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1
CHAPTER

QUALITY CONTROL

SQC 1 – Quality Control for Firm

Question 1

J.A.C.K. & Co., a Chartered Accountant firm was appointed as the statutory auditor of Falcon Ltd. after ensuring the compliance with relevant provisions of the Companies Act, 2013. Mr. Jay was the engagement partner for the aforesaid audit and prior to commencement of the audit, Mr. Jay had called for a meeting of the engagement team in order to direct them and assign them their responsibilities. At the end of meeting, Mr. Jay assigned review responsibilities to two of the engagement team members who were the most experienced amongst all, for reviewing the work performed by the less experienced team members. While reviewing the work performed by the less experienced members of the engagement team, what shall be the considerations of the reviewers? (MTP 5 Marks, March 21)

Answer 1

As per SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", review responsibilities are determined on the basis that more experienced team members, including the engagement partner, review work performed by less experienced team members.

In the given situation, Mr. Jay, engagement partner assigned review responsibilities to two of the engagement team members who were the most experienced team members.

While reviewing the work performed by less experienced members of the engagement team, both the more experienced Reviewers should consider whether:

(i) The work has been performed in accordance with professional standards and regulatory and legal requirements.

(ii) Significant matters have been raised for further consideration.

(iii) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented.

(iv) There is a need to revise the nature, timing and extent of work performed.

(v) The work performed supports the conclusions reached and is appropriately documented.

(vi) The evidence obtained is sufficient and appropriate to support the report; and

(vii) The objectives of the engagement procedures have been achieved.

Question 2

M/s Chandra & Co., Chartered Accountants were appointed as Statutory Auditors of Green Essence Limited for the F.Y 2021-2022. The previous year's audit was conducted by M/s. Nath & Associates. After the audit was completed and report submitted, it was found that closing balances of last financial year i.e., 2020-21 were incorrectly brought forward. It was found that M/s Chandra & Co. did not apply any audit procedures to ensure that correct opening balances have been brought forward to the current period. Accordingly, a complaint was filed against Chandra & Co. in relation to this matter. You are required to inform what policies are required to be implemented by Chandra & Co. for dealing with such complaints and allegations as required by Standard on Quality Control (SQC). (MTP 5 Marks March 22, PYP 5 Marks Jan'21)

Answer 2

In the given question, Chandra & Co. did not apply audit procedures to ensure that opening balances had been correctly brought forward. A complaint was filed against the auditors in this context. As per Standard on Quality Control (SQC) 1 "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements",

(i) The firm should establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with:

(a) Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements; and

(b) Allegations of non-compliance with the firm's system of quality control.

(ii) Complaints and allegations (which do not include those that are clearly frivolous) may originate from within or outside the firm. They may be made by firm personnel, clients or other third parties.

They may be received by engagement team members or other firm personnel.

(iii) As part of this process, the firm establishes clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals.

(iv) The firm investigates such complaints and allegations in accordance with established policies and procedures. The investigation is supervised by a partner with sufficient and appropriate experience and authority within the firm but who is not otherwise involved in the engagement, and includes involving legal counsel as necessary. Small firms and sole practitioners may use the services of a suitably qualified external person or another firm to carry out the investigation. Complaints, allegations and the responses to them are documented.

(v) Where the results of the investigations indicate deficiencies in the design or operation of the firm's quality control policies and procedures, or non-compliance with the firm's system of quality control by an individual or individuals, the firm takes appropriate action.

QUALITY CONTROL

Question 3

(Includes concepts of SA 220-Quality Control for an Audit of Financial Statements) CA Ragini is offered an appointment to act as Engagement Quality Control Reviewer (EQCR) for the audit of the financial year 2022-23 of XPM Limited, a listed company operating from a small town. She is also based in the same town and was not engaged previously to conduct an audit of a listed entity. She accepts the appointment to act as ECQR. She performs the review by ticking a Yes/ No checklist and signing on some of the working papers prepared by the engagement team. The audit file does not contain any material misstatement which shows that the work of EQCR is separate from the work of the engagement team. Do you agree with the approach adopted by EQCR? Comment. (MTP 5 Marks Sep '23)

Answer 3

As per SQC 1 engagement quality control reviewer can be a partner, other person in the firm (member of ICAI), suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report.

It also states that the engagement quality control reviewer for an audit of the financial statements of a listed entity is an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities.

In addition, the work of EQCR involves objective evaluation of the significant judgments made by the engagement team and ensuring that the conclusions reached by the team in formulating audit report are appropriate. It is necessary for EQCR to have the requisite technical expertise and experience to enable her to perform the assigned role of evaluating the work of engagement team so that any possible misstatement can be avoided. Without ensuring the appropriate technical expertise and experience, the whole purpose of EQCR is defeated. Therefore, it was not appropriate for her to accept appointment as ECQR for listed entity.

Further, SA 220 states that the engagement quality control reviewer shall document, for the audit engagement reviewed, that the procedures required by the firm's policies on engagement quality control review have been performed. It also states that it shall also be documented that the reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

In the given situation, CA Ragini is offered an appointment to act as Engagement Quality Control Reviewer (EQCR) for the audit of the financial year 2022-23 of XPM Limited, a listed company operating from a small town. She has accepted the appointment and performed the review by ticking a Yes / No checklist and signing on some of the working papers prepared by the engagement team.

In the instant case, there are no working papers to show that evaluation has been done by EQCR on conclusions reached by engagement team. Mere ticking of a Yes/No checklist and signing on some working papers of engagement team shows that no such evaluation and review of work performed by engagement team has been made by EQCR. Therefore, her approach was not proper in performing work of EQCR.

Question 4

BSS & Associates is a partnership firm of Chartered Accountants which was established five years back. The firm was offering only advisory services at the beginning, however, after audit rotation and advent of GST, firm sees lot of potential in these areas also and started looking for opportunities in these areas also. These services being assurance in nature, the firm required some internal restructuring and set up some policies and procedures for compliance year on year.

The firm started getting new clients for these new services and is now looking to obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it has been setting up a process to document how the issues were resolved.

The firm is now looking to work with only select clients which are in line with the policies of the firm. The firm understands that the extent of knowledge it will have regarding the integrity of a client will grow within the context of an ongoing relationship with that client. With regard to the integrity of a client, you are required to give some examples of the matters to be considered by the firm as per the requirements of SQC 1. (RTP May 19, PYP 4 Marks, Nov-19, Old SM)

OR

MB & Associates is a partnership firm of Chartered Accountants which was established seven years back. The firm is getting new clients and has also, been offered new engagement services with existing clients. The firm is concerned about obtaining such information as it considers necessary in the circumstances before accepting an engagement with a new client and acceptance of a new engagement with an existing client. The firm is looking to work with only select clients to adhere to the Quality Control Standards. Guide MB & Associates about the matters to be considered with regard to the integrity of a client, as per the requirements of SQC 1. (New SM)

Answer 4

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

With regard to the integrity of a client, matters that the firm considers include, for example:

- The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.
- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
- Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.
- Indications of an inappropriate limitation in the scope of work.
- Indications that the client might be involved in money laundering or other criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES: Matters to be considered with regard to integrity of a client: Only few Examinees have given correct answers while most of the Examinees wrongly mentioned about KYC and background of clients.

Question 5

HK & Co. Chartered Accountants have been auditors of SAT Ltd (a listed entity) for the last 8 financial years. CA. H, partner of the firm, has been handling the audit assignment very well since the appointment. The audit work of CA. H and her team is reviewed by a senior partner CA. K to assure that audit is performed in accordance with professional standards and regulatory and legal requirements. CA. K was out of India for some personal reasons, so this year CA. G has been asked to review the audit work. In your opinion, what areas CA. G should consider at the time of review. List any four areas and also comment whether firm is complying with Standard on Quality Control or not. (PYP 5 Marks July 21)

Answer 5

Compliance with Standard on Quality Control on review of audit work -

As per SQC 1, an engagement quality control review for audits of financial statements of listed entities includes considering the following:

(i) The work has been performed in accordance with professional standards and regulatory and legal requirements;

(ii) Significant matters have been raised for further consideration;

(iii) Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;

(iv) There is a need to revise the nature, timing and extent of work performed;

(v) The work performed supports the conclusions reached and is appropriately documented;

(vi) The evidence obtained is sufficient and appropriate to support the report; and

(vii) The objectives of the engagement procedures have been achieved.

The firm should establish policies and procedures:

(i) Setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time; and

(ii) For all audits of financial statements of listed entities, requiring the rotation of the engagement partner after a specified period in compliance with the Code.

The familiarity threat is particularly relevant in the context of financial statement audits of listed entities.

For these audits, the engagement partner should be rotated after a pre- defined period, normally not more than seven years.

From the facts given in the question and from the above stated paras of SQC 1, it can be concluded that firm is not complying with SQC 1 as Engagement Partner H is continuing for more than 7 years.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Most of the examinees did not highlight regarding the rotation of the engagement partner for a maximum period of seven years and hence the firm is not complying with SQC 1.

Question 6

PQR & Associates, Chartered Accountants, is a partnership firm having 3 partners CA P, CA Q and CA R. PQR & Associates are appointed as Statutory Auditors of ABC Limited, a listed entity for the financial year 2021-22 and CA P is appointed as Engagement Partner for the audit of ABC Limited.

Before issuing the Audit Report of ABC Limited, CA P asked CA R to perform Engagement Quality Control Review and is of the view that his responsibility will be reduced after review by CA R. Whether the contention of CA P is correct? What are the aspects that need to be considered by CA R while performing Engagement Quality Control Review for audit of financial statements of ABC Limited? (PYP 5 Marks May '22)

Answer 6

As per SQC 1, "Quality Control for Firms that Perform Audit and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements", the review does not reduce the responsibilities of the engagement partner. Hence, contention of CA. P that after engagement quality control review by CA. R, his responsibility will be reduced, is not correct.

However, CA. R needs to consider the following aspect while performing Engagement Quality Control Review for audit of financial statements of a listed entity ABC Ltd.:

1. The engagement team's evaluation of the firm's independence in relation to the specific engagement.
2. Significant risks identified during the engagement and the responses to those risks.
3. Judgments made, particularly with respect to materiality and significant risks.

4. Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations.
5. The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
6. The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.
7. Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.
8. The appropriateness of the report to be issued.

Engagement quality control reviews for engagements other than audits of financial statements of listed entities may, depending on the circumstances, include some or all of these considerations.

Question 7

AP & Associates, Chartered Accountants, are Statutory Auditors of XP Limited for the last four years. XP Limited is engaged in the manufacture and marketing of FMCG Goods in India. During 2021-22, the Company has diversified and commenced providing software solutions in the area of "e-commerce" in India as well as in certain European countries. AP & Associates, while carrying out the audit for the current financial year, came to know that the company has expanded its operations into a new segment as well as new geography. AP & Associates does not possess necessary expertise and infrastructure to carry out the audit of this diversified business activities and accordingly wishes to withdraw from the engagement and client relationship. Discuss the issues that need to be addressed before deciding to withdraw. (PYP 5 Marks Nov 22)

Answer 7

Acceptance and Continuance of Client Relationships and Specific Engagements: As per SQC 1, "Quality Control for Firms that Perform Audit and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements", the firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will undertake or continue relationships and engagements only where it is competent to perform the engagement and has the capabilities, time and resources to do so.

In the given case, AP & Associates, Chartered Accountants, statutory auditors of XP Limited for the last four years, came to know that the company has expanded its operations into a new segment as well as new geography. AP & Associates does not possess necessary expertise for the same, therefore, AP & Associates wish to withdraw from the engagement and client relationship. Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship address issues that include the following:

- Discussing with the appropriate level of the client's management and those charged with its governance regarding the appropriate action that the firm might take based on the relevant facts and circumstances.
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship, and the reasons for the withdrawal.
- Considering whether there is a professional, regulatory or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- Documenting significant issues, consultations, conclusions and the basis for the conclusions.

AP & Associates should address the above issues before deciding to withdraw.

Question 8

JJJ & Associates, an audit firm working mainly in field of statutory audits, has been selected by Quality Review Board (QRB) for review. During review, it has been found that Audit Firm Under Review (AFUR) has not maintained quality of audits of selected companies as evidenced from their respective audit files. AFUR has not complied with requirements of SA 501 and SA 505 in these cases. Further, in these cases, companies had not complied with accounting standards as required by law and AFUR has issued clean audit reports. Dwell upon functions of QRB in this regard. (MTP 5 Marks Oct '23)

Answer 8

Central Government has constituted a Quality Review Board as an independent body under the Chartered Accountants Act, 1949 to review the quality of services provided by the Chartered Accountants in India including audit services.

Accordingly, u/s 28B of the Chartered Accountants Act, 1949, the Board shall perform the following functions, namely: -

(a) to make recommendations to the Council with regard to the quality of services provided by the members of the Institute

(b) to review the quality of services provided by the members of the Institute including audit services

(c) to guide the members of the Institute to improve the quality of services and adherence to the various statutory and other regulatory requirements and

(d) to forward cases of non-compliance with various statutory and regulatory requirements by the members of the Institute or firms, noticed by it during the course of its reviews, to the Disciplinary Directorate for its examination.

In the given situation, AUFR has not performed audits of selected companies qualitatively and has failed to perform audits in accordance with Standards on Auditing, Further, it has issued clean reports despite non-adherence to accounting standards by respective companies. Therefore, QRB is empowered to act on the lines mentioned above in respect of AUFR.

SA 220 – Quality Control

Question 1

OP & Associates are the statutory auditors of BB Ltd. BB Ltd is a listed company and started its operations 5 years back. The field work during the audit of the financial statements of the company for the year ended 31 March 2018 got completed on 1 May 2018. The auditor's report was dated 12 May 2018. During the documentation review of the engagement, it was observed that the engagement quality control review was completed on 15 May 2018. Engagement partner had completed his reviews in entirety by 10 May 2018. Please comment. (MTP 5 Marks, Mar 19 & Oct 18)

Answer 1

Review by Engagement Partner: As per SA 220, "Quality Control for an Audit of Financial Statements", the engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. For audits of financial statements of listed entities, the engagement partner shall:

- Determine that an engagement quality control reviewer has been appointed;
- Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
- Not date the auditor's report until the completion of the engagement quality control review.

SA 700, "Forming an Opinion and Reporting on Financial Statements", requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements. In cases of an audit of financial statements of listed entities where the engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction on or before the date of the auditor's report.

In the instant case, OP & Associates are the statutory auditors of a listed company BB Ltd. Which started its operations 5 years back. The field work during the audit of the financial statements of the company for the year ended March 31, 2018 got completed on May 1, 2018. The auditor's report was dated May 12, 2018. During the documentation review of the engagement, i t was observed that the engagement quality control review was completed on May 15, 2018.

Thus, in the given case, signing of auditor's report i.e., on May 12, 2018 which is before the completion of review engagement quality control review i.e., May 15, 2018, is not in order.

Question 2

During the audit of FMP Ltd, a listed company, Engagement Partner (EP) completed his reviews and also ensured compliance with independence requirements that apply to the audit engagement. The engagement files were also reviewed by the Engagement Quality Control Reviewer (EQCR) except the independence assessment documentation. Engagement Partner was of the view that matters related to independence assessment are the responsibility of the Engagement Partner and not Engagement Quality Control Reviewer. Engagement Quality Control Reviewer objected to this and refused to sign off the documentation. Please advise as per SA 220 (MTP 4 Marks, Oct 19, RTP May'22 & RTP May'19, Old & New SM)

Answer 2

As per SA 220, Engagement Partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, Engagement Partner shall:

a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;

b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and

c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

Engagement Partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures.

As per SA 220, "Quality Control for Audit of Financial Statements", for audits of financial statements of listed entities, Engagement Quality Control Reviewer (EQCR), on performing an engagement quality control review, shall also consider the engagement team's evaluation of the firm's independence in relation to the audit engagement.

In the given case, Engagement Partner is not right. The independence assessment documentation should also be given to Engagement Quality Control Reviewer for his review.

Question 3

Rishi Kumar & Co. has been appointed as an auditor of PK Ltd. for the financial year 2016 -17. CA. Kumar, one of the partners of M/s Rishi Kumar & Co., completed entire routine audit work by 29th May, 2017.

Unfortunately, on the very next morning, while roving towards office of PK Ltd. to sign final audit report, he met with a road accident and died. CA. Rishi, another partner of M/s Rishi Kumar & Co., therefore, signed the accounts of PK Ltd., without reviewing the work performed by CA. Kumar. Advise, whether CA. Rishi is right in expressing an opinion on financial statements the audit of which is performed by another auditor. (5 Marks, April 18)

Answer 3

Relying on Work Performed by Another Auditor: As per SA 220 "Quality Control for an Audit of Financial Statements", an engagement partner taking over an audit during the engagement may apply the review procedures such as the work has been performed in accordance with professional standards and regulatory and legal requirements; significant matters have been raised for further consideration; appropriate consultations have taken place and the resulting conclusions have been documented and implemented; there is a need to revise the nature, timing and extent of work performed; the work performed supports the conclusions reached and is appropriately documented; the evidence obtained is sufficient and appropriate to support the auditor's report; and the objectives of the engagement procedures have been achieved.

Further, one of the basic principles, which govern the auditor's professional responsibilities and which should be complied with wherever an audit is carried, is that when the auditor delegates work to assistants or uses work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. This is the fundamental principle which is ethically required as per Code of Ethics.

However, the auditor should carefully direct, supervise and review work delegated. He should obtain reasonable assurance that work performed by other auditors/experts and assistants is adequate for his purpose.

In the given case, all the auditing procedures before the moment of signing of final report have been performed by CA. Kumar. However, the report could not be signed by him due to his unfortunate death.

Later on, CA. Rishi signed the report relying on the work performed by CA. Kumar. Here, CA. Rishi is allowed to sign the audit report, though, will be responsible for expressing the opinion. He may rely on the work performed by CA. Kumar provided he further exercises adequate skill and due care and review the work performed by him as required in compliance with SA 220.

Question 4

(Includes concepts of SQC 1)

NEMI Limited (manufacturer of textile goods) got an order of manufacturing of PPE kits in December 2021. But there was shortage of machinery and manpower to accomplish the ordered requirement of PPE kits. NEMI Limited approached another manufacturing unit Rathnemi Limited for purchase of the unit. Rathnemi Limited was interested in the sale of unit, so the deal

went through, and NEMI Limited acquired ninety five percent shares of Rathnemi Limited. The new management of Rathnemi Limited proposed and appointed Mani Associates, Chartered Accountants, (already auditors of NEMI Limited) as new auditors of Rathnemi Limited. Mani Associates accepted the assignment without considering information whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate. Comment with respect to appropriate Standard on Auditing what type of information assists the engagements partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate or not? (MTP 5 Marks Sep 22)

Answer 4

Acceptance and Continuance of Client Relationships and Audit Engagements : As per SA 220, "Quality Control for an Audit of Financial Statements" , SQC 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

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

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

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

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

QUALITY CONTROL

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

VKPL & Associates, a firm of Chartered Accountants, have been operating for the last 5 years having its office in Gurgaon. The firm has staff of around 25 persons with 3 Partners.

The firm has been offering statutory audit, risk advisory and tax services to its various clients. The major work of the firm is for taxation services. The audit partners also discussed that the firm needs to work significantly to improve the quality of the services they offer and that would also help the firm to grown its business. Considering this objective, the firm started training programmes for the staff which were made mandatory to be attended.

During one of the training programmes on quality, a topic was discussed regarding the information that should be obtained by the firm before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. It was explained that the following points may assist the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate (as per SA 220):

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

(ii) The qualification of all the employees of the entity;

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

(iv) The remuneration offered by the entity to its various consultants;

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

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

We would like to understand from you which of the above mentioned points are relevant for the topic under discussion or not?

(a) i, ii, iv and v.

(b) ii, iv, v and vi.

(c) iii, iv, v and vi.

