p> <ul style="list-style-type: none"> <li>Audit strategy helps in <b>managing, directing, supervising the resources</b></li> <li>Such as when team <b>briefing and debriefing meetings</b> are expected to be held,</li> <li>How <b>engagement partner and manager reviews</b> are expected to take place (for example, on-site or off-site), and</li> <li>Whether to complete <b>engagement quality control reviews</b>.</li> </ul>  |

|   |   |
|---|---|
| 8.  | <b>Audit Strategy &amp; Audit Plan</b><br>Discuss the relationship between overall audit strategy and audit plan. (Nov-2016)<br><b>OR</b><br>Write short note on: Relationship in between audit strategy and audit plan.  |
| <b>Ans.</b><br> | <b>Relationship between Audit Strategy and Audit Plan</b><br><b>(i) Inter-related</b><br>Audit strategy and audit plan are inter-related to each other because change in one would result into change in the other.<br><b>(ii) Before plan &amp; more detailed</b><br>The audit strategy is prepared before the audit plan. The audit plan contains more details than the overall audit strategy.<br><b>(iii) Guidelines</b><br>The audit strategy provides the guidelines for developing the audit plan.<br><b>(iv) Basis for developing plan</b><br>Audit strategy establishes the scope, timing and direction of the audit and thereby works as basis for developing a detailed audit plan<br><b>(v) Nature, timing &amp; extent of AP</b><br>Detailed audit plan would include the nature, timing and extent of the audit procedures so as to obtain sufficient appropriate audit evidence. |

### 2.3 - Audit Programme –Drafting

|   |   |
|---|---|
| 9.  | <b>Audit Programme -Adequacy of Records</b><br>CA. Dev, a recently qualified practicing Chartered Accountant got his first internal audit assignment of a large manufacturing concern Growth Limited. As an internal auditor for Growth Limited, CA. Dev is required to verify whether there are adequate records for identification and value of Plant and Machinery, tools and dies and whether any of these items have become obsolescent and not in use. Draft a suitable audit programme for the above. (RTP-May-2021)<br><b>OR</b><br>As an internal auditor for a large manufacturing concern, you are asked to verify whether there are adequate records for identification and value of Plant and Machinery, tools and dies and whether any of these items have become obsolescent and not in use. Draft a suitable audit programme for the above. (MTP-May-2018)  |
| <b>Ans.</b><br> | <b>Audit Programme to determine adequacy of records w.r.t. Plant and Machinery:</b><br>The <b>Internal Audit Programme</b> in connection with <b>Plant and Machinery and Tools and Dies</b> may be on the following lines:<br><b>(i) Internal control aspects:</b> The following may be incorporated in the audit programme to check the internal control aspects- <ul style="list-style-type: none"> <li>• <b>Maintaining separate register</b> for hired assets, leased asset and jointly owned assets.</li> <li>• <b>Maintaining register of fixed asset</b> and reconciling to physical inspection of fixed asset and to nominal ledger.</li> <li>• <b>All movements</b> of assets are <b>accurately recorded</b>.</li> <li>• <b>Authorisation be obtained for –</b> <ul style="list-style-type: none"> <li>➤ a declaring a fixed asset <b>scrapped</b>.</li> <li>➤ <b>selling</b> a fixed asset.</li> </ul> </li> <li>• Check whether additions to fixed asset register are <b>verified and checked</b> by authorised person.</li> <li>• <b>Proper recording</b> of all additions and disposal.</li> <li>• <b>Examining procedure for the</b> purchase of new fixed assets, including written authority, work order, voucher and other relevant evidence.</li> <li>• Regular review of <b>adequate security</b> arrangements.</li> <li>• <b>Periodic inspection</b> of assets is done or not.</li> </ul> |

- (ii) **Assets register:** To review the **registers and records** of plant, machinery, etc. showing clearly the **date of purchase of assets, cost price, location, depreciation charged, etc.**
- (iii) **Cost report and journal register:** To review the **cost relating to each plant and machinery** and to verify items which have been **capitalised**.
- (iv) **Code register:** To see that **each item of plant and machinery** has been given a **distinct code number** to facilitate **identification** and verify the **maintenance** of Code Register.
- (v) **Physical verification:** To see physical verification has been **conducted at frequent intervals**.
- (vi) **Movement register:** To verify
  - whether **Movement Register** for movable equipments and
  - **log books in case of vehicles**, etc. are being maintained properly.
- (vii) **Assets disposal register:** To review whether assets have been disposed off after **proper technical and financial advice** and sales/disposal/retirement, etc. of these assets are governed by **authorisation**, sales memos or other appropriate documents.
- (viii) **Spare parts register:** To examine the maintenance of a **separate register of tools, spare parts** for each plant and machinery.
- (ix) **Review of maintenance:** To scrutinise the programme for an **actual periodical servicing and overhauling of machines** and to examine the extent of utilisation of maintenance department services.
- (x) **Review of obsolescence:** To scrutinise whether **expert's opinion have been obtained** from time to time to ensure purchase of technically most useful efficient and advanced machinery after a thorough study.
- (xi) **Review of R&D:** To review R&D activity and ascertain the extent of **its relevance to the operations** of the organisation, maintenance of machinery efficiency and prevention of early obsolescence.

10.

**Audit Programme - Multiplex Cinema House**

Cineplex, a movie theatre complex, is the foremost theatre located in Delhi. Along with the sale of tickets over the counter and online booking, the major proportion of income is from the cafe, shops, pubs etc. located in the complex. It's other income includes advertisements exhibited within/outside the premises such as hoardings, banners, slides, short films etc. The facility for parking of vehicles is also provided in the basement of the premises. Cineplex appointed your firm as the auditor of the entity. Being the head of the audit team, you are therefore required to draw an audit programme initially in respect of its revenue and expenditure considering the above-mentioned facts along with other relevant points relating to a complex.

(MTP-May-2022)(MTP-May-2021)(MTP-May-2021)(Study Material)(Nov-2019-New)  
OR

You have been appointed as the auditor of a Multiplex Cinema House. Draw an audit programme in respect of its Revenue and Expenditure. (RTP-May-2018)

**Ans.**

**Audit Programme for Revenue and Expenditure of Multiplex:**

- (i) **Study the MOA and AOA:-** of the entity so as to ensure that the object clause of MOA permits the entity to engage in this business.
- (ii) In respect of **income from sale of tickets**, perform the following:
  - Examine the internal control system to ensure **proper accounting** of sale of tickets.
  - Examine the system of **on line booking and realization of money**.
  - Examine the system of **reconciliation of collections** with the number of seats available.
- (iii) Examine the **existence and effectiveness of internal control system** relating to the **income from cafes shops, pubs etc.**, located within the multiplex.
- (iv) Examine the control exercised relating to the **income receivable from advertisements exhibited** within the premises.
- (v) Examine the system of collection from the **parking areas**.
- (vi) Examine the system of **payment to the distributors** which may be either through out right payment or percentage of collection.

- (vii) Examine the system of **payment of salaries and other benefits** to the employees and ensure compliance of statutory requirements.
- (viii) Examine the expenses incurred in respect of the **maintenance of the building** and **ensure the same is in order.**
- (ix) Verify the **insurance premium paid** and ensure it covers the entire assets.

#### 2.4 - Audit Execution -Key phases

11.

#### Key Phases in the Audit Execution

Key phases in the audit execution stage are Execution Planning, Risk and Control Evaluation, Testing and Reporting. Explain. (RTP-Nov-2018)

OR

Briefly explain the key phases in the audit execution.

Ans.



**Key phases in the audit execution stage are Execution Planning, Risk and Control Evaluation, Testing and Reporting.**

#### Phase-I: Execution Planning

- In order to carry out the audit in an **effective, efficient & timely manner**
- Auditors need to plan the work and a **detailed audit program should be prepared**
- Covering the audit **objectives, scope and audit approach.**
- During execution planning, auditor should consider the **manpower requirement, qualification of members of ET, time factor etc.**

#### Phase-II: Risk and Control Evaluation

- Auditor need to conduct a **detailed assessment of risk and control** as per requirements of SA 315.
- **Steps involved in assessment of risk are:**
- **List the risk** that need to be **reviewed** for each segment of audit.
- **Capture for each risk** the controls that exist or those that are needed
- **Determine the steps** required to test the effectiveness of each controls.

#### Phase-III: Testing

- **As required by SA 330-** auditor should test the **operating effectiveness** of the controls to determine **whether controls are operating as designed.**
- Auditor should perform **appropriate substantive procedures** (Tests of Details and SAP) so as to collect **sufficient appropriate audit evidences** w.r.t. completeness, accuracy and validity of accounting data.

#### Phase-IV: Reporting

- The auditor should **review and assess the conclusions** drawn from the audit evidence obtained as the basis for the expression of an opinion on the F.S.
- The opinion so formed **should be expressed in the form of audit report** as required by SA 700.
- Auditor's report should contain a **clear written expression of opinion** on the financial statements taken as a whole.

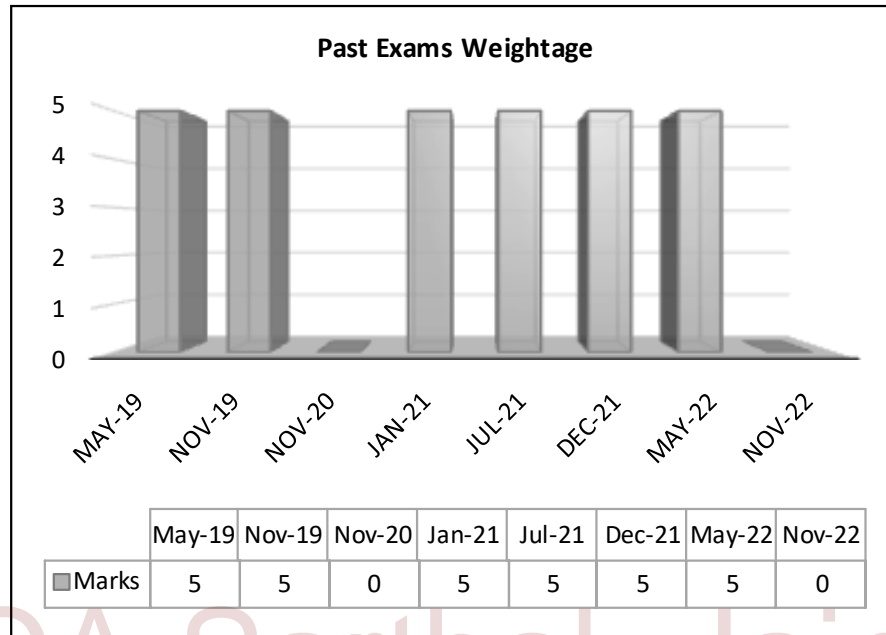
## Notes





# Chapter 3

## RISK ASSESSMENT & INTERNAL CONTROL



| Topics   | Unique Qs | Total Qs |
|--|-----------|----------|
| 3.1 - Risk Assessment  | 7         | 9        |
| 3.2 - Internal Control & Risk Assessment                       | 1         | 1        |
| 3.3 - Internal Control System                                  | 4         | 4        |
| 3.4 - Components of Internal Control                           | 9         | 12       |
| 3.5 - Techniques of Evaluation of Internal Control             | 1         | 1        |
| 3.6 - Internal Control Assessment & Evaluation                 | 1         | 2        |
| 3.7 - Reporting to clients on internal control weaknesses      | 1         | 1        |
| 3.8 - Risk Based Audit (RBA)                                   | 2         | 5        |
| 3.9 - International Internal Control Frameworks & Other Topics | 5         | 5        |

## 3.1 - Risk Assessment

## 1. Components of Audit Risk

SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" categorizes the types of assertions used by the auditor to consider the different types of potential misstatements that may occur. Briefly explain with example. **(Study Material)**

Ans.

The major components of audit risk are



| Nature   | Description  | Commentary  |
|--|--|---|
| <b>Inherent Risk</b>   | Susceptibility of an assertion to a misstatement that <b>could be material, individually or when aggregated</b> with other misstatements, assuming that there are <b>no related controls</b> . Inherent risk is addressed at <b>both the financial statement level and at the assertion level</b> . For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. | These are the <b>business and other risks</b> that arise from the entity's <b>objectives, nature of operations and industry, the regulatory environment in which it operates and its size and complexity</b> .<br>The risks of material misstatement will vary based on the nature of the account balance or class of transaction. Risks of particular concern to the auditor might include: <ul style="list-style-type: none"> <li>• <b>Complex calculations</b> which could be misstated;</li> <li>• <b>High value inventory</b>;</li> <li>• <b>Accounting estimates</b> that are subject to significant measurement uncertainty;</li> <li>• <b>Lack of sufficient working capital</b> to continue operations;</li> <li>• <b>A declining or volatile industry</b> with many business failures; and</li> <li>• <b>Technological developments</b> that might make a particular product obsolete.</li> </ul> |
| <b>Control Risk (Do internal controls in place mitigate the inherent risks?)</b> | Risk that the entity's <b>internal control system will not prevent, or detect and correct on a timely basis</b> , a misstatement that could be material, individually or when aggregated with other misstatements.   | The entity should <b>identify and assess its business and other risks</b> (such as fraud) and respond by designing and implementing a system of internal control. Entity level controls such as board oversight, IT general controls, and HR policies are pervasive to all assertions whereas activity level controls generally, relate to specific assertions. Some control risk will always exist because of the inherent limitations of any internal control system. The auditor is required to understand the entity's internal control and perform procedures to assess the risks of material misstatement at the assertion level.   |
| <b>Detection Risk</b>  | This is the risk that the <b>auditor will not detect a misstatement that exists in an assertion</b> that could be material, either individually or when aggregated with other misstatements. The acceptable level of detection risk for a given level of audit risk bears an inverse relationship to the risks of material misstatement at the assertion level   | The auditor <b>identifies assertions</b> where there are <b>risks of material misstatement</b> and concentrates audit procedures on those areas. In designing and evaluating the results of performing procedures, the auditor should consider the possibility of: <ul style="list-style-type: none"> <li>• Selecting an <b>inappropriate</b> audit procedure;</li> <li>• <b>Misapplying</b> an appropriate audit procedure; or</li> <li>• <b>Misinterpreting</b> the results from an audit procedure.</li> </ul>   |

2. **Audit Risk & RoMM**  
 Compute the overall Audit Risk if looking to the nature of business there are chances that 40% bills of services provided would be defalcated, inquiring on the same matter management has assured that internal control can prevent such defalcation to 75%. At his part the Auditor assesses that the procedure he could apply in the remaining time to complete Audit gives him satisfaction level of detection of frauds & error to an extent of 60%. Analyse the Risk of Material Misstatement and find out the overall Audit Risk.

(MTP-May-2019) (MTP-Nov-2020)(Study Material)

Ans.



**Determination of Audit Risk**

- (i) **As per SA-200:-**“Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing”, the Audit Risk is a risk that Auditor will issue an inappropriate opinion while Financial Statements are materially misstated.
- (ii) **Audit Risk is a function of two components:**  
 Risk of material Misstatement and Detection Risk, i.e.  $\text{Audit Risk} = \text{Risk of material Misstatement} \times \text{Detection Risk}$
- (iii) **Risk of Material Misstatement:-**  
 It is anticipated risk that a material Misstatement may exist in Financial Statement before start of the Audit. **It has two components** Inherent risk and Control risk. The relationship can be defined as:  
**Risk of material Misstatement = Inherent risk X control risk**
- **Inherent Risk:-** The susceptibility of an assertion about account balance; class of transaction, disclosure towards misstatements which may be either individually or collectively with other Misstatement becomes material before considering any related internal control.
    - **In the given case:-** Inherent Risk is 40%.
  - **Control Risk:-** It is the risk that material misstatement will not be prevented or detected and corrected on a timely basis by the internal control system.
    - **In the given case :-** Control risk is 25% (100%-75%).
- $\text{Risk of material Misstatement} = 40\% \times 25\% = 10\%$
- (iv) **Detection Risk:-** It is the risk that the substantive procedures performed by the auditor fails to detect material misstatement.
- **In the given case :-** Detection Risk is  $100-60 = 40\%$
  - **Hence overall Audit Risk** = Risk of Material Misstatement X Detection Risk =  $10 \times 40\% = 4\%$

3. **Evaluation of IR at the Level of FSS**  
 Write short note on: Evaluation of inherent risk at the level of financial statements.  
**OR**  
 In the audit planning process of X Ltd., you would like to consider audit risk at the financial statement level. What are the factors can influence your decision?

Ans.



**Factors to be evaluated to assess inherent risk at the level of financial statements:**

- Integrity** of management.
- Management's **experience and knowledge** and changes in management during the period.
- Unusual pressures** on management.
- The **nature** of the entity's business.
- Factors affecting the **industry** in which the entity operates.

4. **IR at the Account Balance and Class of Transaction Level**  
 Describe how you would identify the inherent risk at the account balance and class of transaction level in the planning process of the audit of a large multi-locational company.  
**OR**  
 As the auditor of a large multi locational company, in the planning process, you are requested to identify the inherent audit risk at the account balance and class of transaction level.

Ans.

**Identifying inherent risk at the account balance and class of transaction level:**

To evaluate the inherent risk at the account balance and transaction level, auditor should evaluate the following factors:

- (i) Quality of the **accounting system**.
- (ii) Susceptibility of **Financial statements** to misstatement.
- (iii) The complexity of **underlying transactions and other events** which might require using the work of an expert.
- (iv) The degree of judgement involved in **determining account balances**.
- (v) Susceptibility of **assets to loss** or misappropriation.
- (vi) The completion of **unusual and complex transactions**, particularly at or near period end.
- (vii) Transactions **not subjected** to ordinary processing.

5.

**Risk Identification - Steps**

Your engagement team is seeking advice from you as engagement partner regarding steps for risk identification. Elaborate. **(Study Material)**

Ans.



- 1) Assess the **significance of the assessed risk**, impact of its **occurrence** and also **revise the materiality** accordingly for the specific account balance.
- 2) Determine the **likelihood for assessed risk to occur** and its impact on our auditing procedures.
- 3) Document the **assertions that are effected**.
- 4) Consider the **impact of the risk** on each of the assertions (**completeness, existence, accuracy, validity, valuation and presentation**) relevant to the account balance, class of transactions, or disclosure.
- 5) **Identify the degree of significant risks** that would require separate attention and response by the auditor. Planned audit procedures should directly address these risks.
- 6) **Enquire and document the management's response**.
- 7) Consider the nature of the **internal control system in place** and its **possible effectiveness** in mitigating the risks involved. **Ensure the controls :**
  - **Routine in nature** (occur daily) or periodic such as monthly.
  - **Designed to prevent or detect** and correct errors.
  - **Manual or automated**.
- 8) Consider any **unique characteristics** of the risk.
- 9) Consider the **existence of any particular characteristics** (inherent risks) in the class of transactions, account balance or disclosure that need to be addressed in designing further audit procedures.
- 10) **Examples could include high value inventory, complex contractual agreements**, absence of a paper trail on certain transaction streams or a large percentage of sales coming from a single customer.

6.

**Assessment of Risk and Acceptable Level**

While commencing the statutory audit of B Company Limited, the auditor undertook the risk assessment and found that the detection risk relating to certain class of transactions cannot be reduced to acceptance level. Explain. **(May-2017)**

Ans.



- SA 315 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" and SA 330 "The Auditor's Responses to Assessed Risks"
- Establishes standards on the procedures to be followed to obtain an **understanding of the accounting and internal control systems** and on audit risk and its components.
- SA 315 and SA 330
- Require that the auditor should **use professional judgement** to assess **risk of material misstatement** and to design **audit procedures** to ensure that it is reduced to an **acceptably low level**.
- Risk of Material Misstatements comprises of **Inherent risk and Control Risk**.

- **"Detection risk"** is the risk that an auditor's **substantive procedures** will not detect a misstatement that exists in an account balance or class of transactions that could be material
- The **higher the risk of material misstatement**, the more audit evidence the auditor should obtain from the performance of substantive procedures.
- When **both inherent and control risks are assessed as high**, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level.
- The auditor should use his **professional judgement** to assess **audit risk** and to **design audit procedures** to ensure that it is reduced to an **acceptably low level**. If it cannot be reduced to an acceptable level, the auditor should **express a qualified opinion** or a **disclaimer of opinion** as may be appropriate.

**7. Audit Procedures to Address the Validity of Account Balance Level**  
 During the process of extracting the exception reports, the auditors noted numerous purchase entries without valid purchase orders. In terms of percentage, about 40% of purchases were made without valid purchase orders whereas few purchase orders were validated after the actual purchase. Also, there was no reconciliation between the goods received and the goods ordered. You are required to briefly explain the audit procedures to address the validity of account balance level. **(MTP-May-2021)**

**Ans.**



**(i) In the given scenario:**

- The auditors noted **numerous purchase entries** without **valid purchase orders** during the process of extracting **the exception reports**.
- Further, in terms of percentage, **about 40% of purchases were made without valid purchase orders** and also **few purchase orders were validated after the actual purchase**.
- Also there was **no reconciliation** between the goods received and the goods ordered.

**(ii) Audit Procedures:** The following procedures may address **the validity of the account balance**:

- **Make a selection of the purchases**, review correspondence with the vendors, purchase requisitions (internal document) and reconciliations of their accounts.
- **Review Vendor listing** along with the ageing details. Follow up the material amounts paid before the normal credit period and analyse the reasons for exceptions.
- **Meet with the company's Purchase officer** and obtain responses to our inquiries regarding the purchases made without purchase orders.
- **Discuss the summary** of such issues with the client.

### 3.2 - Internal Control & Risk Assessment

**8. Risk Management**  
 The volatility, unpredictability and pace of fast changes that exists in the automated environment today is far greater than in the past and consequently it throws more risk to business which requires them to have a need to continuously manage such risks. State various risks which an enterprise may have to face and manage. **(MTP-May-2022)(May-2019-New)**

**Ans.**



**Following risks which an enterprise may have to face and manage:**

- Businesses today operate in a **dynamic environment**
- **Some of the reasons** for this dynamic environment include globalization, use of technology, etc.
- Because of this dynamic environment the **associated risks** to business have **also increased** and
- Companies have a need to **continuously manage risks**.

**Examples of risks include:**

- **Market Risks;**
- **Regulatory & Compliance Risks;**
- **Technology & Security Risks;**



- **Financial Reporting** Risks;
- **Operational** Risks;
- **Credit** Risk;
- **Business Partner** Risk;
- **Product or Project** Risk;
- **Environmental** Risks.

### 3.3 - Internal Control System

9. **Control Objectives**  
 As auditor of ZED Ltd., you would like to limit your examination of account balance tests. What are the control objectives you would like the accounting control system to achieve to suit your purpose?

(MTP-May-2021) (Study Material)

Ans.



The basic accounting control objectives which are sought to be achieved by any accounting control system are:

1. Whether all transactions are **recorded**;
2. whether recorded transactions are **real**;
3. Whether all recorded transactions are **properly valued**;
4. Whether all transactions are recorded **timely**;
5. Whether all transactions are properly **posted**;
6. Whether all transactions are properly **classified and disclosed**;
7. Whether all transactions are properly **summarized**.

10. **Basic Accounting Control Objectives**  
 One of the objectives of Internal control relating to accounting system is that all transactions are promptly recorded in an appropriate manner to permit the preparation of financial information and to maintain accountability of assets. To achieve this objective, certain matters should be ensured by accounting controls. List down matters to be ensured by accounting controls.

(July-2021-New)

Ans.



**Matters to be ensured by accounting controls –**

**Basic Accounting Control Objectives:** The basic accounting control objectives which are sought to be achieved by any accounting control system are -

- (i) Transactions are executed in accordance with management's **general or specific authorisation**;
- (ii) Transactions and other events are **real & promptly/timely recorded** at correct amounts;
- (iii) Transactions should be **classified in appropriate accounts** and in the appropriate period to which it relates;
- (iv) Transactions are **properly posted**.
- (v) Transactions should be **recorded in a manner** so as to facilitate preparation of financial statements in accordance with applicable accounting standards, other accounting policies and practices and relevant statutory requirements;
- (vi) Transactions are **properly disclosed**.
- (vii) Recording of transactions should **facilitate maintaining accountability** for assets;
- (vii) Assets and records are required to be **protected from unauthorized access, use or disposition**;
- (ix) Records of assets, such as **sufficient description of the assets** (to facilitate identification, its location should also be maintained, so that the assets could be **physically verified** periodically.
- (x) Transactions are **properly summarized**.

11. **ICS and Inherent Limitations of the IC**  
 Astha Ltd., a manufacturing concern want to develop internal control system. You are an expert in developing the internal control system, hereby called to brief about the same. In view of above, you are required to brief about internal control system and inherent limitations of the internal control?

Ans.

**Internal Control System and its Inherent Limitations:**

- (i) SA 315 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" defines :

**Internal control** as the process **designed, implemented and maintained** by TCWG, management and other personnel to provide **reasonable assurance** about the achievement of an **entity's objectives** with regard to :

- **Reliability** of financial reporting;
- **Effectiveness and efficiency** of operations;
- **Safeguarding** of assets; and
- **Compliance** with applicable laws and regulations.

- (ii) **Inherent Limitations of Internal Control System:**

- a) Management's consideration that a control should be **cost-effective**.
- b) The fact that the most controls do not tend to be directed at **transactions of unusual nature**.
- c) Potential for **human error**.
- d) Possibility of circumvention of controls through **collusion with parties** outside the entity or with employees of entity.
- e) Possibility that a person responsible for exercising control could **abuse that authority**.
- f) Possibility that **procedures may become inadequate** due to changes in conditions and compliance with procedures may deteriorate.
- g) **Manipulations by management** with respect to transactions or estimates and judgments required in the preparation of financial statements.

12.

**Key Components - Internal Control Structure**

XYZ Hospital Private Ltd. is engaged in running a hospital of 200 Beds since last 20 years. Revenue Track of the hospital for last 3 years is as under:

2019-20 : ₹ 20 Crores

2020-21 : ₹ 25 Crores

2021-22 : ₹ 35 Crores

Hospital has its own Pharmacy, Laboratory, Blood Bank, Radiology & General Stores. Its management suspects that leakages/theft is happening in Pharmacy, Radiology, Laboratory and General Stores departments. It seeks advice of RST & Co., Internal Auditors of the Company, as to how it can Institute/Improve its Internal Control. In this context, Management wants to understand the concept of components of Internal Control Structure in detail. Advise.

(MTP-Nov-2018)

Ans.



- The Internal Control structure in an organization is referred to as the **policies and procedures established by the entity** to provide **reasonable assurance** that the objectives are achieved. The control structure in an organization basically has the **following components**:
  - 1. Control Environment** - Control environment covers the effect of various factors like management attitude; awareness and actions for establishing, enhancing or mitigating the effectiveness of specific policies and procedures.
  - 2. Accounting System** - Accounting system means the series of task and records of an entity by which transactions are processed for maintaining financial records. Such system identifies, assemble, analyze, calculate, classify, record, summarize and report transactions and other events.
  - 3. Control Procedure** - Policies and procedures means those policies and procedures in addition to the control environment and accounting systems which the management has established to achieve the entity's specific objectives.
- In this regard, the **management is responsible for maintaining an adequate accounting system** incorporating **various internal controls** to the extent that they are appropriate to the size and nature of the business.

- There should be **reasonable assurance** for the auditor that the accounting system is **adequate** and that all the accounting information required to be recorded has in **fact been recorded**. Internal controls normally contribute to such **assurance**.
- The auditor should gain an understanding of the **accounting system and related internal controls** and should **study and evaluate** the operation of those internal controls upon which he wishes to rely in determining the **nature, timing and extent** of other audit procedures.
- Where the auditor concludes that **he can rely on certain internal controls**, he could reduce his **substantive procedures** which otherwise may be required and may also differ as to the nature and timing.
- **Specific Requirement under SA 315** - "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment" deals with the auditor's responsibility to **identify and assess the risks of material misstatement** in the financial statements, through **understanding** the entity and its environment, including the **entity's internal control**.

### 3.4 - Components of Internal Control

#### 13. Internal Control Framework – Components

What are the components of an internal control framework?

(Study Material)

Ans.



**There are five components of an internal control framework.**

**They are as follows:**

- Control Environment;
- Risk Assessment;
- Information & Communication;
- Monitoring;
- Control Activities

#### 14. Integrity and Ethical Values

The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Explain.

(Study Material)

Ans.



- The effectiveness of controls **cannot rise above the integrity and ethical values** of the people who create, administer, and monitor them.
- **Integrity and ethical behavior** are the product of the entity's **ethical and behavioral standards**, how they are **communicated**, and how they are **reinforced** in practice.
- The **enforcement of integrity and ethical values** includes, **for example**, management actions to **eliminate** or **mitigate** incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts.
- The **communication of entity policies** on integrity and ethical values may include the communication of **behavioral standards** to personnel through policy statements and **codes of conduct** and by example.