(d) i, iii, v and vi. (RTP Nov 19)

Ans : (d)

Question 1

PQR & Associates are statutory auditors of a listed company. There arose an issue during the course of audit relating to related party transactions. The engagement partner wants to consult engagement quality control reviewer on this matter during the course of audit process itself. Can he consult with engagement quality control reviewer? Discuss.

Answer 1

It is necessary to maintain objectivity of reviewer. Therefore, participation in engagement or making decisions for engagement team is to be avoided at all costs. However, engagement partner may consult engagement quality control reviewer during the engagement so as not to compromise his objectivity and eligibility to perform the role.

Question 2

Beta Private Limited has approached a firm of Chartered accountants to assist them in preparation of financial statements and issue a compilation report in this regard. Does CA firm have responsibility in relation to quality control for above said engagement? Discuss with reasons.

Answer 2

Such kind of services fall in category of "related services". SQC 1 is applicable to all type of engagements including engagement pertaining to "related services".

Question 3

Ramanujan, a CA final student, feels that engagement file in audit engagement should be ready prior to issue of audit report. Discuss whether Ramanujan's view is in order.

Answer 3

The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized. Engagement files should be completed in not more than 60 days after date of auditor's report in case of audit engagements. Thus, view of Ramanujam is not in order.

Question 4

BNE & Co. are in midst of audit process of a listed company. During the course of audit, an issue arose relating to revenues from contracts with customers in terms of Ind AS 115. The engagement partner took a certain stand. However, engagement quality control reviewer recommended otherwise after review. The engagement partner is not willing to accept recommendations of reviewer. How can the stalemate be ended?

Answer 4

In case, recommendations of engagement quality control reviewer are not accepted by engagement partner and matter is not resolved to reviewer's satisfaction, the matter should be resolved by following established procedures of firm like by consulting with another practitioner or firm, or a professional or regulatory body.

The audit report should be issued only after resolution of matter.

Question 5

MB & Associates is a partnership firm of Chartered Accountants which was established seven years back. The firm is getting new clients and has also, been offered new engagement services with existing clients. The firm is concerned about obtaining such information as it considers necessary in the circumstances before accepting an engagement with a new client and acceptance of a new engagement with an existing client. The firm is looking to work with only select clients to adhere to the Quality Control Standards. Guide MB & Associates about the matters to be considered with regard to the integrity of a client, as per the requirements of SQC 1.

Answer 5

As per SQC 1, the firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Where issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, it should document how the issues were resolved.

With regard to the integrity of a client, matters that the firm considers include, for example:

(i) The identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance.

(ii) The nature of the client's operations, including its business practices.

(iii) Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.

(iv) Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.

(v) Indications of an inappropriate limitation in the scope of work.

(vi) Indications that the client might be involved in money laundering or other criminal activities.

(vii) The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

Question 6

ABC & Associates, Chartered Accountants has a policy to accept the clients wherein the risk evaluation is conducted with respect to the Company and the promoter. XYZ Limited approached ABC & Associates.

Promoter of XYZ Limited is a close associate and family friend of Mr. A, Managing Partner of ABC & Associates. XYZ Limited is in news in the previous year for certain inquiries from the regulatory authorities in relation to certain matters. The existing auditor of XYZ Limited has resigned and has created a casual vacancy. XYZ Limited is ready to offer 25% more than the existing fees and has approached ABC & Associates for appointment as Auditor. Mr. A has strong recommendation to the Firm to accept the audit.

What is your understanding of the functioning of the tone at the top of the Firm ABC & Associates, Chartered Accountants.? What are the considerations one should exercise to uphold Quality of the Firm?

Answer 6

The given situation indicates that proposed client is a new one whose promoter is close associate and family friend of managing partner of M/s ABC & Associates. However, previous auditor of proposed client has resigned and company is offering hike in audit fees in comparison to audit fees paid to previous auditor.

Besides, there are also regulatory inquires against the company. In spite of all this, managing partner of firm Mr. A has recommended for acceptance of offered audit of the company.

It reflects poorly regarding functioning at top of the firm as regards to quality control. SQC 1 requires that firm should establish a system of quality control designed to provide it with reasonable assurance that firm and its personnel comply with professional standards and legal and regulatory requirements. It further requires that firm's business strategy is subject to overriding requirement of firm to achieve quality in all engagements.

However, in the given situation, commercial considerations seem to be overriding factor.

The managing partner of firm is close associate and family friend of promoter. The matter should have been brought to knowledge of firm in accordance with requirements of SQC 1 as it involves issue of independence of managing partner of the firm with respect to proposed audit engagement. Further, matters of inquiries from regulators and resignation of previous auditor raise question about integrity of the proposed client. SQC 1 further requires firm to consider before acceptance of an engagement that client does not lack integrity. All these factors need to be taken into consideration before accepting engagement.

Overall, such a situation reflects lack of proper establishment of quality control framework at top of the firm.

Following considerations should be taken into account while upholding quality of firm: -

1. The firm assigns its management responsibilities so that commercial considerations do not override quality of work performed

2. The firm's policies and procedures in relation to its personnel are designed to demonstrate its overriding commitment to quality.
3. The firm devotes sufficient resources for development and documentation of its quality control policies and procedures
4. A firm before accepting an engagement should acquire vital information about the client. Such an information should help firm to decide about integrity of Client, promoters and key managerial personnel, competence (including capabilities, time and resources) to perform engagement and compliance with ethical requirements.

Question 7

MNP & Co., a firm of auditors, is appointed by a bank to conduct stock audit of a borrower. It deputes one of its paid Chartered accountant employees, Sudhanshu, to conduct above said stock audit. He leverages it as an opportunity to prevail upon the client to get the accounts audited from their firm. He also assures the client of a clean stock audit report without adverse comments as a quid pro quo. Is approach of Sudhanshu proper? How does it reflect upon quality control system of firm?

Answer 7

Approach of Sudhanshu is not proper. Such practices blatantly violate code of ethics and its spirit. It reflects poorly upon quality control system of firm envisaged in SQC 1 which requires that quality control policies and procedures should be documented and communicated to the firm's personnel. It shows that firm's personnel are not properly sensitized regarding requirements of SQC 1.

Question 8

CA M is introduced to a prospective client in a social function. He assures to visit office of CA M very soon in relation to professional work. During discussions over a cup of coffee next week, it transpires that there was a search by Enforcement Directorate in his premises about a month back resulting in recovery of huge sum of cash. The income tax department had also searched his premises in relation to bogus capital gains on penny stocks. Lamenting poor quality of services provided by his present auditor, he offers appointment as tax auditor of his five family-owned firms to CA M in lieu of handsome fees. What are the factors to be evaluated by CA M if he wants to take up the engagement?

Answer 8

As per SQC 1, before accepting a new engagement, integrity of client should be considered including matters that indicate involvement in money laundering or criminal activities. There has been search of ED on the said party leading to recovery of huge amount of cash. The above coupled with actions of income tax department relating to bogus capital gains on penny stocks indicates that client might be involved in money laundering activities. Therefore, offer should not be accepted.

Question 9

GVN & Associates are auditors of a listed company involved in "fin-tech" sector. The engagement team is stuck up with some issue pertaining to a particular Ind-AS applicable to the company. They have framed a query and sent to ICAI for expert opinion on the matter. The issue was resolved upon receipt of expert opinion. Since expert opinion was provided by ICAI, engagement team was of the view that appointment of engagement quality control reviewer has lost its relevance. Do you agree?

Answer 9

Engagement quality control review in listed entities is a mandatory requirement. Expert opinion of ICAI pertains to issue of interpretation. The appointment of reviewer is a separate and mandatory requirement in audits of listed companies.

Question 10

RST & Co., a firm of Chartered accountants, are auditors of a listed company engaged in manufacturing of heavy machinery components. The audit report for year 2021-22 also included report on matters listed in CARO,2020. While reporting under clause vii(a) of the said order relating to regularity of undisputed statutory dues by the company, the auditors have commented that company is "generally regular" in depositing statutory dues to appropriate authorities. Is above reporting qualitative and in line with requirements of SA-220?

Answer 10

Such type of reporting is not qualitative. It is not in accordance with SA 220. One of the objectives of the auditor, as per SA 220, is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that the audit complies with professional standards and regulatory and legal requirements. The reporting under CARO, 2020 is not proper. Hence, the audit does not comply with regulatory and legal requirements.

Integrated case scenario

CA Mritunjay is statutory auditor of a listed company engaged in providing services relating to "tourism sector". He is practicing in sole-proprietorship capacity. The audit of abovesaid listed company was conducted by his proprietary firm and report was issued for year 2021-22. Subsequently, audit report was selected by NFRA to oversee quality of service and compliance with Standards. Necessary information was called from auditor towards above objective.

It was required of him to produce audit working papers to show that audit was carried out in accordance with Standards on auditing. Details of the audit plan and details of risk assessment procedures carried out to identify and assess risk of material misstatement in financial statements were called. It was also required to show how response to assessed risks was designed and implemented and communicated with those charged with governance.

Audit working papers sent by him through email included procedures on how some balances in financial statements were verified. Also included in working papers were procedures performed by him relating to verification of inventories, trade receivables and trade payables.

The working papers sent by him to the authority did not include details on audit plan and manner of identifying and assessing risks of material misstatement. On being asked to respond, it was reasoned by him that audit was properly planned and required procedures were carried out in relation to material items on test check basis.

It has been further clarified by him to the authority that audit was carried out in accordance with Standards and it was practically not feasible for a firm of small size to make a detailed audit plan. It was also put on record with authority that he had assessed risk of material misstatement to be low based upon his understanding of the company. He has further reasoned that assessing risks is a matter of professional judgment. Representation has also been made by him stating that communications as necessary were made orally with those charged with governance.

It was also pointed out to him that engagement quality control review was not carried out. He has answered that no contentious matter arose during the course of audit and therefore, no need was felt to carry out this exercise.

Attention was also drawn to the fact that financial statements of company were required to be prepared on basis of Ind-AS. However, at some places in notes to accounts, reference is made to accounting standards which are not applicable to the company. These errors have been attributed to data feeding entry errors by junior staff.