#### 15. Risk Assessment Process

Briefly describe the various stages of a risk assessment process.

(Study Material)

Ans.



- Risk Assessment is **one of the most critical components** of Enterprise Risk Management.
- The risk assessment process involves considerations for :
  - Qualitative and quantitative factors,
  - Definition of key performance and risk indicators,
  - Risk appetite,
  - Risk scores,
  - Scales and maps,
  - Use of data & metrics and benchmarking.

(iii) The various stages in a Risk Assessment process are as follows

1. **Define** Business Objectives and Goals;
2. **Identify** events that affect achievement of business objectives;
3. **Assess** likelihood and impact;
4. **Respond** and mitigate risks;
5. **Assess** residual risk.

16.

**Circumstances in which - Risks can Arise or Change**

The Entity's Risk Assessment Process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of occurrence and decides upon actions to respond to and manage them and the results thereof. Elucidate the circumstances in which risks can arise or change.

(Study Material)(Nov-2019-New)

OR

For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. Explain the circumstances under which risk can arise or change.

(Nov-2020-Old)

Ans.



**Risks can arise or change due to circumstances such as the following:**

(i) **Changes in operating environment**

Changes in the regulatory or operating environment can result in **changes in competitive pressures** and significantly different risks.

(ii) **New personnel**

New personnel may have a **different focus** on or **understanding** of internal control.

(iii) **New or revamped information systems.**

Significant and rapid changes in information systems **can change the risk** relating to internal control.

(iv) **Rapid growth**

Significant and rapid expansion of operations **can strain controls** and increase the risk of a breakdown in controls.

(v) **New technology**

Incorporating new technologies into **production processes or information systems** may change the risk associated with internal control.

(vi) **New business models, products, or activities**

Entering into business areas or transactions with **which an entity has little experience** may introduce new risks associated with internal control.

(vii) **Corporate restructurings**

Restructurings may be accompanied by **staff reductions** and **changes in supervision** and **segregation of duties** that may change the risk associated with internal control.

(viii) **Expanded foreign operations**

The expansion or acquisition of foreign operations **carries new and often unique risks** that may affect internal control, for example, additional or changed risks from foreign currency transactions.

(ix) **New accounting pronouncements**

Adoption of new accounting principles or changing accounting principles **may affect risks in preparing financial statements.**

17.

**Deficiencies in ICS & General Conditions pertaining to Internal Check**

New life Hospital is a multi-specialty hospital which has been facing a lot of pilferage and troubles regarding their inventory maintenance and control. On investigation into the matter it was found that the person in

charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records. According to you, which basic system control has been violated? Also list down the other general conditions pertaining to such system which needs to be maintained and checked by the management.

(Study Material)(Nov-2015)

OR

Navjeevan Hospital is a multi-specialty hospital which has been facing a lot of pilferage and troubles regarding their inventory maintenance and control. On investigation into the matter it was found that the person in charge of inventory inflow and outflow from the store house is also responsible for purchases and maintaining inventory records. According to you, which basic system control has been violated? Also list down the other general conditions pertaining to such system which needs to be maintained and checked by the management.

(RTP-May-2020)

Ans.



**Basic system of Control:**

- **Internal Checks** and **Internal Audit** are important constituents of **Accounting Controls**. Internal check system implies organization of the **overall system of book-keeping** and arrangement of **Staff duties** in such a way that no one person can carry through a transaction and record every aspect thereof.
- **In the given case of New Life Hospital:** - The **person-in-charge** of inventory inflow and outflow from the store house is **also responsible** for purchases and maintaining inventory records.
- Thus, **one of the basic system of control** i.e. internal check which includes **segregation of duties** or **maker and checker** has been violated where transaction processing are allocated to different persons in such a manner that **no one person can carry through the completion of a transaction** from start to finish or the work of one person is made complimentary to the work of another person.
- **General Conditions pertaining to internal check:**
  - a) **No single person** should have an **independent control** over any important aspect of the business operation. **Every employee's action** should come under the review of another person.
  - b) **Staff duties** should be **rotated from time to time** so that members **do not perform the same function** for a considerable length of time.
  - c) **Every member of the staff** should be encouraged to **go on leave** at least once in a year.
  - d) **Persons having physical custody of assets** must not be permitted to have **access to the books of account**.
  - e) There should **exist an accounting control** in respect of each class of assets, in addition, there should be **periodical inspection** so as to establish their **physical condition**.
  - f) **Mechanical devices** should be used, where ever practicable to **prevent loss or misappropriation** of cash.
  - g) **Budgetary control** would enable the management to **review from time to time** the progress of trading activities.
  - h) For inventory taking, at the close of the year, **trading activities should, if possible be suspended**, and it should be done by staff belonging to several sections of the organization.
  - i) The **financial and administrative powers** should be distributed **very judiciously among different officers** and the manner in which those are actually exercised should be reviewed periodically.
  - j) Procedures should be laid down for **periodical verification and testing** of different sections of accounting records to ensure that they are accurate.

18.

**General Conditions- Internal Check**

State the considerations on which effectiveness of an efficient system of internal check depends.

(Nov-2016)

OR

The Auditor of S Limited has just commenced the statutory audit. What should be considerations for the effectiveness of a system of internal check?



Ans.

**Considerations for effectiveness of a system of internal check:**

- **No single person** should have an **independent control** over any important aspect of the business operation. **Every employee's action** should come under the review of another person.
- **Staff duties** should be **rotated from time to time** so that members **do not perform the same function** for a considerable length of time.
- **Every member of the staff** should be encouraged to **go on leave** at least once in a year.
- **Persons having physical custody of assets** must not be permitted to have **access to the books of account**.
- There should **exist an accounting control** in respect of each class of assets, in addition, there should be **periodical inspection** so as to establish their **physical condition**.
- **Mechanical devices** should be used, where ever practicable to **prevent loss or misappropriation** of cash.
- **Budgetary control** would enable the management to **review from time to time** the progress of trading activities.
- For inventory taking, at the close of the year, **trading activities should, if possible be suspended**, and it should be done by staff belonging to several sections of the organization.
- The **financial and administrative powers** should be distributed **very judiciously among different officers** and the manner in which those are actually exercised should be reviewed periodically.
- Procedures should be laid down for **periodical verification and testing** of different sections of accounting records to ensure that they are accurate.

19.

**General Conditions pertaining to Internal Check**

BSF Limited is engaged in the business of trading leather goods. You are the internal auditor of the company for the year 2021-22. In order to review internal controls of the sales department of the company, you visited the department and noticed the work division as follows:

- (1) An officer was handling the sales ledger and cash receipts.
- (2) Another official was handling dispatch of goods and issuance of Delivery challans.
- (3) One more officer was there to handle customer/ debtor accounts and issue of receipts.
  - (a) As an internal auditor you are required to briefly discuss the general condition pertaining to the internal check system.
  - (b) Do you think that there was proper division of work? If not, why?

**(MTP-May-2022)(Study Material)(RTP-Nov-2019)(MTP-Nov-2019)**

Ans.

**(a) General Conditions pertaining to internal check:**

Considerations for effectiveness of a system of internal check:

- **No single person** should have an **independent control** over any important aspect of the business operation. **Every employee's action** should come under the review of another person.
- **Staff duties** should be **rotated from time to time** so that members **do not perform the same function** for a considerable length of time.
- **Every member of the staff** should be encouraged to **go on leave** at least once in a year.
- **Persons having physical custody of assets** must not be permitted to have **access to the books of account**.
- There should **exist an accounting control** in respect of each class of assets, in addition, there should be **periodical inspection** so as to establish their **physical condition**.
- **Mechanical devices** should be used, where ever practicable to **prevent loss or misappropriation** of cash.
- **Budgetary control** would enable the management to **review from time to time** the progress of trading activities.
- For inventory taking, at the close of the year, **trading activities should, if possible be suspended**, and it should be done by staff belonging to several sections of the organization.

- The **financial and administrative powers** should be distributed **very judiciously among different officers** and the manner in which those are actually exercised should be reviewed periodically.
- Procedures should be laid down for **periodical verification and testing** of different sections of accounting records to ensure that they are accurate.

**(b) Conclusion:-** In the present condition **company has not done proper division of work** as:

- The receipts of cash **should not be handled by the official handling sales ledger** and
- Delivery challans **should be verified by an authorised official** other than the officer handling dispatch of goods.

20.

### Good Internal Control System – Assumptions

In the use of standardized Internal Control Questionnaire (ICQ), certain basic assumptions about elements of a good internal control system are taken into account. List down few such assumptions. **(Nov-2018-New)**

Ans.



**Assumptions presumed about elements of good control while using standardized internal control questionnaire:**

- Certain procedures** in general used by **most business concerns** are essential in achieving reliable internal control.  
**For example:-** deposits into bank of the entire receipts of a day or daily balancing of the cash book and ledgers or periodic reconciliation with the control accounts
- Extensive **division of duties and responsibilities** within the organisation.
- Separation** of accounting function with the custodial function.
- No single person** is entrusted with the responsibility of completing a transaction all by himself.
- There should always be **evidence to identify the person** who has done the work whether involving authorisation, implementation or checking.
- The work performed by each one is expected to **come under review** of another in the usual course of routine.
- There is **proper documentation and recording** of the transactions.

21.

### Internal Check System

Write short note on: Objectives of internal check system.

Ans.



**Objectives of Internal Check System:**

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

## 3.5 - Techniques of Evaluation of Internal Control

22.

### Flow Chart Technique

Explain briefly the flow chart technique for evaluation of the internal control system. **(Study Material)**

Ans.



- It is a **graphic presentation of internal controls** in the organisation and is normally drawn up to show the controls in each section or sub-section.
- It provides the **most concise and comprehensive way** for reviewing the internal controls and the evaluator's findings.
- A flow chart is a diagram **full with lines and symbols** and if judicious use of them can be made, it is probably an **effective way of presenting** the state of internal controls in the client's organisation.
- A properly drawn up flow chart can provide a **neat visual picture of the whole activities** of the section or department involving flow of documents and activities.

More specifically it can show–

- At what point a **document is raised** internally or received from external sources;
- The **number of copies** in which a document is raised or received;
- The **intermediate stages** set sequentially through which the document and the activity pass;
- **Distribution of the documents** to various sections, department or operations;
- **Checking authorisation** and matching at relevant stages;
- **Filing** of the documents; and
- **Final disposal** by sending out or destruction.

### 3.6 - Internal Control Assessment & Evaluation

23.

#### SOPs of Assessment and Evaluation of Control

During the course of audit of Fortune Ltd., CA Prasad is concerned with the quality and effectiveness of internal control. Towards achieving his objective he wants to assess and evaluate the control environment. Guide CA Prasad with well-defined set of the Standard Operating Procedures in the assessment and evaluation of control. **(Dec-2021-New)**

OR

A newly qualified professional has received his first appointment as auditor of a large company and is very much concerned about the effectiveness of internal control and wants to assess and evaluate the control environment as part of his audit program. Towards achieving his objective, he seeks your help in knowing the Standard Operating Procedures (SOPs) of assessment and evaluation of control. **(May-2019-New)**

Ans.



**Guidance to CA Prasad with well defined set of Standard Operating Procedure is given hereunder:**

- Standard Operating Procedures (SOPs):** A well defined set of SOPs helps define **role, responsibilities, process & controls** & thus helps clearly communicate the operating controls to all touch points of a process. The controls are likely to be **clearly understood & consistently applied** even during employee turnover.
- Enterprise Risk Management:** An organization which has robust process to **identify & mitigate risks** across the enterprise & its periodical review will assist in **early identification of gaps & taking effective control measures**. In such organizations, **surprises of failures** in controls is likely to be few.
- Segregation of Job Responsibilities:** A key element of control is that **multiple activities** in a transaction/decision should not be concentrated with one individual. Segregation of duties is an **important element of control** such that no two commercial activities should be **conducted by the same person**. A buyer should not be involved in **receiving of materials or passing of bills**. Similarly bank reconciliation should be prepared by a **person other than** the one who maintains bank book
- Job Rotation in Sensitive Areas:** Any job carried out by the same person over a long period of time is likely to **lead to complacency & possible misuse** in sensitive areas. It is therefore important that in key commercial functions, the **job rotation is regularly followed** to avoid degeneration of controls. **For example**, if the same buyer continues to conduct purchase function for long period, it is likely that he gets into comfort zone with existing vendors & hence does not exercise adequate controls in terms of vendor development, competitive quotes etc.
- Delegation of Financial Powers Document:** As the organization grows, it needs to delegate the **financial & other powers to their employees**. A clearly **defined document** on delegation of powers allows controls to be clearly operated without being dependent on individuals.
- Information Technology based Controls:** With the advent of computers & enterprise resource planning (ERP) systems, **it is much easier to embed controls through the system** instead of being human dependent. The failure rate for IT embedded controls is **likely to be low**, is likely to have better **audit trail** & is thus easier to monitor. **For example** at the stage of customer invoicing, application of correct rates in invoices or credit control can all be exercised directly through IT system improving control environment.

### 3.7 - Reporting to clients on internal control weaknesses

24.

#### Letter of Weaknesses-Drafting

During the course of his audit, the auditor noticed material weaknesses in the internal control system and he wishes to communicate the same to the management. You are required to elucidate the important points the auditor should keep in the mind while drafting the letter of weaknesses in internal control system.

(Study Material)(RTP-May-2020)(MTP-May-2020)

Ans.



#### Points to be considered while drafting letter of weaknesses:

(i) As per SA 265, "Communicating Deficiencies in Internal Control to Those who Charged with Governance and Management" The auditor shall include in the written communication of significant deficiencies in internal control –

- A **description of the deficiencies** and an **explanation of their potential effects**; and
- **Sufficient information** to enable those charged with governance and management to **understand the context of the communication**.

This communication should be, preferably, in writing through a letter of weakness.

(ii) **Important points with regard to such a letter are as follows:**

- It lists down the **area of weaknesses** in the internal control system and recommends suggestions for improvement.
- It should **clearly indicate** that this letter covers only weaknesses **which have come to the attention of the auditor** during his evaluation of internal control for the purpose of determining nature, timing and extent of further audit procedures.
- Letter should clearly indicate that his examination of internal control has **not been designed to determine the adequacy of internal control** for management.
- This letter serves as a significant means for management and governing body for the purpose of **improving the system and its strict implementation**.
- The letter may also serve to **minimize legal liability** in the event of a major defalcation or other loss resulting from a weakness in internal control.

### 3.8 - Risk Based Audit (RBA)

25.

#### Risk Based Audit

What are the general steps in the conduct of risk based audit? (Study Material)(MTP-Nov-2020)(May-2016)

OR

ST Ltd is a growing company and currently engaged in the business of manufacturing of tiles. The company is planning to expand and diversify its operations. The management has increased the focus on the internal controls to ensure better governance. The management had a discussion with the statutory auditors to ensure the steps required to be taken so that the statutory audit is risk based and focused on areas of greatest risk to the achievement of the company's objectives. Please advise the management and the auditor on the steps that should be taken for the same. (Study Material)(MTP-May-2019)(RTP-May-2019)

OR

Audit should be risk-based or focused on areas of greatest risk to the achievement of the audited entity's objectives. 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. What are the general steps for conducting Risk Based Audit? (Nov-2020-Old)

OR

What are the main phases in the conduct of risk-based audit?

(May-2017)

Ans.

(i) **Definition:** -Risk Based audit is an audit approach **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.**

**(ii) General Steps in the Conduct of Risk Based Audit:**

- The **auditor's objective** in a risk-based audit is to **obtain reasonable assurance** that no **material misstatements** whether caused by **fraud or errors** exist in the financial statements.
- **This involves the following three key steps:**
  - **Assessing the risks of material misstatement** in the financial statements
  - **Designing and performing further audit procedures** that respond to **assessed risks** and reduce the **risks of material misstatements** in the financial statements to an acceptably low level; and
  - **Issuing an appropriate audit report** based on the audit findings.
- **The risk-based audit process is presented in three distinct phases:**

**(a) Risk assessment.**

**The risk assessment phase of the audit involves the following steps:**

- 1) Performing **client acceptance or continuance** procedures;
- 2) Planning the **overall engagement**;
- 3) Performing **risk assessment procedures** to understand the business and identify inherent and control risks;
- 4) Identifying **relevant internal control procedures** and assessing their **design and implementation** (those controls that would prevent material misstatements from occurring or detect and correct misstatements after they have occurred);
- 5) Assessing the **risks of material misstatement** in the financial statements; Identifying the significant risks that require special audit consideration and those risks for which substantive procedures alone are not sufficient;
- 6) Communicating **any material weaknesses** in the design and implementation of internal control to management and those charged with governance; and
- 7) Making an **informed assessment** of the risks of material misstatement at the financial statement level and at the assertion level.

- (b) Risk response:** -This phase of the audit is to **design and perform further audit procedures** that respond to the **assessed risks of material misstatement** and will provide the evidence necessary to support the **audit opinion**.

**Some of the matters the auditor should consider when planning the audit procedures include:**

1. Assertions that **cannot be addressed by substantive procedures** alone. This can occur where there is **highly automated processing** of transactions with little or no manual intervention.
2. **Existence of internal control** that, if tested, could reduce the **need/scope** for other substantive procedures.
3. The **potential for substantive analytical procedures** that would reduce the need/scope for other types of procedures.
4. The need to **incorporate an element of unpredictability** in procedures performed.
5. The need to **perform further audit procedures** to address the potential for management override of controls or other fraud scenarios.
6. The need to **perform specific procedures** to address "significant risks" that have been identified.

**(c) Reporting.**

The **final phase of the audit is to assess the audit evidence** obtained and determine whether it is **sufficient and appropriate to reduce the risks** of material misstatement in the financial statements to an acceptably low level.



It is important at this stage to determine:

1. If there had been a **change in the assessed level of risk**;
2. Whether **conclusions drawn** from work performed are **appropriate**; and
3. **If any suspicious circumstances have been encountered**. Any additional risks should be **appropriately assessed**, and further audit procedures performed as required. When all procedures have been performed and conclusions reached:
4. **Audit findings** should be **reported to management** and those charged with governance; and
5. An **audit opinion** should be **formed**, and a **decision made** on the appropriate wording for the **auditor's report**.

26.

#### Risk Based Audit & Risk Assessment Phase

PADHAM Ltd is engaged in the business of manufacturing of carpets. The company is planning to expand and diversify its operations. The management has increased the focus on internal controls to ensure better governance. The management discussed with the statutory auditors to ensure the steps required to be taken so that the statutory audit is risk based and focused on areas of greatest risk to the achievement of the company's objectives.

(a) Name the key steps and phases involved in Risk Based Audit.

(b) Also, discuss the steps to be taken for the risk assessment phase of the audit.

(RTP-May-2022)

Ans.



(a) The auditor's objective in a **risk-based audit** is to obtain **reasonable assurance** that **no material misstatements** whether caused by **fraud or errors exist** in the financial statements.

**This involves the following three key steps:**

- Assessing the **risks of material misstatement** in the financial statements
- Designing and performing **further audit procedures** that respond to assessed risks and reduce the risks of material misstatements in the financial statements to an acceptably low level; and
- Issuing an **appropriate audit report** based on the audit findings. The risk-based audit process is presented in three distinct phases: Risk assessment. Risk response; and Reporting.

(b) **The risk assessment phase of the audit involves the following steps:**

- Performing **client acceptance or continuance** procedures;
- Planning the **overall engagement**;
- **Performing risk assessment procedures** to understand the business and identify inherent and control risks;
- Identifying relevant **internal control procedures** and **assessing their design and implementation** (those controls that would prevent material misstatements from occurring or detect and correct misstatements after they have occurred);
- Assessing the **risks of material misstatement** in the financial statements;
- Identifying the significant risks that require **special audit consideration** and those risks for which substantive procedures alone are not sufficient;
- **Communicating any material weaknesses** in the design and implementation of internal control to management and those charged with governance; and
- **Making an informed assessment** of the risks of material misstatement at the **financial statement level** and **at the assertion level**.

### 3.9 - International Internal Control Frameworks & Other Topics

27.

#### COSO Framework – Principles

Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework includes 17 principles representing the fundamental concepts associated with its five components. List these principles.

Ans.



**Principles representing fundamental concepts associated with five components of Internal Control:**

Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework includes 17 principles representing the fundamental concepts associated with its five components. These components and the associated principles are:

| Components                        | Principles   |
|-----------------------------------|--|
| (i) Control Environment           | <ul style="list-style-type: none"> <li>• Demonstrates commitment to <b>integrity and ethical values</b></li> <li>• Exercises <b>oversight responsibility</b></li> <li>• Establishes <b>structure, authority, and responsibility</b></li> <li>• Demonstrates <b>commitment to competence</b></li> <li>• Enforces <b>accountability</b></li> </ul> |
| (ii) Risk Assessment              | <ul style="list-style-type: none"> <li>• Specifies <b>suitable objectives</b></li> <li>• <b>Identifies and analyses risk</b></li> <li>• Assesses <b>fraud risk</b></li> <li>• <b>Identifies and analyses significant change</b></li> </ul>   |
| (iii) Control Activities          | <ul style="list-style-type: none"> <li>• Selects and develops <b>control activities</b></li> <li>• Selects and develops <b>general controls over technology</b></li> <li>• Deploys through <b>policies and procedures</b></li> </ul>   |
| (iv) Monitoring                   | <ul style="list-style-type: none"> <li>• Uses <b>relevant information</b></li> <li>• Communicates <b>internally</b></li> <li>• Communicates <b>externally</b></li> </ul>   |
| (v) Information and Communication | <ul style="list-style-type: none"> <li>• Conducts <b>ongoing and/or separate evaluations</b></li> <li>• Evaluates and communicate <b>deficiencies</b></li> </ul>   |

28.

**CoBIT-Framework**

Write a short note on: Control objectives for information and related technology (CoBIT) Framework.

Ans.


**Control Objectives for Information and Related Technology (CoBIT) Framework:**

- Control Objectives for Information and Related Technology commonly **known as CoBIT**, is a framework created by the **ISACA** (Information Systems Audit and Control Association) **for IT governance and management**.
- It is meant to be a **supportive tool for managers** and allows bridging the crucial gap between technical issues, business risks and control requirements.
- Business managers are **equipped with a model** to deliver value to the organization and practice better risk management practices associated with the IT processes.
- **It is a control model** that guarantees the **integrity of the information system**.
- Today, COBIT is **used globally by all managers** who are responsible for the IT business processes. It is a thoroughly recognized guideline that can be applied to any organization across industries.
- Overall, **COBIT ensures quality, control and reliability of information systems** in organization, which is also the most important aspect of every modern business.

29.

**Corporate Responsibility – SOX, 2002 & Co. Act, 2013**

The corporate responsibility under the SOX, 2002 and the Corporate Social Responsibility under the Companies Act, 2013 are referring to the same concept. Please evaluate this statement critically.

(Nov-2020-Old)

Ans.


**Corporate Responsibility under the SOX 2002 and the Corporate Responsibility under the Companies Act, 2013 – Referring to the same concept:**

The Sarbanes Oxley Act of 2002 established **corporate accountability** and **civil and criminal penalties** for white – collar crimes. The **title three of SOX 2002** deals with the **Corporate Responsibility** whereas **Section 135 of the Companies Act, 2013** deals with **Corporate Social Responsibility**.

**Both refer the same concepts such as:**

- More independence** be given to Audit Committee and auditor.
- Strict reporting** by an auditor on insider trading.

- (iii) **Additional disclosures** imposed on financial reporting.
- (iv) If there is any **conflict between company and its auditor**, the Audit Committee should be **empowered to resolve** the same.
- (v) **Higher penalties and criminal prosecution** on financial frauds.
- (vi) To include **effectiveness of Internal Control System** in the financial reporting.
- (vii) **More responsibilities** must be imposed on **managerial personal** with higher penalties and prosecutions on the breach.
- (viii) **Strict action** against white collar crime.
- (ix) **Disclosers of the % of shareholdings** by Directors, Executive Officers and principal shareholders. In view of above, it can be concluded that Corporate Responsibility under SOX and Corporate Social Responsibility under Companies Act, 2013 are referring to the same concept.

30.

**Integrated Framework its Components and Objectives**

Explain the concept of Integrated framework issued by Committee of the Sponsoring Organisations of the Tread way Commission (COSO Framework) duly mentioning its four out of five components and discuss the three category of objectives that can be achieved as per COSO framework. **(Jan-2021-New)**

Ans.


**Concept of COSO**
**(i) Concept of integrated framework:**

- **COSO's Internal Control** – Integrated Framework was **introduced in 1992** as guidance on **how to establish better controls** so companies can achieve their objectives.
- **COSO categorizes** entity –level objectives into **operations, financial reporting, and compliance**.
- **The framework includes more than 20 basic principles** representing the fundamental concepts associated with its **five components**: control environment, risk assessment, control activities, information and communication, and monitoring.
- **Some of the principles include key elements** for compliance, **such as** integrity and ethical values, authorities and responsibilities, policies and procedures, and reporting deficiencies

**(ii) Components of COSO framework**

- 1) **Control Environment**
- 2) **Risk Assessment**
- 3) **Control Activities: -**
- 4) **Information and Communication**
- 5) **Monitoring**

The COSO Framework is designed to be used by organizations to **assess the effectiveness of the system of internal control** to achieve objectives as determined by management.

**(iii) The Framework lists three categories of objectives as below:**

- a) **Operations Objectives** – related to the **effectiveness and efficiency** of the entity's operations, including **operational and financial performance goals**, and safeguarding assets against loss.
- b) **Reporting Objectives** – related to **internal and external financial and non-financial reporting** to **stakeholders**, which would encompass reliability, timeliness, transparency, or other terms as established by regulators, standard setters, or the entity's policies.
- c) **Compliance objectives** – In the Framework, the compliance objective was described as **"relating to the entity's compliance with applicable laws and regulations."** The Framework considers the increased demands and complexities in laws, regulations, and accounting standards.

31.

**System towards Collection of Money**

Y Co. Ltd. has five entertainment centers to provide recreational facilities for public especially for children and youngsters at 5 different locations in the peripheral of 200 kilometers. Collections are made in cash. Specify the adequate system towards collection of money. **(Study Material)(MTP-May-2018)**

Ans.



**Control System over Selling and Collection of Tickets:** In order to achieve proper internal control over the sale of tickets and its collection by the Y Co. Ltd., following system should be adopted -

- (a) **Printing of tickets:** Tickets should be **serially numbered and pre-printed** Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover.
- (b) **Sale of Tickets:** Tickets should be **sold from the Central ticket office** at each of the 5 centers, preferably through machines.
- (c) **Reconciliation of daily cash:** Cash collection at each office **should be reconciled** with the number of tickets sold.
- (d) **Banking of daily cash collection:** Daily collection should be **deposited in the bank on next working day** of the bank. Till that time, the cash should be in the **custody of properly authorized person**.
- (e) **Cancellation of Entrance ticket:** Entrance tickets **should be cancelled at the entrance gate** when public enters the centre.
- (f) **Advance booking:** If **advance booking of facility** is made available, the system should ensure that **all advance booked tickets are paid for**.
- (g) **Discounts and free pass:** The discount **policy should be such that the concessional rates** should be properly authorized and **signed forms for such authorization** should be preserved.
- (h) **Surprise checks:** Internal audit system should **carry out periodic surprise checks** for cash counts, daily banking, reconciliation and stock of unsold tickets etc.

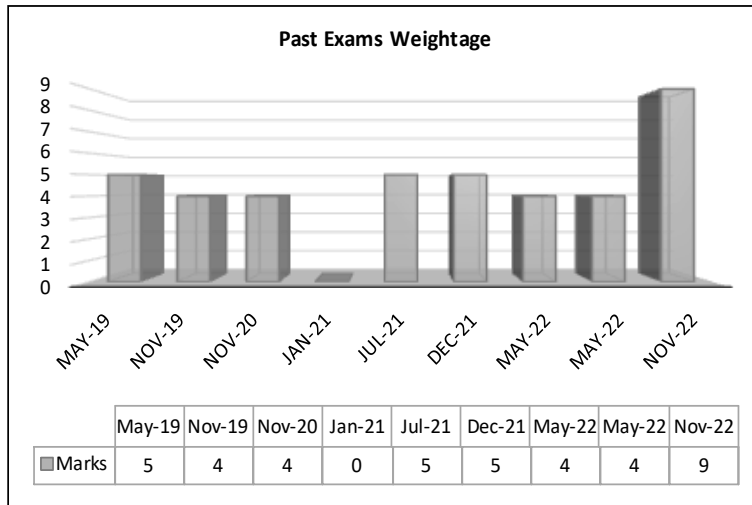
## Notes



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## Chapter 4

# SPECIAL ASPECTS OF AUDITING IN AN AUTOMATED ENVIRONMENT



| Topics                                      | Unique Qs | Total Qs |
|---|-----------|----------|
| 4.1 - Real Time Environment – IT Components | 1         | 1        |
| 4.2 - Auditing in Real Environment          | 4         | 10       |
| 4.3 - Enterprise Risk Management            | 1         | 1        |
| 4.4 - IT Related Risk & Controls            | 6         | 8        |
| 4.5 - Data Analytics                        | 2         | 5        |

### 4.1 - Real Time Environment – IT Components

#### 1. Components and Example of Real Time Environment

A real-time environment is a type of automated environment in which business operations and transactions are initiated, processed and recorded immediately as they happen without delay. It has several critical IT components that enable anytime, anywhere transactions to take place. You are required to name the components and its example of real-time environment.