Based upon above, answer the following questions:

1) It has been contended by auditor that audit was properly planned. He has further stated that it was practically not feasible for firm of small size to prepare a detailed audit plan? Which of the following views is most appropriate in this regard?

a) Audit was, in fact, planned as evidenced by auditor's submissions.

b) Although auditor has no record of audit plan, it does not affect compliance with SA 220.

c) Since auditor has no record of audit plan, it goes on to show non-compliance with SA 220.

d) Audit was, in fact, planned as evidenced by auditor's submissions. However. there is an exemption for small CA firms doing away with cumbersome documentation in relation to audit plan.

Ans: (c)

2) The auditor has reasoned that risk of material misstatement has been assessed to be low based upon his understanding of the company and it is a matter of professional judgment. Identify the most appropriate statement from below in this regard.

a) Assessing risks of material statement is a matter of professional judgment. It cannot be demanded from him how his judgment was arrived at.

b) Although auditor has not submitted record of how risk of material misstatement was arrived at, it does not affect compliance with SA 220.

c) Since auditor has no record of how risk of material misstatement was arrived at, it goes on to show non-compliance with SA 220.

d) Such a query, itself, is outside the mandate of authority.

Ans: (c)

3) Considering auditor's point of view regarding engagement quality control review, identify the most appropriate statement from below: -

a) Engagement quality control review is mandatory in such type of engagement. It was not proper for auditor to bypass such review. He has violated mandatory requirement of SA 220.

b) Engagement quality control review is optional in such type of engagement. Therefore, question of not following SA 220 does not arise.

c) No contentious matter arose during the course of engagement. Therefore, question of not following SA 220 does not arise in respect of engagement quality control review.

d) Engagement quality control review is dependent upon benchmarks established under SQC 1. If those bench marks are satisfied, such a review is necessary.

Ans: (a)

4) Considering auditor's reply regarding errors in data feeding entry by junior staff in relation to accounting standards, which of the following statements is proper?

a) Such are examples of clerical errors encountered during preparation of reports. There is no question of non-compliance with SA 220.

b) Such are examples of clerical errors encountered during preparation of reports. There is no effect on auditor's opinion and consequently question of non-compliance with SA 220 does not arise.

c) Such are examples of serious lapses on part of auditor showing non-compliance with SA 220.

d) Such are examples of serious lapses on part of auditor. However, these are not related to compliance with SA 220.

Ans: (c)

5) On your overall reading of the case study, which of the following statements appears to be true?

a) The firm has an effective system of quality control described in SQC 1. Audit engagement has also been performed in accordance with SA-220.

b) The firm does not have effective system of quality control described in SQC 1. Audit engagement has also not been performed in accordance with SA 220.

c) SQC 1 is not applicable in the case. Audit engagement has not been performed in accordance with SA 220.

d) SQC 1 is not applicable in the case. Audit engagement has been performed in accordance with SA 220.

Ans: (b)

QUALITY CONTROL

2

CHAPTER

GENERAL AUDITING PRINCIPLES AND AUDITOR'S RESPONSIBILITIES

SA 240 – The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

Question 1

(Includes concepts of 143(12) Duties of Auditor & CARO)

On 15th March, 2020, the directors of Phony Ltd. instructed their accountant to enter purchases amounting Rs. 1.02 crores from a company incorporated dated 11th March, 2020. However, no amount was actually paid and Rs. 1.02 crore was provided in the books of account as purchases for the year ending on 31st March, 2020.

On inspection, no documentary or other evidence of such purchases was found. As the auditor of Phony Ltd., what would be your approach regarding reporting of such bogus purchases? (MTP 5 Marks, May 20)

Answer 1

Reporting of Fraud Committed by Management/Directors of the Company: As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", fraud can be committed by management overriding controls using such techniques as recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

In the given case, Phony Ltd. has made purchases amounting Rs. 1.02 crores, at year-end. It also debited the sum in the books of account; however, no documentary or other evidence of such purchases was found, on investigation. It is clear that company has passed fictitious journal entries, near year-end, to manipulate the operating results.

Accordingly, the auditor would adopt the approach which will be based on the result of misstatement on the basis of such fictitious journal entry, i.e. if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities; or the auditor may consider for appropriateness of withdrawal from such engagement, where withdrawal from the engagement is legally permitted.

In addition, the auditor is required to report according to section 143(12) of the Companies Act, 2013. As per section 143(12), if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of Rs. 1 crore or above is being or has been committed in the company by its officers or employees, he shall report the matter to the Central Government in prescribed manner.

The auditor is also required to report under ~~clause (x)~~ clause (xi)of paragraph 3 of Companies (Auditor's Report) Order, 2020, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

Question 2

(Includes concepts of 143(12) Duties of Auditor & CARO)

The Managing Director of the Company has committed a "Teeming and Lading" Fraud. The amount involved has been however subsequently after the year end deposited in the company. As a Statutory Auditor, how would you deal? (MTP 4 Marks, March 18)

Answer 2

Fraud Committed by Managing Director: The Managing Director of the company has committed a "Teeming and Lading" fraud. The fact that the amount involved has been subsequently deposited after the year end is not important because the auditor is required to perform his responsibilities as laid down in SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements". First of all, as per SA 240, the auditor needs to perform procedures whether the financial statements are materially misstated. Because an instance of fraud cannot be considered as an isolated occurrence and it becomes important for the auditor to perform audit procedures and revise the audit risk assessment.

Secondly, the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. Thirdly, the auditor should communicate the matter to the Chairman and Board of Directors. Finally, in view of the fact that the fraud has been committed at the highest level of management, it affects the reliability of audit evidence previously obtained since there is a genuine doubt about representations of management.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is ₹ 1 crore or above)or Audit Committee or Board in other cases (in case the amount of fraud involved is less than ₹ 1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report under ~~clause (x)~~ clause (xi)of paragraph 3 of Companies (Auditor's Report) Order, 2020, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

GENERAL AUDITING PRINCIPLES AND AUDITOR'S RESPONSIBILITIES

Question 3

(Includes concepts of 143(12) Duties of Auditor, CARO & SA 580- Written representations) In the course of audit of K Ltd., its auditor Mr. 'N' observed that there was a special audit conducted at the instance of the management on a possible suspicion of a fraud and requested for a copy of the report to enable him to report on the fraud aspects. Despite many reminders it was not provided. In absence of the special audit report, Mr. 'N' insisted that he be provided with at least a written representation in respect of fraud on/by the company. For this request also, the management remained silent. Please guide Mr. 'N'. (MTP 5 Marks, Oct 18, RTP May'18)

Answer 3

Auditor's Responsibilities Relating to Fraud: As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", the auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.

As per SA 580 "Written Representations", if management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist.

In the instant case, the auditor observed that there was a special audit conducted at the instance of the management on a possible suspicion of fraud. Therefore, the auditor requested for special audit report which was not provided by the management despite of many reminders. The auditor also insisted for written representation in respect of fraud on/by the company. For this request also management remained silent.

It may be noted that, if management does not provide one or more of the requested written representations, the auditor shall discuss the matter with management; re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is Rs. 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than Rs. 1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report under ~~clause (x)~~ clause (xi)of paragraph 3 of Companies (Auditor's Report) Order, 2020, whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(i) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(ii) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(iii) If the auditor withdraws:

(1) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(2) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Question 4

In the course of audit of Kushal Ltd, you suspect that the management has made misstatements in the financial statements intentionally to deceive the users and to succumb to pressures to meet market expectations. Elucidate how the fraudulent financial reporting may be accomplished and also discuss the techniques of committing fraud by management overriding controls. (MTP 5 Marks Oct 21, PYP 5 Marks Nov'20)

Answer 4

In the given case, management of Kushal Ltd has made intentional misstatements to deceive the users in order to meet market expectations. Auditor is suspecting such intentional behavior of the management and in such situations, SA 240 discusses how fraudulent financial reporting may be accomplished and also discusses techniques of committing fraud by management overriding controls.

As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements"

Fraudulent financial reporting may be accomplished by the following:

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

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

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

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

GENERAL AUDITING PRINCIPLES AND AUDITOR'S RESPONSIBILITIES

i. Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

ii. Inappropriately adjusting assumptions and changing judgments used to estimate account balances.

iii. Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.

iv. Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.

v. Engaging in complex transactions that are structured to misrepresenting the financial position or financial performance of the entity.

vi. Altering records and terms related to significant and unusual transactions.

Question 5

M/s Prakash & Co., Chartered Accountants were appointed as statutory auditors of JIN Limited for the financial year 2021-22. During the course of audit, one of the partners CA Prakash observed that there is misappropriation of assets in the form of theft of entity's inventory and is perpetrated by employees in relatively small and immaterial amounts. CA Prakash is concerned with the existence of certain circumstances for increasing the susceptibility of assets to misappropriation. Guide CA Prakash with respect to risk factors related to misstatements arising from misappropriation of assets with reference to relevant Standard on Auditing. (MTP 5 Marks March '23, PYP 5 Marks Dec'21)

Answer 5

Guidance to CA. Prakash with respect to risk factors that relate to misstatements arising from misappropriation of assets as per SA 240 is:

As per SA 240, "The Auditor's Responsibilities Relating to Fraud in an audit of Financial Statements", misappropriation of assets involves the theft of entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.

Misappropriation of assets can be accomplished in a variety of ways including stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).

Risk factors that relate to misstatements arising from misappropriation of assets are also classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization.

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

(i) Known or anticipated future employee layoffs.

(ii) Recent or anticipated changes to employee compensation or benefit plans.

(iii) Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation.

For example, opportunities to misappropriate assets increase when there are the following:

(i) Large amounts of cash on hand or processed.

(ii) Inventory items that are small in size, of high value, or in high demand.

(iii) Easily convertible assets, such as bearer bonds, diamonds, or computer chips.

(iv) Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

(i) Inadequate segregation of duties or independent checks.

(ii) Inadequate oversight of senior management expenditures, such as travel and other reimbursements.