(MTP-May-2021)(Study Material) (MTP-May-2020)(MTP-Nov-2018)(RTP-Nov-2018)

Ans.



**Real Time Environment:**

(i) **IT Components:** To facilitate transactions in real-time, it is essential to have the **systems, networks and applications** available during all times. A real-time environment has **several critical IT components** that enable anytime, anywhere transactions to take place. Any failure even in **one component could render the real-time system** unavailable and could result in a loss of revenue.

(iii) **IT Components include:**

- **Applications** like ERP, Core Banking Etc.
- **Middleware** like web servers
- **Networks** like WAN, Internet hosting.
- **Hardware** like Data centers, storage devices, power supply etc.

### 4.2 -Auditing in Real Environment

#### 2. Automated Environment - Understanding

CA Vipin has been appointed as Statutory Auditor by IG Insurance Co. Ltd. for 3 of its branches for the F.Y. 2021-2022. Insurance Company is using a 'software called "Applied Epic" wherein all transactions (policy issuance, premium receipts, expense of insurance company, incomes, assets and liabilities) are recorded and financial statements generated at the end of the financial year. CA Vipin not technically equipped and well versed with technology, decided to follow traditional manual auditing approach and started the audit. He is of the view that understanding and using the auditee's automated environment is optional and not required. Do you agree with the approach and views of CA Vipin?

(Nov-2020-New)

OR



Write a short note on: Understanding and documenting automated environment.

**(RTP-May-2020)**

**OR**

SA 315 requires the auditor to obtain an understanding of the entity and its environment as a part of Risk Assessment procedure to identify and assess Risk of Material Misstatements. List the areas of which auditor is required to obtain understating in an automated environment.

**Ans.**



- (i) Understanding of the **automated environment of a company** is required **as per SA 315**. The auditor's understanding of the automated environment should **include the following**:
- (a) The **applications that are being used** by the company;
  - (b) **Details of the IT infrastructure components** for each of the application;
  - (c) The **organisation structure** and governance;
  - (d) The **policies, procedures and processes** followed;
  - (e) **IT risks and controls**.
- (ii) **Conclusion**: -The auditor is required to document the **understanding of a company's automated environment** as per SA 230. Thus **the approach of CA Vipin is not correct** considering the above mentioned **requirements of SA 315 and SA 230**.

**3.**

**Identification of Risks Associated with the IT systems (Statutory Audit)**

A Company is using ERP for all its business processes including Procurement, Sales, Finance and Reporting. You are required to explain the Statutory Auditor's approach to identify the risks associated with the IT systems.

**(Study Material)**

**Ans.**



The **Statutory Auditor's approach to identify the risks** associated with the IT systems

- (i) The Auditor should **understand and document** each of the business processes in form of **narratives and / or flowcharts**.
- (ii) The next process will be to **identify areas / events that can lead to risks**, viz. manual Invoicing and accounting once goods are dispatched could lead to incorrect Invoicing and accounting and hence is a 'risk'.
- (iii) The Auditor should also **analyse the risks** i.e. the impact it will have if materializes.
- (iv) Next will be **prioritization in terms of probability** of how often the risks will materialize.

**4.**

**Considerations of Automated Environment in Different Stages of Audit**

In a risk-based audit, the audit approach can be classified into three broad phases comprising of planning, execution, and completion. You are required to briefly explain the relevant considerations for every phase in above audit approach in case of an automated environment.

**(Study Material)**

**OR**

In a controls-based audit, the audit approach can be classified into three broad phases comprising of planning, execution, and completion. You are required to briefly explain the relevant considerations for every phase in above audit approach in case of an automated environment.

**(Nov-2019-New)**

**OR**

"The audit cycle consists of Planning, Execution and Completion. The automation in processing of business transactions has considerations to be weighed by auditor at every phase of this cycle" – Enumerate the focal points of such considerations when auditing in automated environment.

**(Nov-2018-New)**

**OR**

In a controls-based audit, the audit approach can be classified into three broad phases comprising of planning, execution, and completion. In this approach, the considerations of automated environment will be relevant at every phase. Comment.

**(RTP-May-2018)(MTP-Nov-2018)**

**Ans.**



In a controls-based audit, the audit approach **can be classified into three broad phases** comprising of **planning, execution, and completion**. In this approach, the considerations of automated environment will be **relevant at every phase** as given below:

- (i) during risk assessment, the auditor should consider **risk arising from the use of IT systems** at the company;

- (ii) when obtaining an understanding of the **business process and performing walkthroughs** the use of IT systems and applications should be considered;
- (iii) while assessing the entity level controls the aspects related to **IT governance** need to be understood and reviewed;
- (iv) pervasive controls including **segregation of duties**, general IT controls and applications should be considered and reviewed;
- (v) during **testing phase**, the results of general IT controls would impact the nature, timing and extent of testing;
- (vi) when testing of reports and information produced by the entity (IPE) generated through **IT systems and applications**;
- (vii) **at completion stage**, evaluation of control deficiencies may require using data analytics and CAATs.

#### Alternative Answer (Given in Suggested Answers of ICAI)

In a controls-based audit, the **audit approach can be classified into three broad phases** comprising of **planning, execution, and completion**. In this approach, the considerations of automated environment will be **relevant at every phase** as given below:

#### (i) Risk Assessment

- Identify significant **accounts and disclosures**
- **Qualitative and Quantitative** considerations
- Relevant **financial statement assertions**
- Identify likely **sources of misstatement**
- **Consider risk** arising from use of IT system

#### (ii) Understand and Evaluate

- Document understanding of **business process** using **Flowchart/Narratives**
- Prepare **Risk Control Matrix (RCM)**
- Understand **design of controls** by performing **walk through** of end-by-end process
- Process wide considerations for **entity level controls, segregation of duties**
- **IT general controls, application controls**

#### (iii) Test for Operating Effectiveness

- Assess **nature timing and extent** of control testing
- Assess reliability of **key reports** and spreadsheet
- **Sample testing**
- Consider **competence and independence** of staff/team performing control testing

#### (iv) Reporting

- Evaluate **control deficiencies**
- Significant deficiencies, **material weakness**
- Remediation of **control weakness**
- **Internal control memo (ICM)** or management letter
- **Auditor's Report**

5.

#### **Standards relevant to Audit & Automated Environment**

Explain some of the International IT related Standards, Guidelines and Framework.

**(Study Material)**

**OR**

When auditing in an automated environment the auditor should be aware, adhere to and be guided by the various standards, guidelines and procedures that may be relevant to both audit and the automated environment. Briefly describe any four such standards.

**Ans.**


When auditing in an automated environment the **auditor should be aware, adhere to and be guided by the various standards, guidelines and procedures** that may be relevant to both audit and the automated environment. Given below are some of the common standards and guidelines that are relevant in this context include:

- (i) **Standards on Auditing (SA):** AASB of ICAI issues various standards which are required to be followed while auditing the financial statements of an entity
- (ii) **Sec. 143(3)(i) of Companies Act, 2013:** Section 143(3)(i) of Companies Act 2013 requires statutory auditors to provide an **Independent Opinion on the Design and Operating Effectiveness of Internal Financial Controls** with reference to financial statements of the company as at Balance Sheet date.
- (iii) **Section 404 of SOX Act, 2002:** Section 404 of Sarbanes Oxley Act of 2002 requires **public listed companies** to implement, assess and ensure **effectiveness of internal controls over financial reporting**. Auditors of such companies are required to **express an independent opinion** on the **design and operating effectiveness** of internal controls over financial reporting (ICFR).
- (iv) **ISO 27001: 2013** is the **Information Security Management System (ISMS)** standard issued by the **International Organization for Standardization (ISO)**. This standard provides the framework, **guidelines and procedures** for implementing information security and related controls in a company.
- (v) **ITIL (Information Technology Infrastructure Library) and ISO 20000** provide a set of best practice processes and procedures for **IT service management** in a company. **For example**, change management, incident management, problem management, IT operations, IT asset management are some of the areas that could be relevant to audit.
- (vi) **The Payment Card Industry:** Data Security Standard or PCI-DSS, is the **most widely adopted information security standard** for the payment cards industry. Any company that is involved in the storage, retrieval, transmission or handling of credit card/debit card information are required to implement the security controls in accordance with this standard.
- (vii) **CoBIT : Control Objectives for Information and Related Technologies** is best practice IT Governance and Management framework published by **Information Systems Audit and Control Association**. It provides the required tools, resources and guidelines that are relevant to IT governance, risk, compliance and information security
- (viii) **CSF : Cyber security Framework** published by the **National Institute of Standards and Technology** is one of the most **popular framework** for improving critical infrastructure cyber security, which provides a set of standards and best practices for companies to manage cyber security risks.

#### 4.3 - Enterprise Risk Management

**6.**

#### Enterprise Risk Management (ERM)

Write short note on: Enterprise risk management.

**Ans.**


- **Risk is the possibility** that an **event will happen** which **prevents a company** from achieving **business objectives**
- Risk management is a **combination of process, people, tools & techniques** through which company identifies, assess, respond mitigate and monitor risk
- **ERM is a formal program** that is implemented across an enterprise **for enabling risk management**. In many countries, companies are required to **have a formal ERM Program as a statutory requirement**.
- **In India, Sec. 134(3) of Companies Act, 2013** requires the **Board of Directors to include in their report a statement indicating** development and implementation of a **risk management policy** for the company including identification therein of **elements of risk**, if any, which in the opinion of the Board may threaten **the existence of the company**.
- **This Enterprise Risk Management – Integrated Framework** expands on internal control, providing a **more robust and extensive focus on the broader subject** of enterprise risk management.

- While it is **not intended to and does not replace** the internal control framework, **but rather incorporates the internal control framework** within it, companies may decide to look to this enterprise risk management framework both to satisfy their internal control needs and to move toward a fuller risk management process.
- The most common framework that is suitable for implementing an effective ERM is the COSO Enterprise Risk Management** – Integrated Framework developed by the **Committee of Sponsoring Organisations (COSO)** in 2004 and subsequently updated in 2017 to **address the changes in business environment**.

#### 4.4 - IT Related Risk & Controls

##### 7. General IT Controls

Write short note on: General IT controls.

(Study Material)

Ans.



- General IT-controls are **policies and procedures** that relate to **many applications** and support the **effective functioning of application controls**.
- They apply to **mainframe, mini frame**, and end-user environments.
- General IT-controls that **maintain the integrity** of information and **security of data** commonly **include controls over the following: (SA-315)**
  - **Data Centre and network operations.**
  - **System software** acquisition, change and maintenance.
  - **Program change.**
  - **Access security.**
  - **Application system** acquisition, development, and maintenance.

These are IT controls generally implemented to mitigate the **IT specific risks** and applied commonly across multiple IT systems, applications and business processes. Hence, **General IT controls** are known as “**pervasive**” controls or “**indirect**” controls.

##### 8. Application Controls & Its Examples

Describe application controls and give three examples of automated application controls.

(Study Material)

OR

What is application controls and give three examples of automated application controls.

Ans.



##### (i) Definition:- Application Controls:

- Application controls are manual or automated procedures that **typically operate at a business process level** and apply to the processing of **individual applications**.
- Automated Application controls are embedded into **IT applications viz., ERPs** and help in ensuring the **completeness, accuracy and integrity** of data in those systems.

##### (ii) Examples of Application controls include the following:

- Edit checks** and Validation of input data,
- Sequence Number checks.**
- Limit Checks.**
- Reasonable Checks.**
- Mandatory Data Fields.**



##### 9. Direct & Indirect Entity Level Controls (ELCs)

While evaluating the risks and controls at entity level, the Auditor should take cognizance of the prevalent direct and indirect entity level controls operating in the entity. Explain what they pertain to with few examples.

(May-2018)

OR

**Distinguish between:** Direct entity level controls and indirect entity level controls.

|   |   |
|---|---|
| <p><b>Ans.</b></p>    | <p><b>Entity Level Risk &amp; Controls</b></p> <p>(i) <b>Direct ELCs</b> operate at a level higher than <b>business activity or transaction</b> level such as a business process or sub-process level, account balance level, at a sufficient level of precision, <b>to prevent, detect or correct</b> a misstatement in a timely manner.</p> <p><b>Examples of Direct ELCs are:</b></p> <ul style="list-style-type: none"> <li>• <b>Business performance reviews;</b></li> <li>• <b>Monitoring of effectiveness of control</b> by Internal Audit function.</li> </ul> <p>(ii) <b>Indirect ELCs</b> do not relate to any specific <b>business process, transaction or account balance</b> and hence, <b>cannot prevent or detect misstatements</b>. However, they contribute indirectly to the <b>effective operation</b> of direct ELC and other control activities.</p> <p><b>Examples of Indirect ELCs are:</b></p> <ul style="list-style-type: none"> <li>• Company <b>code of conduct &amp; ethics policies;</b></li> <li>• <b>Human resource policies;</b></li> <li>• Employee <b>Job roles &amp; responsibilities.</b></li> </ul>  |
| <p><b>10.</b></p>   | <p><b>Identification of Controls</b></p> <p>Identify the controls which are automated, manual or IT dependent manual for the below mentioned cases?</p> <p>(i) Price master configured in the sales master can only be edited by authorised personnel in the system.</p> <p>(ii) Invoice cannot be booked in SAP in case Purchase orders are not approved.</p> <p>(iii) Inventory ageing report is pulled out from the system based on which provisioning is calculated after analyzing the future demand by the inventory personnel and approved by the controller.</p> <p>(iv) All invoices are signed by warehouse personnel before the goods are dispatched to the customer.</p> <p>(v) Credit limit is assigned to the customer and goods cannot be sold in excess of credit limit configured in the system.</p> <p>(vi) All changes to the credit limit is approved manually by sales manager.</p> <p>(vii) Ageing report is pulled out from SAP based on which provisioning is calculated by accounting personnel and approved by financial controller.</p> <p>(viii) PO, CRN (Good received note) and invoice are matched by the system before it is posted in the financial records.</p> <p style="text-align: right;"><b>(MTP-May-2018)</b></p> |
| <p><b>Ans.</b></p>  | <p>(i) <b>Automated control</b> as there is inbuilt control <b>which allows editing</b> in sales master by <b>only authorised personnel</b>.</p> <p>(ii) <b>Automated control</b> as there is inbuilt control <b>which doesn't allow approval</b> of invoice in case of <b>non approval of purchase order</b>.</p> <p>(iii) <b>IT dependent manual control</b> as <b>inventory ageing report</b> is pulled out from the system after which <b>provision for inventory</b> is manually approved.</p> <p>(iv) <b>Manual control</b> as sign off is required <b>to be done for the invoice before the dispatch of the goods</b>.</p> <p>(v) <b>Automated control</b> as there is <b>inbuilt control</b> that doesn't allow goods to be sold <b>if credit limit assigned to the customer has been crossed</b>.</p> <p>(vi) <b>Manual control</b> as sign off is required for <b>every change to the credit limit</b>.</p> <p>(vii) <b>IT dependent manual control</b> as ageing report is relied upon for <b>calculation of provisioning for debtors</b>.</p> <p>(viii) <b>Automated control</b> as PO, GRN and invoice is <b>matched by the system before recording</b> of the invoice to the vendor account.</p>  |
| <p><b>11.</b></p>   | <p><b>Auditing Virtually - Pros and Cons</b></p> <p>Auditing virtually through remote working model has its own pros and cons for the Auditors. Elucidate any four pros and cons with reasons.</p> <p style="text-align: right;"><b>(Nov-2020-Old)</b></p>  |
| <p><b>Ans.</b></p>  | <p>Auditing virtually has several <b>benefits as well as disadvantages</b> for the Auditors, <b>the details of which are summarised as under:</b></p>   |





| Particulars  | Remarks  |
|--|--|
| <b>Pros of auditing virtually through remote working model:</b>            |  |
| <b>Heightened use of technology for better execution</b>                   | Virtual audit is possible only with the <b>use of technology</b> . Hence embracing technology helps in <b>better audit delivery</b> and in making <b>auditors tech savvy</b> to prepare for the future.  |
| <b>Improved audit quality</b>  | Use of technology helps in <b>improving the audit quality</b> .  |
| <b>Greater audit coverage</b>  | With the <b>interplay of technology</b> and the <b>availability of quality time</b> — the audit coverage could be <b>enhanced significantly</b> .  |
| <b>Audit efficiencies</b>  | Through proper <b>planning, upfront engagement</b> with the client, <b>audit efficiencies are possible</b> .   |
| <b>Lesser cost of delivery</b>   | The cost of audit delivery would be <b>comparatively lesser</b> through remote working.  |
| <b>Higher scalability</b>  | The possibility of <b>capacity ramp up</b> is feasible without any restrictions on availability of space etc.  |
| <b>High speed</b>  | Information can be <b>generated very quickly</b> . Even <b>complex reports</b> in specific report format can be generated for audit purposes <b>without much loss of time</b> . This <b>cuts down the time</b> enabling the auditor to <b>extend their analytical review</b> with high speed of operation.   |
| <b>Low clerical error</b>  | <b>Computerised operation</b> being a <b>systematic and sequential programmed</b> course of action the chances of commission of error is <b>considerably reduced</b> . Clerical error is <b>highly minimised</b> .   |
| <b>Concentration of duties</b>   | Computer programs perform <b>more than one set of activities at a time</b> thereby restricting the duty of personnel involved in the work.   |
| <b>Control distribution of the output and timely corrections of errors</b> | Auditor being able to <b>control distribution of the output</b> and ensuring the <b>timely correction of errors</b> , for example, if the wrong input file were to be used.  |
| <b>Cons of auditing virtually through remote working model:</b>            |  |
| <b>Lack of conclusive evidence</b>   | Aspects such as <b>physical verification of inventory etc.</b> requires physical presence and the same cannot be done virtually.   |
| <b>High level of dependency</b>  | <b>Dependency on technology</b> and <b>various infrastructure</b> associated with it would <b>pose challenges</b> .  |
| <b>Increased time in coordination</b>                                      | Time spent in coordination is <b>very high</b> .   |
| <b>Security and compliance issues</b>                                      | The entire audit process is carried out with the help of technology which is <b>prone to various security concerns</b> . Further, aspects relating to <b>confidentiality, data protection etc.</b> are very critical for a successful virtual audits. Further, the possibility of non identification of frauds/ reliance on fake scanned documents etc. is very high in a virtual audit environment. |
| <b>Feel of audit and client engagement</b>                                 | In the absence of face to face interactions, the <b>real feel of the audit</b> and the <b>client engagement could be a challenge</b> .   |
| <b>Non-availability of sufficient IT knowledge and expertise:</b>          | The audit team should have <b>sufficient knowledge to plan, execute and use the results</b> of the same. In the <b>absence of sufficient knowledge</b> it would be difficult to audit through remote working model.  |

|  |  |
|--|--|
| <b>Non-availability of suitable computer facilities and data in suitable format:</b> | The auditor may plan to use other computer facilities when the use of remote working model on an entity's computer is <b>uneconomical or impractical</b> , for example, because of an <b>incompatibility</b> between the <b>auditor's package programme</b> and <b>entity's computer</b> .   |
| <b>Impracticability of manual tests due to lack of evidence:</b>                     | Some audit procedures <b>may not be possible to perform manually</b> because they rely on <b>complex processing</b> (for example, <b>advanced statistical analysis</b> ) or <b>involve, amounts of data</b> that would overwhelm any manual procedure.   |
| <b>Time constraints in certain data</b>  | Time constraints in certain data, such as transaction details, are <b>often kept for a short time</b> and <b>may not be available in machine-readable form</b> by the time auditor wants them. Thus, the auditor will <b>need to make arrangements for the retention of data</b> required, or <b>may need to alter the timing</b> of the work that requires such data. |

**SJ Note:-** Any four Pros & Cons can be written in exam

- 12. Whistle-Blower Policy**
- The auditors are required to understand, evaluate and validate the entity level controls as a part of audit engagement, the result of which has an impact on the nature, timing and extent of other audit procedures. In evaluating the effect of such control, existence, effectiveness and assessment of the whistle-blower policy in the company is very important. Specify the procedure you would perform for an understanding and evaluation of such whistle-blower policy.
- (MTP-May-2022)(July-2021-New)**

**Ans.**



- (i) Procedure for understanding and evaluation of whistle-blower policy**
- Auditors are required to **understand, evaluate and validate** the entity level controls as a part of an audit engagement.
  - The **results of testing entity level controls** could have an impact on the **nature, timing and extent** of other audit procedures including testing of controls.
  - **For example**, when the entity level controls at a company are effective, the auditor may consider **reducing the number of samples** in the test of controls and where the auditor finds the **entity level controls ineffective**, the auditor may consider to **increase the rigour of testing** by increasing sample sizes.
  - **In small and less complex companies**, the entity level controls may **not formally defined or documented**. In such situations, the auditor should design audit procedures accordingly to obtain evidence of the existence and effectiveness of entity level controls.
- (ii) The following example shows how the auditor performs an understanding and evaluation of the whistle-blower policy in a company:**
- Does the company have a **whistle-blower policy**?
  - Is this policy **documented and approved**?
  - Has the whistle-blower policy been **communicated to all the employees**?
  - Are employees **aware** of this policy and **understand** its purpose and their obligations?
  - **Has the company taken measures** viz., training, to make the employees understand the contents and purpose of the policy?
  - Does the company **monitor effectiveness** of the policy from time-to-time?
  - How does the company deal with **deviations** and **non-compliance**?

#### 4.5 - Data Analytics

- 13. Data Analytics & Its Application**
- You came to know that the data stored and processed in systems can be used to get various insights into the way business operates in an automated environment. This data can be useful for the preparation of management information system (MIS) reports and electronic dashboards that give a high-level snapshot of business performance. In view of above you are required to briefly discuss the meaning of data analytics and example of circumstances when auditing in an automated environment, auditors can apply the concepts of data analytics.
- (RTP-May-2022)**

**OR**

In an automated environment, the data stored and processed in systems can be used to get various insights into the way business operates. This data can be useful for preparation of management information system (MIS) reports and electronic dashboards that give a high-level snapshot of business performance. In view of above you are required to briefly discuss the meaning of data analytics and example of circumstances when auditing in an automated environment, auditors can apply the concepts of data analytics. **(Study Material)(RTP-May-2019)**

**OR**

What is Data Analytics, When auditing in an automated environment, auditors can apply the concepts of data analytics for several aspects of an audit. State those aspects

**Ans.****(i) Data Analytics:**

- Generating and preparing **meaningful information** from **raw system data** using **processes, tools, and techniques** is **known as Data Analytics**.
- The data analytics methods used in an audit are known as **Computer Assisted Auditing Techniques** or CAATs.

**(ii)** Auditors can apply the **concept of data analytics** for several aspects of an audit **including the following:**

- **Preliminary Analytics;**
- **Risk Assessment;**
- **Control Testing;**
- **Non-Standard Journal Analysis;**
- **Evaluation of Deficiencies;**
- **Fraud Risk assessment.**

**14.****Approach to get the Benefit from the use of CAATs**

Long Age Foundations Ltd. (LAF), a pharmaceutical company, collected the data from some hospitals and their experts tried to understand medical needs of elderly people. After complete study, their experts developed an application where LAF will provide complete health care after charging a nominal amount from the customers, if customers download this application in their mobile phones. CA P in his audit has used data analytics method also known as Computer Assisted audit techniques. Give illustrations of suggested approach to get the benefit from the use of CAATs.

**(Dec-2021-New) (MTP-Nov-2022)****OR**

"Generating and preparing meaningful information from raw system data using processes, tools, and techniques is known as Data Analytics and the data analytics methods used in an audit are known as Computer Assisted Auditing Techniques or CAATs." You are required to give a suggested approach to get the benefit from the use of CAATs.

**(Study Material)(MTP-Nov-2020)(RTP-Nov-2019)****Ans.**

The **data analytics methods** used in an audit are known as **Computer Assisted Auditing Techniques** or **CAATs**. There are several steps that should be followed to **achieve success with CAATs** and any of the supporting tools. **A suggested approach to benefit from the use of CAATs is as given below:**

Step 1: **Understand** Business Environment including IT;Step 2: **Define** the Objectives and Criteria;Step 3: **Identify** Source and Format of Data;Step 4: **Extract** Data;Step 5: **Verify** the Completeness and Accuracy of Extracted Data;Step 6: **Apply** Criteria on Data Obtained;Step 7: **Validate** and Confirm Results;Step 8: **Report and Document** Results and Conclusions **[SA 230]****14A.****IT Risk & Controls**

M/s RST & Associates have been appointed as auditors of ADI Ltd. for the financial year 2021-22. The processes,

operations, accounting and decisions are carried out by using computers in ADI Ltd. M/s RST & Associates understand that there are several aspects that they should consider to determine the level of automation and complexity in the business environment of ADI Ltd. While planning the audit work, the engagement partners discussed with the audit staff about the various types of controls in the automated environment that are put in place to mitigate the IT risks and to maintain the confidentiality, integrity, availability and security of data such as General IT Controls; Application Controls; and IT-Dependent Controls. You are required to briefly explain:

- (i) General IT Controls.
- (ii) Application Controls.
- (iii) IT-Dependent Controls.

(RTP-Nov-2022)

Ans.



**The controls that are put in place to mitigate the IT risks and to maintain the confidentiality, integrity, availability and security of data are - General IT Controls, Application Controls and IT-Dependent Controls.**

- (i) **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 environment. **General IT controls** that maintain the integrity of information and security of data commonly **include controls over the following:**" (SA 315)

- Data center and network operations;
- System software acquisition, change and maintenance
- Program change;
- Access security;
- Application system acquisition, development, and maintenance (Business Applications).

These are IT controls **generally implemented to mitigate the IT specific risks** and **applied commonly** across multiple IT systems, applications and business processes. Hence, General IT controls are known as "**pervasive**" controls or "**indirect**" controls.

- (ii) **Application Controls:**

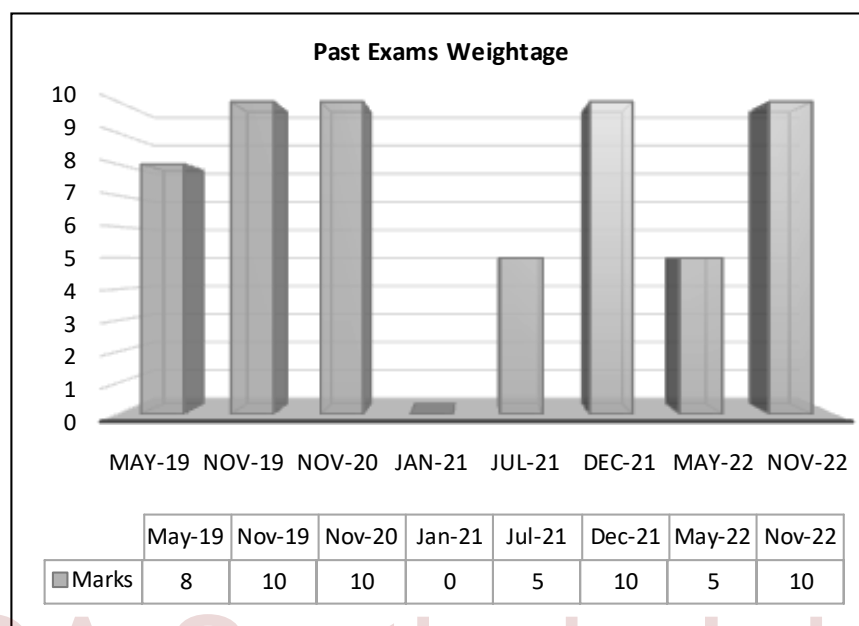
- Application controls include **both automated or manual controls** that operate at a business process level.
- **Application controls can be preventive as well as detective** in nature and are designed to ensure the integrity of the accounting records. application controls relate to procedures used to initiate, record, process and report transactions or other financial data.
- **These controls help ensure** that transactions occurred, are authorised, and are completely and accurately recorded and processed.
- **Automated Application controls** are embedded into IT applications viz., ERPs and help in ensuring the completeness, accuracy and integrity of data in those systems.
- **Examples of automated applications include** edit checks and validation of input data, sequence number check, limit check, format check, range check, reasonableness check, mandatory data fields, existence check etc.