(iii) Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations.

(iv) Inadequate job applicant screening of employees with access to assets.

(v) Inadequate record keeping with respect to assets.

(vi) inadequate system of authorization and approval of transactions (for example, in purchasing).

(vii) Inadequate physical safeguards over cash, investments, inventory, or fixed assets.

(viii) Lack of complete and timely reconciliations of assets.

(ix) Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.

(x) Lack of mandatory vacations for employees performing key control functions.

(xi) Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.

(xii) Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalizations

(i) Disregard for the need for monitoring or reducing risks related to misappropriations of assets.

(ii) Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to take appropriate remedial action on known deficiencies in internal control.

(iii) Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.

(iv) Changes in behavior or lifestyle that may indicate assets have been misappropriated.

(v) Tolerance of petty theft.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

SA 240 - Risk factors related to misstatements arising from misappropriation of assets: Examinees correctly referred to SA 240 and listed down the risk factors correctly. However, the concept / examples of misappropriation of assets and proper explanation of risk factors were not given by examinees.

Question 6

(Includes concepts of 143(12) Duties of Auditor & CARO)

M/s Innocent Limited has entered into a transaction on 25th February, 2018, near year-end, whereby it has agreed to pay Rs. 5 lakhs per month to Mr. Yuvraj as annual retainer-ship fee for "engineering consultation". No amount was actually paid, but Rs. 60 lakhs are provided in books of account as on March 31, 2018.

Your inquiry elicits a response that need-based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service. As the auditor of M/s Innocent Limited, what would be your approach? (RTP Nov 18)

Answer 6

As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", fraud can be committed by management overriding controls using such techniques as Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.

Keeping in view the above, it is clear that Company has passed fictitious journal entries near year end to manipulate the operating results. Also, Auditor's enquiry elicited a response that need-based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service, is not acceptable.

Accordingly, the auditor would adopt the following approach-

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(i) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(ii) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(iii) If the auditor withdraws:

(1) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(2) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is Rs. 1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than Rs. 1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Question 7

Arihant Limited was engaged in the business of owning and managing hotels and resorts, selling tourism packages and performing airline bookings for corporate and individuals. It appointed Upadhyay & Co. as its statutory auditor for the financial year 2021-22. While planning the audit, the audit team decided that the risk of improper revenue recognition from hotel business should not be treated as a fraud risk. This conclusion was based on the assessment of earlier years, wherein no fraud was identified in revenue recorded from such business. While testing the internal financial controls over the process of revenue recognition, it was identified that the controls are not properly designed to mitigate the risk of fraud and risk of improper revenue recognition. As a result, the audit team decided to perform additional substantive testing. However, the audit team still were to the conclusion that there is no risk of fraud in revenue recognition. During the course of substantive testing, it was identified that the management did not account for revenue received from corporate hotel bookings amounting to ₹ 35 crore. These amounts were partially received in the company's bank accounts and partially received in the CFO's personal account. The amounts received in the bank account of the company were disclosed as advances received against the future bookings.

In the light of above scenario, kindly guide the statutory auditors with respect to their responsibility relating to fraud in an audit of a financial statement. (RTP Nov'22)

GENERAL AUDITING PRINCIPLES AND AUDITOR'S RESPONSIBILITIES

Answer 7

As per SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" and SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.

In accordance with SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" and 330," The Auditor's Responses to Assessed Risks" the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level and assertion level.

The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property. However, when there is a complex revenue structure or when there is lack of controls on revenue recognition, then there is a high probability of fraud risk in revenue recognition.

Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit.

In the current scenario, the company was earning revenue from multiple streams. Also, it was identified that the controls are not properly designed to mitigate the risk of fraud and risk of improper revenue recognition. During the year it was identified that the management did not account for revenue from corporate hotel bookings amounting to ₹ 35 crore. These amounts were partially received in the company's bank accounts and partially received in the CFO's personal account. The amounts received in the bank account of the company were disclosed as advances received against future bookings.

Therefore, the auditor while performing the risk assessment procedures should consider the complexity and nature of the revenue for determining the fraud risks in revenue recognition. Also, there were no adequate controls addressing the risk of improper revenue recognition or fraud risk, the audit team rebutted the fraud risk. Moreover, the audit team should have recognized fraud risk by identifying the deficiencies of internal control over the revenue recognition process and should have treated the risk of improper revenue recognition as a significant risk. Also, as per Section 143(12), the auditor is required to report all the frauds identified during the course of the audit involving amounts above ₹ 1 crore within the prescribed time frame to the Central Government.

SA 250 – Consideration of Laws and Regulations in an Audit of Financial Statements

Question 1

(Includes concepts of CARO)

During the course of audit of CT Ltd. for the financial year 2017-18, it is noticed that Rs. 3.00 lakhs of employee contribution and Rs. 7.50 lakhs of employer contribution towards employee state insurance contribution have been accounted in the books of accounts in respective heads. Whereas, it was found that Rs. 5.00 lakhs only has been deposited with ESIC department during the year ended 31st March, 2018. The Finance Manager informed the auditor that due to financial crunch they have not deposited the amount due, but will deposit the amount overdue along with interest as and when financial position improves. Comment as a statutory auditor. (MTP 5 Marks, Aug 18 & April 18)

Answer 1

Non-Compliance of Laws and Regulations & Reporting Requirements: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. If the auditor concludes that the non- compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

Further, the auditor is required to report under clause (vii)(a) of Para 3 of CARO, 2020 whether the company is regular in depositing undisputed statutory dues including employees' state insurance with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

In the instant case, even though accrual principles have been followed, disclosure of non-payment is necessary. The auditor should disclose the fact of non-payment of rupees 7.50 lakhs in his report.

Question 2

(Includes concepts of SA 705- Modifications to the Opinion in the Independent Auditor's Report) While verifying the employee records in a company, it was found that a major portion of the labour employed was child labour. On questioning the management, the auditor was told that it was outside his scope of the financial audit to look into the compliance with other laws. Comment in accordance with relevant Standards on Auditing. (MTP 4 Marks, May 20 & April 21 & March '23, RTP May'18)

Answer 2

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

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

In the instant case, major portion of the labour employed in the company was child labour. While questioning by auditor, reply of the management that it was outside his scope of financial audit to look into the compliance with other laws is not acceptable as it may have a material effect on financial statements.

Thus, auditor should ensure the disclosure of above fact and provision for the cost of fines, litigation or other consequences for the entity. In case if the auditor concludes that non- compliance has a material effect on the financial statements and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statement as per SA 705 "Modifications to the Opinion in the Independent Auditor's Report".

Question 3

(Includes concepts of CARO)

XYZ Pvt. Ltd. has submitted the financial statements for the year ended 31-3-18 for audit. The audit assistant observes and brings to your notice that the company's records show following dues:

Income Tax relating to Assessment Year 2014-15 Rs. 125 lacs - Appeal is pending before Hon'ble ITAT since 30-9-16.

Customs duty Rs. 85 lakhs - Demand notice received on 15-9-17 but no action has been taken to pay or appeal. Comment.

As an auditor, how would you bring this fact to the members? (MTP 5 Marks, Oct 18)

Answer 3

Non-Compliance of Laws and Regulations: As per SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statement", it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework.

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall express a qualified or adverse opinion on the financial statements.

Further, the auditor is required to report on certain matters specified in Para 3 of CARO, 201 6 under section 143 of the Companies Act, 2013.

One of such matter is non-payment of dues to Government, on account of any dispute. As per clause (vii)(b) of Para 3 of CARO, 2020, in case dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned.

In the present case, there is Income Tax demand of Rs. 125 Lacs and the company has gone for an appeal, it needs considerations as to whether the entire demand is disputed, because it is difficult to presume that the demand by Income Tax authority is without any basis. Therefore, as per AS 29 "Provisions, Contingent Liabilities and Contingent Assets", partly to the extent the company considers that the demand is based on some logical basis, that amount may be provided for and the remaining may be disclosed as the contingent liability. Further, it should be brought to notice of the members by reporting.

Additionally, the demand notice has been received for Customs duty of Rs. 85 lakhs and is outstanding on the closure of financial year, for which no action has been taken by the management. Therefore, it should also be brought to notice of the members by reporting.

Question 4

As an Auditor of TRP Ltd., you are suspicious that there might be non-compliance with laws and regulations to which the Company is subject to. Indicate the possible areas or aspects where you may have to look out for forming an opinion as to whether your suspicion has some basis to further inquire. (MTP 4 Marks Oct 21, PYP 4 Marks, May '18)

OR

You are appointed as an auditor of Moksh Ltd., a company engaged in export of agricultural equipment. During the course of audit, your audit team informed you regarding non-deduction of TDS on huge payments made to legal counsel of Moksh Ltd. You want to alert your team on the possibility of noncompliance with Laws and Regulations by Moksh Ltd. Help your audit team in identifying any other indications of non-compliance with Laws and Regulations particularly related to payments made by the company. (MTP 4 Marks April '23)

OR

R & M Co. wants to be alert on the possibility of non-compliance with Laws and Regulations during the course of audit of SRS Ltd. R & M Co. seeks your guidance for identifying the indications of noncompliance with Laws and Regulations. (Old SM)

Answer 4

Indications of Non-Compliance with Laws and Regulations: When the auditor becomes aware of the existence of, or information about, the following matters, it may be an indication of non-compliance with laws and regulations, possible areas or aspects to look out for forming an opinion are:

- Investigations by regulatory organisations and government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
- Unusual payments towards legal and retainership fees.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorised transactions or improperly recorded transactions.
- Adverse media comment.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Indications of Non-compliance with Laws and Regulations: Instead of emphasizing the indications of Non Compliance with Laws and Regulations some examinees gave general answers on SA 250.

Question 5

CA Abhinanadan is an auditor of KM Private Limited. During the course of audit, CA Abhinanadan becomes aware of information concerning an instance of non- compliance or suspected non-compliance with laws and regulations. Being a senior partner of CA. Abhinanadan, guide him regarding audit procedures to be followed when non-compliance is identified or suspected. (RTP May 22)

Answer 5

As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", if the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain:

(i) An understanding of the nature of the act and the circumstances in which it has occurred; and

(ii) Further information to evaluate the possible effect on the financial statements.