- (iii) **IT dependent controls**

- **Basically manual controls** that make use of some form of data or information or report produced from IT systems and applications.
- **In this case**, even though the control is performed manually, the design and effectiveness of such controls depend on the reliability of source data.
- **Due to the inherent dependency** on Information Technology, the effectiveness and reliability of Automated application controls and IT dependent controls require the General IT Controls to be effective.

# Chapter 5

## COMPANY AUDIT



| Topics  | Unique Qs | Total Qs |
|---|-----------|----------|
| <b>UNIT-1 AUDIT &amp; AUDITORS (Section 139-148)</b>                      |           |          |
| 5.1 - Section -139 Appointment of Auditor                                 | 18        | 21       |
| 5.2 - Section-140 Removal & Resignation of Auditor                        | 5         | 8        |
| 5.3 - Section-141 Qualification & Disqualification of Auditor             | 21        | 25       |
| 5.4 - Section-142 Remuneration of Auditors                                | 1         | 1        |
| 5.5 - Section-143 Power & Duties of Auditor                               | 24        | 29       |
| 5.6 - Section 144 Services not to be rendered by the Auditor              | 3         | 3        |
| 5.7 - Section 145 Signature on Audit Report                               | 1         | 1        |
| 5.8 - Section 146 Auditor's duty to attend General Meeting                | 3         | 3        |
| 5.9 - Section 147 Penalty in case of Contravention                        | 1         | 1        |
| 5.10 - Section 148 Cost Audit & Cost Audit Rules                          | 6         | 6        |
| <b>UNIT-2 BOOK OF ACCOUNTS (SECTION 128 TO 138)</b>                       |           |          |
| 5.11 - Section 128 Books of Account                                       | 4         | 6        |
| 5.12 - Section 129 Financial Statements                                   | 4         | 4        |
| 5.13 - Section 130 Re-opening of Accounts on Court's or Tribunal's orders | 1         | 1        |
| 5.14 - Section 132 NFRA   | 2         | 2        |
| 5.15 - Section 133 Accounting Standard                                    | 1         | 1        |



| Topics  | Unique Qs | Total Qs |
|---|-----------|----------|
| 5.16 - Section 134 Board Report   | 4         | 4        |
| 5.17 - Section 135 Corporate Social Responsibility                          | 1         | 1        |
| 5.18 - Section 138 Internal Audit   | 5         | 5        |
| <b>UNIT-3 DIVIDENDS, LLP &amp; OTHER PROVISIONS</b>                         |           |          |
| 5.19 - Section 123 Declaration of Dividend                                  | 8         | 9        |
| 5.20 - Section 125 Investor Education and Protection Fund                   | 1         | 1        |
| 5.21 - Limited Liability Partnership & Other Provisions                     | 2         | 3        |
| 5.22 - Miscellaneous Provision  | 7         | 9        |
| <b>UNIT-4 CARO, 2020 &amp; AS/Ind-AS &amp; Schedule III Based Questions</b> |           |          |
| 5.23 - Applicability of CARO  | 13        | 15       |
| 5.24 - Matters to be Reported in CARO-2020 & Disclosures in Audit Report    | 33        | 41       |
| 5.25 - AS/Ind-AS & Schedule III Based Questions                             | 8         | 8        |

## UNIT-1 : AUDIT & AUDITORS (Section 139-148)

### 5.1 - Section -139 Appointment of Auditor

#### 1. Tenure of Appointment

AGM is not held in time, auditor automatically vacates his office. Comment.

Ans.



#### (i) Provision:- Section 139(1) of the Companies Act, 2013

- Provides that **every company** shall, at the **first annual general meeting** appoint an **individual or a firm** as an auditor
- Who **shall hold office** from the conclusion of that meeting till the **conclusion of its sixth annual general meeting** and thereafter till the conclusion of **every sixth meeting**.
- In case the annual general meeting is **not held within the period** prescribed, the **auditor will continue in office** till the annual general meeting is **actually held and concluded**.

#### (ii) Conclusion:- Auditor shall continue to hold office till the conclusion of the annual general meeting. Auditor's office is **not vacated automatically** if AGM is not held in time.

#### 2. Sec. 139 - Appointment of First Auditor –Other than Government Company

Malta Pvt. Ltd., a newly incorporated company dated 01.07.2021 is engaged in the manufacturing business of Cotton Shirts. On 30.07.2021, the Managing Director of Malta Pvt. Ltd. himself appointed CA. Rajnath, his daughter's husband, as the first auditor of the company.

You are required to –

- State the provisions of the Companies Act, 2013 relating to appointment of first auditor.
- Comment on the action of the Managing Director. **(RTP-Nov-2015, RTP-Nov-2017)**

Ans.



#### (i) Provision:- Section 139(6) of the Companies Act, 2013 deals with appointment of **First Auditor** in the case of a company, **other than a Government Company**.

- The first auditor of a company shall be appointed by the **Board of Directors within 30 days** from the date of registration of the company.
- In the case of failure** of the Board to appoint the auditor, it shall **inform the members** of the company.
- The members** of the company shall **within 90 days at an EGM** appoint the auditor.

- Appointed auditor shall **hold office till the conclusion of the first AGM.**
- (ii) **In the given case:-** Malta Pvt. Ltd. a newly incorporated Company dated **01.07.2021** is engaged in the **manufacturing business** of Cotton Shirts. On **30.07.2021**, the **Managing Director of Malta Pvt. Ltd himself appointed CA. Rajnath**, his **daughter's husband**, as the first auditor of the company.
- (iii) **Conclusion:-**
- As per the **facts given in the case**, the **appointment of CA Rajnath** as first auditor by the Managing Director of Malta Pvt. Ltd. by himself **is in violation of section 139(6)** of the Companies Act, 2013, which authorizes the **Board of Directors** to appoint the **first auditor** of the company within one month of registration of the company. **Thus, the appointment of CA Rajnath is not valid.**
  - Under the circumstances**, the issue relating to **relationship of auditor at Managing Director becomes redundant.**

3.

**Sec. 139 – Appointment of First Auditor of other than Government Company**

KM Pvt. Ltd., engaged in the manufacturing business of Silkshirts, is a newly incorporated company dated 01.09.2021. On 28.09-2021, the members of KM Pvt. Ltd. themselves appointed CA Raj, a renowned practitioner, as the first auditor of the company opposing that Board is not authorised to appoint the auditor. You are required to comment on the action of the Members. **(RTP-May-2017)**

**OR**

Managing Director of PQR Ltd. himself wants to appoint Shri Ganpati, a practicing Chartered Accountant, as first auditor of the company. Comment on the proposed action of the Managing Director. **(Study Material)**

**Ans.**

- (i) **Provision:-** Section 139(6) of the Companies Act, 2013 deals with appointment of **First Auditor** in the case of a company, **other than a Government Company.**
- The first auditor of a company shall be appointed by the **Board of Directors within 30 days** from the date of registration of the company.
  - In the case of failure** of the Board to appoint the auditor, it shall **inform the members** of the company.
  - The members** of the company shall **within 90 days at an EGM** appoint the auditor.
  - Appointed auditor shall **hold office till the conclusion of the first AGM.**
- (ii) **In the given case:-** As per the facts given in the case, the **members of KM Pvt. Ltd. / managing director of PQR Ltd. themselves appointed CA Raj/Shri Ganpati** a renowned practitioner, as the **first auditor** of the company opposing that Board is not authorised to appoint the auditor
- (iii) **Conclusion:-** The **appointment of CA Raj/Shri Ganpati as first auditor by the Members** of KM Pvt. Ltd./MD of PQR Ltd. by themselves **is in violation of section 139(6)** of the Companies Act, 2013, which authorizes the Board of Directors to appoint the first auditor of the company within one month of registration of the company. **Thus, the appointment of CA auditor of the company is not in order.**

4.

**The Companies (Audit and Auditors) Rules, 2014 (Read with Section-139)**

Subject to the provisions of sub-rule (1) of Rule 3 of The Companies (Audit and Auditors) Rules, 2014 where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board consider and recommend an individual or a firm as auditor to the members in the annual general meeting for appointment. Explain manner and procedure of selection and appointment of auditors as per Rule 3 of CAAR 2014. **(RTP-Nov-2018)**

**Ans.**

- Prescribes the following **manner and procedure of selection and appointment** of auditors.
- Qualifications & experience:-**
    - In case of a company that is **required to constitute an Audit Committee** under section 177 the committee, and,
    - In cases where such a committee is **not required to be constituted**, the Board, shall take into

consideration the **qualifications and experience** of the individual or the firm proposed to be considered for appointment as auditor and

- Whether such qualifications and experience are commensurate with **the size and requirements of the company**.
- **Pending proceedings:-** It may be noted that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to **any order or pending proceed, relating to professional matters** of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.
- **Additional information:-** The Audit Committee or the Board, as the case may be, **may call for such other information** from the proposed auditor **as it may deem fit**.
- **Where a company is required to constitute the Audit Committee:-**
  - The committee shall **recommend the name of an individual or a firm** as auditor to the Board for consideration and
  - In **other cases**, the **Board shall consider and recommend** an individual or a firm as auditor to the members in the **annual general meeting** for appointment.
- **If the Board agrees with the recommendation of the Audit Committee:-** It shall further recommend the appointment of an individual or a firm as auditor to the members in the annual general meeting.
- **If the Board disagrees with the recommendation of the Audit Committee:-** It shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.
- **If the Audit Committee, after considering the reasons given by the Board, decides not to reconsider its original recommendation:-** The Board shall record **reasons for its disagreement** with the committee and send **its own recommendation** for consideration of the members in the annual general meeting; and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members in the annual general meeting.
- **Terms of Appointment:-** The auditor appointed in the annual general meeting shall hold office from the conclusion of that meeting **till the conclusion of the sixth annual general meeting**, with the meeting wherein such appointment has been made being counted as the first meeting.

5. **Sec. 139 – Rotation Applicability**

Apple Ltd is an unlisted public company. Its balance sheet shows paid up share capital of ₹5 crore and public deposits of ₹100 crore The company appointed M/s Pear & Co, a chartered accountant firm, as the statutory auditor in its annual general meeting held at the end of September 2021 for 11 years .

You are required to state the provisions related to rotation of auditor and cooling off period as per the section 139(2) of the Companies Act, 2013 in case of an individual auditor or an audit firm, both, and comment upon the facts of the case provided above with respect to aforesaid provisions. **(RTP-Nov-2017)**

**OR**

Ram Ltd. is a private company. Its balance sheet shows paid up share capital of ₹ 5 crore and public borrowings of ₹100 crore. The company appointed M/s Shyam & Co., a chartered accountant firm, as the statutory auditor in its annual general meeting held at the end of September 2021 for 11 years.

You are required to state the provisions related to - rotation of auditors and cooling off period as per the section 139(2) of the Companies Act, 2013 in case of an individual auditor or an audit firm, both, and comment upon the facts of the case provided above with respect to aforesaid provisions. **(RTP-May-2015)**

**Ans.**



**(i) Provision:- Section 139(2) of the Companies Act, 2013**

- The provisions related to rotation of auditor are **applicable to those companies which are prescribed in Companies (Audit and Auditors) Rules, 2014**, which prescribes the **following classes of companies** excluding one person companies and small companies, namely:-
  - **all unlisted public companies** having **paid up share capital of ₹ 10 crore or more**;
  - **all private limited companies** having **paid up share capital ₹ 50 crores or more**
  - **all companies** having **paid up sham capital of below threshold limit** mentioned above, but

having **public borrowings from financial Institutions**, bank or public deposits of ₹ 50 crores or more. [No provision of Section 139(2) applicable on IFSC company]

- **No listed company** or a company belonging to **such class or classes of companies** as mentioned above, shall appoint or re-appoint.
  - **an individual** as auditor for **more than one term of 5 consecutive years**; and
  - **an audit firm** as auditor for **more than two terms of 5 consecutive years**.
- **Proviso to Section 139(2)**
  - **An individual** auditor who has **completed his term** under clause (a) **shall not be eligible for re-appointment** as auditor the **same company for five years** from the completion of his term.
  - **An audit firm** which has completed its term under clause (b), **shall not be eligible for re-appointment** as auditor **in the same company for five years** from the completion of such term:

(ii) **In the given case:-** Apple Ltd. is a **unlisted public company** having **paid up share capital of 5 crore** and **public deposit of ₹ 100 crore**. The company has appointed M/s Pear & Co., a chartered accountant firm, as the statutory auditor in its AGM held at the end of **September, 2021 for 11 years**.

(iii) **Conclusion:-** The provisions relating to rotation of auditor **will be applicable as the public borrowings exceeds ₹ 50 crore**. Therefore Apple Ltd. can appoint M/s Pear & Co. as an auditor of the company for **not more than two terms of 5 consecutive years**. i.e. M/s Pear & Co shall hold office from conclusion of this meeting upto **conclusion of sixth AGM to be held in the year 2026** and thereafter can be **reappointed as auditor for one more term of five years i.e. upto year 2031**. As a result, the appointment of M/s Pear & Co. made by Apple Ltd. for 11 years is void.

#### 6. **Audit Firm having Common Partner**

M/s. ABC & Company is an audit firm having partners Mr. A, Mr. B and Mr. C, whose tenure as statutory auditor in R Ltd. a listed entity, has expired as per the Companies Act, 2013. M/s. XY is another audit firm which is appointed as the statutory auditor of R Ltd. for the subsequent year. Mr. A joins M/s XY as partner, 3 months after it was appointed the statutory auditor of R Ltd. Comment. **(May-2017)**

Ans.



- (i) **Provision:- Section 139(2) of the Companies Act, 2013** provides that as on the **date of appointment**, no audit firm having a **common partner or partners** to the other audit firm, **whose tenure has expired in a company immediately preceding the financial year**, shall be appointed as auditor of the same company for a period of **five years**.
- (ii) **In the given case:-** R Ltd. is a **listed entity**, thus, rotational provisions are applicable. Mr. A is a partner in M/s. ABC & Co., whose **tenure as statutory auditor in R Ltd. has expired**. He joined M/s. XY as partner, 3 months after it was appointed as statutory auditor of R Ltd.
- **It may be noted that** that there **should not be a common partner** in the firms as **on the date of appointment**, however, in the given case, Mr. A has joined M/s. XY after 3 months of its appointment as statutory auditor of R Ltd.
- (iii) **Conclusion:- M/s. XY may continue as statutory auditor of R Ltd.** for the subsequent term.

#### 7. **Rotation of Auditors**

CA. Rock is a partner in M/s Ajay & Associates and M/s Vijay & Associates simultaneously. M/s Ajay & Associates has completed its tenure of 10 years as an auditor in Sanjay Ltd. immediately preceding the current financial year. It may be noted that the provisions for applicability of rotation of auditors are applicable to Sanjay Ltd. Now, the company wants to appoint M/s Vijay & Associates as auditor for 5 years

- (a) Whether M/s Vijay & Associates is allowed to accept the appointment as auditor of Sanjay Ltd.?
- (b) Would your answer be different from above if CA. Rock, being in-charge of M/s Ajay & Associates and certifying authority of financial statements of Sanjay Ltd., retires from the partnership in M/s Ajay & Associates and joins M/s Vijay & Associates? (Assume 10 years = 10 AGMs) **(RTP-May-2016)**

Ans.


**(i) Provision:- Section 139(2) of the Companies Act 2013**

- **No listed company** or a company belonging to **such class or classes of companies** as mentioned above, shall appoint or re-appoint.
  - **an individual** as auditor for **more than one term of 5 consecutive years**; and
  - **an audit firm** as auditor for **more than two terms of 5 consecutive years**.
- **Section 139(2) of the Companies Act, 2013** provides that as on the **date of appointment**, no audit firm having a **common partner or partners** to the other audit firm, **whose tenure has expired** in a company **immediately preceding the financial year**, shall be appointed as auditor of the same company for a period of **five years**.
- **Companies (Audit and Auditors) Rules, 2014:-** For the purpose of **rotation of auditors**, if a partner, **who is in-charge of an audit firm** and also **certifies the financial statements** of the company, retires from the said firm and **joins another firm** of chartered accountants, such other firm shall **also be ineligible** to be appointed for a period of 5 Years

**(ii) In the given case:-** CA. Rock is a **common partner** in M/s Ajay & Associates and M/s Vijay & Associates. **The tenure of 10 years** of M/s Ajay & Associates **as an auditor expired** in Sanjay Ltd. immediately preceding financial year.

**(iii) Conclusion:-**

- (a) Ajay & Associates **shall not be eligible for re-appointment** as auditor in the same company for **5 years from the completion of such term**. Therefore, **M/s Vijay & Associates will also be disqualified to be appointed** as auditor of Sanjay Ltd. for next 5 financial years as CA. Rock is a common partner in M/s Ajay & Associates and M/s Vijay & Associates.
- (b) M/s Vijay & Associates **will also be disqualified to be appointed as auditor of Sanjay Ltd.** for **next 5 financial years** if newly joined partner **CA. Rock has joined Vijay & Associates after retiring from M/s Ajay & Associates** as he was in-charge of the audit firm and also certified the financial statements of the company in immediately preceding the current financial year.

8.

**Sec 139- Rotation Applicability**

Mishra Ltd. is a private limited company, having paid up share capital of rupees 48 crore but having public borrowing from nationalized banks and financial institutions of rupees 42 crore, manner of rotation of auditor will not be applicable. Comment. (Study Material)

Ans.


**(i) Provision:- Section 139(2) of the Companies Act, 2013**

- The provisions related to rotation of auditor are **applicable to those companies which are prescribed in Companies (Audit and Auditors) Rules, 2014**, which prescribes the **following classes of companies** excluding one person companies and small companies, namely:-
  - **all unlisted public companies** having **paid up share capital of ₹ 10 crore or more**;
  - **all private limited companies** having **paid up share capital ₹ 50 crores or more**
  - **all companies** having **paid up sham capital of below threshold limit** mentioned above, but having **public borrowings from financial Institutions**, bank or public deposits of **₹ 50 crores or more**.
- **No listed company** or a company belonging to **such class or classes of companies** as mentioned above, shall appoint or re-appoint.
  - **an individual** as auditor for **more than one term of 5 consecutive years**; and
  - **an audit firm** as auditor for **more than two terms of 5 consecutive years**.

**(ii) In the given case:-** Mishra Ltd. is a **private limited Company**, having **paid up share capital** of rupees **48 crore** and **public borrowing** from nationalized banks and financial institutions of rupees **42 crore**.

**(iii) Conclusion:-** As per the provision & facts given above **rotation will not be applicable to Mishra Ltd.**



9. **Sec 139 – Appointment of First Auditor of a Government Company**  
 M/s IO Ltd. is registered with Registrar of Companies on 1st of May 2021. The Company's 27% of paid up share capital is held by Central Government; 28% by State Government and the remaining 45% by public. The Board of Directors appointed RMG, Chartered Accountants as statutory auditors for the financial year 2021-22 by passing a resolution at the Board Meeting held on 25th May, 2021. Comment whether appointment is valid or not. **(May-2016)**
- OR**
- The first auditor of M/s Healthy Wealthy Ltd., a Government company, was appointed by the Board of Directors. Comment. **(Study Material)**

Ans.



- (i) **Provision:-**
- **Section 139(7) of the Companies Act, 2013**  
 According to section 139(7) of the Companies Act, 2013, **the first auditor of a government company** shall be appointed by the **Comptroller and Auditor-General of India within 60 days** from the date of registration of the company.
  - **Section 2(45) of the Companies Act, 2013**  
 As per section 2(45) of the said Act, a Government Company Is defined as any company In which **not less than 51% of the paid-up share capital** is held by the **Central Government** or by any **State Government** or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary company of such a Government Company.  
 Note:- **"paid up share capital"** shall be construed as **"total voting power"**, where shares with differential voting rights have been issued
- (ii) **In the given case:-**
- 27% of paid-up share capital has been held by **Central Government**,
  - 28% by **State Government** and
  - Remaining **45% by Public**  
 i.e. **total 55% of the paid-up share capital** has been held by **Central Government** and **State Government** which is more than 51% as prescribed in the Companies Act, 2013
- (iii) **Conclusion:-** M/s IO Ltd. is a **government company**. Therefore, the appointment of RMG, Chartered Accountants as **first auditor by the Board of Directors** of M/s IO Ltd. for the financial year 2021-22 is **not valid** as the first auditor of a government company can be appointed by **Comptroller and Auditor-General of India**.

10.

**Government Company**

Nick Ltd. is a subsidiary of Ajanta Ltd., whose 20 % shares have been held by Central Government, 25% by Uttar Pradesh Government and 10% by Madhya Pradesh Government. Nick Ltd. appointed Mr. Prem as statutory auditor for the year. Comment. **(RTP-Nov-2014, MTP-Nov-2019, Study Material)**

Ans.



- (i) **Provisions:-**
- **Government Company:-** As per section 2(45), a Government company is defined as any company in which **not less than 51% of the paid-up share capital** is held by the **Central Government** or by any **State Government** or Governments or **partly** by the **Central Government** and **partly** by **one or more State Governments** and includes a **company which is a subsidiary of a Government Company** as thus defined".
  - Note:- **"paid up share capital"** shall be construed as **"total voting power"**, where shares with differential voting rights have been issued
  - **Appointment of Auditor in Government Company:-** As per **Section 139(7)** of the Companies Act, 2013, the auditors of a government company **shall be appointed or re-appointed** by the **Comptroller and Auditor General of India**.

(ii) In the given case:-

- **Ajanta Ltd is a government company** as its **20% shares** have been held by **Central Government, 25% by U.P. State Government and 10% by M.P. State Government. Total 55% shares** have been held by Central and State governments. **Therefore, it is a Government company.**
- **Nick Ltd. is a subsidiary company of Ajanta Ltd.** Hence Nick Ltd. is **covered in the definition** of a government company.

(iii) **Conclusion:-** Therefore, the **Auditor of Nick Ltd. can be appointed only by C & AG.** Consequently, **appointment of Mr. Prem is invalid** and he should not give acceptance to the Directors of Nick Ltd.

**11. Section 2(45) & 139 - Audit of Government Company & Role of C&AG**  
 VM Ltd., a company wholly owned by Central Government was disinvested during the previous year, resulting in 45% of the shares being held by public. The shares were also listed on the BSE. Since the shares were listed, all the listing requirements were applicable, including publication of quarterly results, submission of information to the BSE etc. Gautam, the Finance Manager of the Company is of the opinion that now the company is subject to stringent control by BSE and the markets, therefore the auditing requirements of a limited company in private sector under the Companies Act 2013 would be applicable to the company and the C&AG will not have any role to play. Comment. (MTP-May-2021)

Ans.



- (i) **Provision: -Section 2(45) of the Companies Act, 2013,** defines a **“Government Company”** as a company in which **not less than 51% of the paid-up share capital** is held by the **Central Government** or by **any State Government or Governments or partly by the Central Government and partly by one or more State Governments**, and includes a company which is a **subsidiary company** of such a Government company.
- (ii) **Appointment of Auditors: -**The auditors of these **government companies** are firms of Chartered Accountants, **appointed by the Comptroller & Auditor General**, who gives the auditor directions on the manner in which the **audit should be conducted** by them.
- (iii) **In the given scenario: -** VM Ltd., a company **wholly owned by Central Government** was **disinvested** during the previous year, resulting in **45% of the shares being held by public**. Since, shares were **listed on the BSE** therefore all the listing requirements were applicable.
- (iv) **Conclusion: -**Opinion of **Finance Manager of the Company** Mr. Gautam that since company is **subject to stringent control by BSE** and the markets, therefore the **auditing requirements** of a limited company in **private sector** under the Companies Act 2013 would be applicable to the Company and the C&AG will not have any role to play, **is not correct as listing of company's shares on a stock exchange is irrelevant for this purpose.**

**12. Sec 139(8) - Holding of Office in Case of Casual Vacancy**  
 M/s Young & Company, a Chartered Accountant firm, and Statutory Auditors of Old Ltd., is dissolved on 1.4.2021 due to differences of opinion among the partners. The Board of Directors of Old Ltd. in its meeting on 6.4.2021 appointed another firm M/s Sharp & Company as their new auditors for one year. Comment.

Ans.



- (i) **Provision:- Section 139(8)** of the Companies Act, 2013 provides that any **casual vacancy** in the office of an auditor **shall be filled** by the **Board of Directors within 30 days**.
- However, if such casual vacancy is as a **result of the resignation** of an auditor, such appointment shall **also be approved by the company** at a general meeting convened **within 3 months** of the recommendation of the Board and **he shall hold the office** till the conclusion of the **next annual general meeting**.
  - The expression **“casual vacancy”** has **not been defined in that Act**. Taking its natural meaning it may arise due to a **variety of reasons** which **include** death, resignation, disqualification, dissolution of the firm etc.
- (ii) **In the present case:-** M/s Young & Company, a Chartered Accountant firm, and Statutory Auditors of Old Ltd., is **dissolved on 1.4.2021** due to differences of opinion among the partners. The Board of

Directors of Old Ltd. in its **meeting on 6.4.2021** appointed another firm **M/s Sharp & Company** as their new auditors for one year.

- (iii) **Conclusion:-** The **action of the board of directors** in appointing M/s Sharp & Co. to fill up the casual vacancy due to dissolution of M/s Young & Co., is **correct**. However, the **board of directors are not correct in giving them appointment for one year**. M/s Sharp & Co. can hold office until the conclusion of next AGM only.

**13. Section 139- Filling of a Casual Vacancy**  
 While auditing Y Ltd., CA Max, the statutory auditor of Y Ltd. encounters exceptional circumstances that bring into question his ability to continue performing the audit. Considering it appropriate, resigned from the office of auditor of Y Ltd. Due to the resignation of the existing auditor, the Directors of Y Ltd. itself appointed CA Mini, a practicing Chartered Accountant, as the statutory auditor till the conclusion of 6th meeting.  
 You are required to state the provisions related to filling of casual vacancy as per the Companies Act, 2013 and comment upon the validity of appointment made by the Board. **(RTP-Nov-2015)**

Ans.



- (i) **Provision:- Section 139(8)** of the Companies Act, 2013 provides that any **casual vacancy** in the office of an auditor **shall be filled** by the **Board of Directors within 30 days**.
- However, if such casual vacancy is as a **result of the resignation** of an auditor, such appointment shall **also be approved by the company** at a general meeting convened **within 3 months** of the recommendation of the Board and **he shall hold the office** till the conclusion of the **next annual general meeting**.
- (ii) **In the present case:-** CA Max, the statutory auditor of Y Ltd. has resigned from the office of auditor. The Board of Directors of Y Ltd. itself appointed CA Mini, a practicing Chartered Accountant, as the statutory auditor till the conclusion of 6th meeting.
- (iii) **Conclusion:-** Such casual vacancy **can be filled by the Board of Directors** subject to approval by the **company at a general meeting** convened **within 3 months** of the recommendation of the Board. Thus, the **appointment of CA Mini** made by the Board of Directors **without the approval of the company at a GM is invalid**.  
 Further, **if appointment is approved by the company**, CA Mini **cannot hold the office of auditor till the conclusion of 6th meeting** i.e. the appointment cannot be made for five years. The auditor can hold office only till the conclusion of the next AGM

**14. Filling of a Casual Vacancy**  
 Mr. A was appointed auditor of AAS Ltd. by Board to fill the casual vacancy that arose due to death of the auditor originally appointed in AGM. Subsequently, Mr. A also resigned on health grounds during the tenure of appointment. The Board filled this vacancy by appointing you through duly passed Board resolution. As an auditor, comment.

Ans.



- (i) **Provision:- Section 139(8)** of the Companies Act, 2013 provides that any **casual vacancy** in the office of an auditor **shall be filled** by the **Board of Directors within 30 days**.
- However, if such casual vacancy is as a **result of the resignation** of an auditor, such appointment shall **also be approved by the company** at a general meeting convened **within 3 months** of the recommendation of the Board and **he shall hold the office** till the conclusion of the **next annual general meeting**.
- (ii) **In the present case:-** The auditor **Mr. A resigned** and the vacancy had been filled in by Board. But, the **vacancy caused by resignation** cannot be filled by Board itself, such appointment shall also be approved by the company at general meeting.
- (iii) **Conclusion:-** The fact that Mr. A was appointed by Board originally is a matter irrelevant in this situation. If the **cause of vacancy is resignation**, then the power of appointment shall vest with **the general meeting only**. As such, the **appointment made by Board is invalid**.

**15. Appointment of New Auditor in Case of Resignation**  
 At the AGM of ICI (P) Ltd., Mr. X was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to give up practice and join industry. State, how the new auditor will be appointed by ICI (P) Ltd. and the conditions to be complied for.