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

If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reli ability of written representations, and take appropriate action.

Question 6

(Includes concepts of section 143 & SA 705 Modification of Opinion)

Abhinandan Limited a chemical manufacturing company, having its factory located at Nanded Village, for the year 2021-22 appointed Subahu & Co. as their statutory auditors. During the course of the audit, Subahu & Co. identified that Abhinandan Limited received a show cause notice from National Green Tribunal based on the investigation performed by the regional forest department for violating environmental laws. Upon gathering a further understanding of the said matter, it was identified that Abhinandan Limited was dumping toxic solid waste, without treating it, on the nearby grounds, and because of this, the nearby water bodies were getting polluted. Based on the preliminary investigation performed by the regional forest department under the directions of the National Green Tribunal, it was identified that these practices were carried out since 2009 and a lot of damage has been done to the environment by Abhinandan Limited. A show cause notice was already issued to Abhinandan Limited by the National Green Tribunal for levying the penalty of an amount of ₹ 500 crore. The unaudited profit for the financial year 2021 -22 of Abhinandan Limited was ₹ 35 crore and the unaudited turnover was ` 100 crore. Upon inquiry it was identified that Abhinandan Limited has disclosed this matter in the financial statements by way of footnote, the extract of which is provided below:

"The company has received a show cause notice from the National Green Tribunal for some potential violation of environmental laws and the company's legal department has assessed and found that the judgment would be in favour of the company. Accordingly, no provision has been created for such notices."

In the light of the above scenario kindly provide what should be the appropriate opti on for the statutory auditor of the company to report this matter. (RTP Nov'22)

Answer 6

As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", the auditor is required to obtain an understanding and need to evaluate the impact of other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements.

The auditor shall perform the following audit procedures to help identify instances of non - compliance with other laws and regulations that may have a material effect on the financial statements:

(a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and

(b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities As per Section 143(3)(j) read with Rule 11(a), the auditor is required to report whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement.

As per SA 570, "Going Concern", if the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(i) Adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(ii) Disclose clearly that there is material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

If adequate disclosure about the material uncertainty is not made in the financial statements, the auditor shall (a) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705; and (b) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

In the current scenario, Abhinandan Limited has received a show cause notice from the National Green Tribunal of an amount which is more than the net profit and the turnover of the company for the year.

In the event of an unfavorable order for Abhinandan Limited, there will be an impact on Abhinandan Limited's ability to continue as a going concern.

As a result, appropriate disclosure should be provided by management for such events which cast significant doubt on the entity's ability to continue as a going concern. As no appropriate disclosure has been provided by Abhinandan Limited for such show cause notice, Subahu & Co. should report this matter in their audit report under "Going Concern Para" as per SA 570 and under clause (j) of Section 143(3) of the Companies Act, 2013. Also, the auditor is required to issue an adverse opinion as per SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

Question 7

CA Paras has been appointed as the Chief Financial Officer (CFO) of Prashanth Limited. In this role, CA Paras is tasked with the responsibility of ensuring that the company's entity's operations are conducted in accordance with relevant laws and regulations. As part of his duties, CA Paras is emphasising the importance of adhering to all applicable laws and regulations that could impact the entity's specific disclosures in its financial statements. Additionally, he is focusing on compliance with laws and regulations that dictate the appropriate financial reporting framework for the company. CA Paras is also highlighting the significance of avoiding any non-compliance, as certain laws and regulations may impose penalties in the event of violations. Now CA Paras wants to implement policies and procedures in an entity that can assist in the prevention and detection of non-compliance with the laws and regulations. Help CA Paras by citing examples of such policies and procedures. (RTP Nov '23)

Answer 7

Management Responsibility for Compliance with Laws and Regulations:

SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements", states that it is the responsibility of management, with the oversight of those charged with governance to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations. For this purpose, management may apply the following procedures:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate systems of internal control.
- Developing, publicizing and following a code of conduct.
- Ensuring employees are properly trained and understand the code of conduct.
- Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
- Engaging legal advisors to assist in monitoring legal requirements.
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

Question 8

PQ Limited, a listed entity, is in the business of manufacturing of specialty chemicals. The company has appointed CA Jazz as CFO of the company. CA Jazz is concerned about compliance with the provisions of laws and regulations that determine the reported amounts and disclosure in financial statements of PQ Limited. Accordingly, CA Jazz wants to implement such policies and procedures that can assist him in the prevention and detection of non-compliance with laws and regulations. Help CA Jazz by citing examples of such policies and procedures. (PYP 5 Marks, NOV-20)

Answer 8

In PQ Ltd, listed entity, CA Jazz has been appointed as CFO. PQ Ltd is in the business of manufacturing of specialty chemicals. CA Jazz is concerned about compliance with the provisions of Laws and regulations and wants to implement such policies and procedures that would assist him in prevention and detection of non-compliance with laws and regulations. CA Jazz is specifically wanting examples of types of policies and procedures that PQ Ltd may implement so that relevant laws and regulations are properly complied with. Such examples of policies and procedures are given in SA250.

- As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements",
- The following are examples of the types of policies and procedures PQ Ltd. may implement to assist in the prevention and detection of non-compliance with laws and regulations:
  - (i) Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
  - (ii) Instituting and operating appropriate systems of internal control.
  - (iii) Developing, publicizing and following a code of conduct.
  - (iv) Ensuring employees are properly trained and understand the code of conduct.

(i) Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.

(ii) Engaging legal advisors to assist in monitoring legal requirements.

(iii) Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

KJA Ltd is in the business of consultancy services. The business of the company has been growing significantly and considering the nature of business, it becomes subject to various laws and regulations.

Compliances have also increased because of this and management has found this very difficult to keep in pace with the changing regulatory requirements. The statutory auditors of the company, Shilpa & Associates, have considered compliance with laws and regulations as a significant risk for the purpose of their audit.

Auditors had a audit planning meeting with the management and management has understood that it will be their responsibility including those charged with governance to ensure that the company's operations are fully compliant with the provisions of various laws and regulations. This may also have an impact on the reported amounts and disclosures in the financial statements of the company.

Management is planning to ensure full compliance and may implement policies and procedures, wherever required, to assist in the prevention and detection of non-compliance with laws and regulations. Please suggest among the following which one will not be a policy/ procedure to be implemented to assist in the prevention and detection of non-compliance with laws and regulations in accordance with SA 250?

(a) Maintaining a register of significant transactions of the company with comparison to particular industry and a record of complaints.

(b) Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.

(c) Developing, publicizing and following a code of conduct.

(d) Instituting and operating appropriate systems of internal control. (MTP 2 Marks, Mar 19)

Ans: (a)

Question 2

Shripal Company got a show cause notice from State Pollution Control Board for the contravention of the provisions of Hazardous and waste Management Rule. As per SA 250, the auditor shall perform the audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements. As the audit team of the company became aware of information concerning an instance of non-compliance with law, what would NOT be the audit procedure to be performed?

(a) Understand the nature of the act and circumstances in which it has occurred and obtain further information to evaluate the possible effect on the financial statement.

(b) Discuss the matter with management and if they do not provide sufficient information; and if the effect of non-compliance seems to be material, legal advice may be obtained.

(c) Monitoring legal requirement and compliance with code of conduct and ensuring that operating procedures are designed to assist in the prevention of non-compliance with law and regulation and report accordingly.

(d) Evaluate the implication of non-compliance in relation to other aspects of audit including risk assessment and reliability of written representation and take appropriate action. (MTP 1 Mark April 22)

Ans: (c)

Question 3

M/s ADI & Associates are the statutory auditors of PRAKASH Ltd. for the financial year 2022-23. While conducting the audit, CA Saurabh, the engagement partner noticed the following:

- Payments to various government employees not supported by any document.
- Notices received from various regulatory authorities.
- Payments of various fines and penalties
- Heavy payments to legal counsels.
- Unusual cash payments

CA Saurabh should consider the above as indicative of:

(a) Doubt on the accounting system of PRAKASH Ltd.

(b) Doubt of non-compliance to laws by PRAKASH Ltd.

(c) Doubt on the going concern assumption of PRAKASH Ltd.

(d) Doubt on Internal Controls of PRAKASH Ltd. (RTP May '23)

Ans: (b)

Question 1

A, B and C are joint auditors of a company. B is of the opinion that there are material misstatements in financial statements of a company which, if accounted for, would turn profit reflected in financial statements for 25 crores to a loss of ₹ 5 crores. He, therefore, wants an adverse opinion to be expressed in audit report. However, A and B do not concur with his views and are inclined to accept management's version. Is B required to go by majority opinion of 2-1?

Answer 1

Where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement. Therefore, B is not required to go by majority opinion of 2-1.

In such circumstances, the audit report issued by the joint auditors shall make a reference to the separate audit report issued by the other joint auditor. Further, separate audit report shall also make reference to the audit report issued by other joint auditors. Such reference shall be made under the heading "Other Matter Paragraph" as per SA 706.

Question 2

CA. Shelly Goel is offered appointment as auditor of RUTE Limited, a listed company. The audit committee of the company wants her to justify independence in relation to company through proper communication.

Although she has ensured that there are no threats to her independence, she feels requirement of audit committee to be beyond its purview. What is your opinion in this regard?

Answer 2

As required in SA 260, in the case of listed entities, the auditor shall communicate with those charged with governance: -

A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable,network firms have complied with relevant ethical requirements regarding independence and

i. All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor and

ii. The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

Question 3

You are auditor of a social media company. Of late, government has tightened noose around companies operating in this segment by bringing in a maze regulatory legislations to protect interests of users. How you can proceed to verify that company is compliant with new regulatory requirements? Besides, what does above situation underscore to you as an auditor?

Answer 3

It needs to be verified that the company has put in place systems and procedures to meet with new regulatory requirements. The same can be verified by examining policies and procedures developed by company in this regard like devising appropriate system of internal control, sensitizing employees regarding new rules, engaging legal advisors etc.

Further, financial stability of the company may be threatened due to new regulatory requirements. The management may be under pressure. It is also a fraud risk factor and may need to be evaluated by auditor.

Question 4

Discuss why the potential effects of inherent limitations of an auditor's ability to detect material misstatements described in SA 200 are far greater in respect of-compliance with laws and regulations?

Answer 4

In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following: -

- There are many laws and regulations, relating principally to the operating aspects of an entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.
- Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

Question 5

MN & Associates are the statutory auditors of ABC Ltd. for the FY 2-02221. During the course of audit, the engagement partner, Mr. Manohar notices a misstatement resulting from a suspected fraud that brings into question the audit team's ability to continue performing the audit. How should the audit team deal with the situation?

GENERAL AUDITING PRINCIPLES AND AUDITOR'S RESPONSIBILITIES

Answer 5

During the course of audit, the engagement partner, Mr. Manohar notices a misstatement resulting from a suspected fraud that brings into question the audit team's ability to continue performing the audit. In such a situation the audit team should:

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(c) If the auditor withdraws: -

  (i) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal and

  (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Question 6

CA Anand is the engagement partner for the audit assignment of NHT Ltd. engaged in manufacture of Iron and Steel bars. The company has its plants in the state of Sikkim. While verifying the wages record of the company, CA Anand found that maximum of the labour employed in the plants of the company was child labour. He questioned the management of the company about the same to which the management replied that looking into the compliance of such law is outside his scope of financial audit. Give your comments with respect to such situation.

Answer 6

As per SA 250 "Considerations of Laws and Regulations in an Audit of Financial Statements", the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework.

For the compliance with provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, the auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations.

For other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements but compliance with which may be fundamental to the operating aspects of the business, the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

In the instant case, maximum of the labour employed in the plants of the company was child labour. When CA Anand questioned the management of the company about the same, the management replied that looking into the compliance of such law is outside his scope of financial audit. Such reply by the management is not acceptable as such situation may have a material effect on the financial statements. Therefore, CA Anand should ensure as to whether any penal provisions will be there for non- compliance of such law and also whether the same has been duly disclosed by the company. If CA Anand concludes that such non- compliance has a material effect on the financial statements and the same has not been adequately reflected in the financial statements by the company, he shall express an adverse or a qualified opinion on the financial statements.

Question 7

Magnet Interiors Ltd. is a listed company engaged in the manufacture of office furniture. The company has its activities divided into four geographic regions. The company has appointed two joint auditors, namely, AB & Co. and & Co. to conduct the joint audit of the financial statements of the company for the year ending 31.03.2023. The engagement partners from both the firms, CA Amar and CA Chetanya along with their audit teams had a meeting to discuss the areas of the work to be divided and their respective responsibilities.

Explain the responsibilities of the joint auditors with respect to such joint audit.

Answer 7

As per SA 299 "Joint Audit of Financial Statements", in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the separate and specific responsibility of each joint auditor to obtain information and explanations from the management in respect of such divisions/ zones/units and to evaluate the information and explanations so obtained by said joint auditor. The joint auditors shall have proper coordination and rationality wherever required.

All the joint auditors shall be jointly and severally responsible for: -

(a) the audit work which is not divided among the joint auditors and is carried out by all joint auditors

(b) decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors.

(c) matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors

(d) examining that the financial statements of the entity comply with the requirements of the relevant statutes

(e) presentation and disclosure of the financial statements as required by the applicable financial reporting framework

(f) ensuring that the audit report complies with the requirements of the relevant statutes, the applicable Standards on Auditing and the other relevant pronouncements issued by ICAI.

Where, in the course of the audit, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.

It shall be the responsibility of each joint auditor to determine the nature, timing and extent of audit procedures to be applied in relation to the areas of work allocated to said joint auditor. It is the individual responsibility of each joint auditor to study and evaluate the prevailing system of internal control and assessment of risk relating to the areas of work allocated to said joint auditor.

As regards decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the nature, timing and extent of the audit procedures to be performed by each of the joint auditors, all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing and extent of the audit procedures agreed upon among them, proper execution of these audit procedures is the individual responsibility of the joint auditor concerned.

Question 8

MNO Ltd. gets its accounting data processed by a service organization. CA Riya is the statutory auditor of MNO Ltd. CA Riya wants to obtain an understanding as to how MNO Ltd. is using the services of the service organization. What all understanding should she obtain?

Answer 8

When obtaining an understanding of MNO Ltd. (user entity) in accordance with SA 315, CA Riya shall obtain an understanding of how MNO Ltd. uses the services of a service organization in its operations, including: -

(a) The nature of the services provided by the service organization and the significance of those services to the user entity, including the effect thereof on the user entity's internal control. Information on nature of services provided by a user organization may be available from sources such as user manuals, contract between the user entity and service organization, reports by service auditors etc.

(b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organization. In certain situations, the transactions processed and the accounts affected by the service organization may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.

(c) The degree of interaction between the activities of the service organization and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organization. For example, a high degree of interaction exists between the activities of the user entity and those at the service organization when the user entity authorizes transactions and the service organization processes and does the accounting for those transactions

(d) The nature of the relationship between the user entity and the service organization, including the relevant contractual terms for the activities undertaken by the service organization.

Question 9

UVW & Associates are the statutory auditors of Moon Ltd., a listed company, for the financial year 2022- 23. CA Udhav is the engagement partner for the audit assignment. He was of the understanding that as per the requirement of one of the SAs he has a responsibility to communicate following matters to those charged with governance:

(a) The auditor's responsibilities in relation to the financial statement audit.

(b) Planned scope and timing of the audit.

(c) Auditor independence

Which of the matters is not included in the list prepared by CA Udhav. Discuss such matter in detail.

Answer 9

SA 260 "Communication with Those Charged with Governance" deals with auditor's responsibility to communicate with those charged with governance in relation to an audit of financial statements. Among various matters as included by CA Udhav in his list, one of the matters that is not mentioned in the list is Significant findings from the audit. With respect to such matter, the auditor shall communicate with those charged with governance: -

(a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

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

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

(i) Significant matters arising during the audit that were discussed, or subject to correspondence, with management;

(ii) Written representations the auditor is requesting

(d) Circumstances that affect the form and content of the auditor's report, if any and

(e) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

Question 10

My Decor Limited, presently engaged in manufacturing of fabrics, wants to set up a new plant for manufacturing of special kind of fabric providing an altogether different texture and feel. This kind of fabric has become a hit with retail customers. The company needs to set up plant for manufacturing the above kind of fabric involving huge capital outlays to stay competitive in the market.

You are auditor of the company and find that company's revenue has increased in financial year 2022-23 to ₹ 1000 crore from ₹ 750 crore in last year. By the time, you started the audit, there was no change in plant capacity and information regarding need to set up new plant has become known to you during inquiry of company's personnel.

Discuss, how you should proceed to deal with above situation, as auditor of the company, paying special attention to risk of material misstatement due to fraudulent financial reporting?

Answer 10

The given situation highlights need for the company to set up new plant for manufacturing of special kind of fabric to stay competitive in the market. Setting up of such plant involves huge capital outlays which could entail financing arrangements. Therefore, excessive pressure exists for management to be involved in fraudulent financial reporting. In such a situation, management may be tempted to inflate its revenues to show rosy picture. It is a fraud risk factor and needs to be evaluated by the auditor.

The revenues of company have jumped from ₹ 750 crore in last year to ₹ 1000 crore in year 2022-23 without any change in plant capacity. The auditor may consider abovesaid fraud risk factor for assessing risk of material misstatement due to fraud.

In case of auditor assessing risk of material misstatement due to fraudulent financial reporting, audit procedures to address such risk like performing substantive analytical procedures relating to revenue, use of computer assisted audit techniques to identify unusual revenue transactions and testing controls pertaining to revenue transactions need to be performed.

Question 11

CA. Ridhima, internal auditor of Track Store Limited, has pointed out following deficiencies in internal control of the company, in her reports: -

(i) Receivables are not reconciled at stipulated intervals.

(ii) Customers are provided a credit limit based upon their track record. However, no review of customer credit limits is undertaken at required intervals.

The statutory auditor of the company finds that no action has been taken by the company on the said deficiencies pointed out in reports of internal auditor.

What does above situation allude to statutory auditor of company?

Answer 11

Management failing to remedy known significant deficiencies in internal control on a timely basis is a fraud risk factor for misstatements arising from fraudulent financial reporting.

When management does not correct significant deficiencies in internal control on a timely basis, it reflects an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act.

Failure to rectify known control deficiencies pertaining to reconciliation of receivables and review of customer credit limits has the potential to fraud. Lack of timely reconciliation of receivables may lead to intentional misstatements. Further, non-reviewing customer limit may lead to grant of credit beyond creditworthiness of customers. It may result in intentional tying up of company's funds with risky customers due to collusion.

The above situation is a fraud risk factor for fraudulent financial reporting.

Question 12

FAS Insurance Brokers Limited is a leading online insurance intermediary. During the year, Director General of GST Intelligence (DGGI) has issued notice to the company for allegedly creating fictitious invoices for "marketing and sales services" amounting to ₹ 50 crores in favor of non-life insurance companies. The premises of company were also searched during the year by DGGI officials. The matter was also informed to IRDAI by DGGI for violation of norms and regulations in this regard.

Does above situation has any bearing on your responsibilities as statutory auditor of the company?

Outline briefly in context of possible non-compliance with laws by the company.

Answer 12

When the auditor becomes aware of the existence of or has information about investigations by government departments and regulatory organizations, it may be an indication of non- compliance with laws and regulations.

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In the instant case, notice has been served upon the company by DGGI for allegedly creating fictitious invoices in guise of providing "marketing and sales services ₹50 crores. Issuing an invoice without supply of services is a serious offence under GST laws and it could involve penalties and imprisonment. Such suspected non-compliance may have a direct effect on financial statements.

The matter has also been informed to regulator i.e. IRDAI. Violation of IRDAI regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

If the auditor becomes aware of information concerning an instance of non-compliance or suspected noncompliance with laws and regulations, the auditor shall obtain: -

a) An understanding of the nature of the act and the circumstances in which it has occurred and

b) Further information to evaluate the possible effect on the financial statements.

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

If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

Question 13

CA. Vallabh Sundar is auditor of a leading private sector bank. "IT Systems and controlsi"s under his consideration to be reported as "Key audit matter"in audit report of the bank due to high level of automation and complexity of the IT architecture and its impact on the financial reporting system. At what time he should communicate such identified "Key audit matter"? What are relevant considerations in this regard and their usefulness?

Answer 13

SA 260 requires the auditor to communicate with those charged with governance on a timely basis.

SA 701 states that the appropriate timing for communications about key audit matters will vary with the circumstances of the engagement. However, the auditor may communicate preliminary views about key audit matters when discussing the planned scope and timing of the audit, and may further discuss such matters when communicating about audit findings. Doing so may help to alleviate the practical challenges of attempting to have a robust two- way dialogue about key audit matters at the time the financial statements are being finalized for issuance.

Communication with those charged with governance enables them to be made aware of the key audit matters that the auditor intends to communicate in the auditor's report, and provides them with an opportunity to obtain further clarification where necessary. The auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate this discussion.

Communication with those charged with governance recognizes their important role in overseeing the financial reporting process, and provides the opportunity for those charged with governance to understand the basis for the auditor's decisions in relation to key audit matters and how these matters will be described in the auditor's report. It also enables those charged with governance to consider whether new or enhanced disclosures may be useful in light of the fact that these matters will be communicated in the auditor's report.

Question 14

Four audit firms viz. GPR & Co., MKS & Co., CY & Associates and DES & Associates have been appointed for conducting statutory audit of KNB Bank, a public sector bank in accordance with regulatory guidelines.

The professional work was divided by audit firms on the basis of zones of bank. However, work relating to "IT Systems and controls" was not allocated by them due to its very nature.

While planning for the above common work area, it was decided to test IT general controls, application controls and IT dependent manual controls. Planned key audit procedures relating to this common area also included testing design and operating effectiveness of controls over "computer operations including back-up, batch-processing and data center security".

The actual audit procedures pertaining to "testing controls over batch processing" were performed by team of DES & Associates. In case work in relation to above audit procedures is not performed professionally by DES & Associates, discuss where responsibility for such lapses would lie in line with SA 299?

Answer 14

In respect of common areas, the joint auditors are only responsible for appropriateness of nature, timing and extent of planned audit procedures agreed among them. The responsibility of individual execution lies with concerned joint auditor.

In the instant case, audit procedures relating to testing design and operating effectiveness of controls over computer operations including back-up, batch-processing and data center security have been planned jointly as it is a common area.

However, audit procedures relating to testing controls over batch processing were actually performed by team of DES & Associates although these were planned jointly. In case of any lapses in performing such procedures, DES & Associates would be responsible.

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Integrated Case Scenario

CA. Biswajit is conducting audit of "Have More Limited. "He is auditor of the company since last three years and has found nothing unusual in operations and financial statements of the company. The company has many locations where substantial inventories are stored and lying. During his fourth-year stint, he finds that inventory quantities have risen disproportionately as compared to past few years trends. He has assessed existence of risk of material misstatement due to fraud.

The company has revenue of ` 750 core during the year. He has deeply verified all aspects pertaining to revenue recognition of the company and has concluded that there is no risk of material misstatement due to fraud related to revenue recognition.

During the course of audit, it has come to his knowledge that company is also required to install online air pollution control monitoring systems in its plant as mandated in state pollution control legislation and regulations. Non-installation of such online air pollution control monitoring systems may lead to fines and even sealing of plant.

While verifying pay roll data of the company, it has come to notice that provisions of law preventing employment of child labour are not being adhered to and company is employing child labour in flagrant violation of rules in this regard. The company also exports part of its turnover and matter has gone unnoticed in compliance audits carried out by agencies of overseas buyers.

On the basis of above, answer the following questions

1. Considering description of disproportionate rise in inventory quantities, h of the following is not likely to be an appropriate response to outlined assessed risk of material misstatement due to fraud?

(a) Observing inventory counts at all locations at same date by employing necessary resources.

(b) Observing inventory counts at certain locations after prior intimation.

(c) More rigorous examination of packed items during observing inventory count process.

(d) Observing inventory count at end of reporting period to minimize risk of manipulation.

Ans: (b)

2. It has been concluded by auditor that there is no risk of material misstatement due to fraud related to revenue recognition. Which of the following statements is most appropriate I respect?

(a) The auditor needs to document reasons for arriving at conclusion that there is no risk of material misstatement due to fraud related to revenue recognition.

(b) Identified and assessed risks of material misstatement due to fraud need to be documented. Since no risk of material misstatement due to fraud pertaining to revenue recognition was identified, separate documentation in this respect is not needed.

(c) The auditor needs only to document that no risk of material misstatement due to fraud relating to revenue recognition was identified.

(d) The auditor needs to give reference to discussion among engagement team members to document that no risk of material misstatement due to fraud relating to revenue recognition was identified.

Ans: (a)

3. Which of the following statements most appropriately describes receptibilities of auditor in relation to compliance with state pollution control legislation and regulations?

(a) Sufficient appropriate evidence needs to be obtained by auditor to verify compliance.

(b) physical verification of workability of such systems is required from an auditor.

(c) Only inquiry of company management personnel and review of correspondence with regulatory authorities are suffice to verify compliance.

(d) Only physical verification of workability of such systems and review of correspondence with regulatory authorities are suffice to verify compliance.

Ans: (c)

4. The auditor has observed no-compliance of law prohibiting employment of child labor. Which is the most appropriate course of action for him to proceed in this matter?

(a) He should obtain further information to evaluate the possible effect on financial statements.

(b) He must report the matter to concerned government department.

(c) He should obtain further information to evaluate the possible effect on financial statements. Besides, he should evaluate implications of non-compliance for audit risk assessment.

(d) He should express a modified opinion in audit report.

Ans: (c)

5. Which of the following statements is most appropriate about documentation of- noncompliance with laws and regulations by an auditor in context of SA 250?

(a) Instances of identified non-compliance with laws and regulations need to be documented.

(b) Instances of suspected non-compliance with laws and regulations need to be documented.

(c) Instances of non-compliance with laws and regulations finally determined by Courts of law need to be documented.

(d) Instances of identified as well as suspected non-compliance with laws and regulations need to be documented.

Ans: (d)

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3 CHAPTER AUDIT PLANNING, STRATEGY & EXECUTION

SA 210 – Agreeing the Terms of Audit Engagements

Question 1

Sudharma Limited is a listed company having its operation across India. Sudharma Limited appointed Mr. S, Mr. D and Mr. M, as its joint auditors for the year 2019-20. After making sure that all of them are qualified to be appointed as statutory auditor, Sudharma Limited issued engagement letter to all of them. But Mr. S was not clear on some points, so he requested Sudharma Limited to slightly change the terms of his engagement. This change will not impact the ultimate opinion on the financial statement. The engagement letter contains the details on objective and scope of audit, responsibilities of auditor and identification of framework applicable. It also contains the reference to expected form and content of report from all three joint auditors. In your opinion what was the discrepancy in the Audit engagement letter issued by Sudharma Limited? (MTP 4 Marks Nov 21 & Sep '22, RTP Nov 20)

Answer 1

Agreement on Audit Engagement Terms: As per SA 210, "Agreeing the Terms of Audit Engagements", the auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.

Subject to prescribed details under Law or Regulations, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

(i) The objective and scope of the audit of the financial statements;

(ii) The responsibilities of the auditor;

(iii) The responsibilities of management;

(iv) Identification of the applicable financial reporting framework for the preparation of the financial statements; and

(v) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

In the given scenario, Sudharma Limited appointed Mr. S, Mr. D and Mr. M, as its joint auditors for the year 2019-20 and issued engagement letter to all of them. The engagement letter contains the details on objective and scope of audit, responsibilities of auditor, identification of framework applicable and

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reference to expected form and content of report from all three joint auditors. However, engagement letter issued by Sudharma Ltd. does not specify the responsibilities of management, whereas as per SA 210, it should also specify responsibilities of management.

Question 2

AKJ Ltd. is a small-sized 30 years old company having business of manufacturing of pipes. Company has a plant based out of Dehradun and have their corporate office in Delhi. Recently the company appointed new firm of Chartered Accountants as their statutory auditors.

The statutory auditors want to enter into an engagement letter with the company in respect of their services but the management has contended that since the statutory audit is mandated by law, engagement letter may not be required. Auditors did not agree to this and have shared a format of engagement letter with the management for their reference before getting that signed. In this respect management would like to understand that as per SA 210 (auditing standard referred to by the auditors), if the agreed terms of the engagement shall be recorded in an engagement letter or other suitable form of written agreement, what should be included in terms of agreed audit engagement letter? (MTP 4 Marks, April 19, RTP May '23, Old & New SM)

Answer 2

As per SA 210 Agreeing the Terms of Audit Engagements The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.

The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

(i) The objective and scope of the audit of the financial statements;

(ii) The responsibilities of the auditor;

(iii) The responsibilities of management;

(iv) Identification of the applicable financial reporting framework for the preparation of the financial statements; and

(v) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

Question 3

Mr. Ram Kapoor, Chartered Accountant, has been appointed as the statutory auditor by XYZ Private Limited for the audit of their financial statements for the year 2018-19. The company has mentioned in the audit terms that they will not be able to provide internal audit reports to Mr. Ram during the course of audit. Further, company also imposed some limitation on scope of Mr. Ram.

What are the preconditions Mr. Ram should ensure before accepting/ refusing the proposal? Also advise, whether Mr. Ram should accept the proposed audit engagement? (RTP Nov 19)

Answer 3

As per SA 210 **"Agreeing the Terms of Audit Engagements"**, in order to establish whether the preconditions for an audit are present, the auditor shall:

(a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and

(b) Obtain the agreement of management that it acknowledges and understands its responsibility

  (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;

  (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

  (iii) To provide the auditor with:

    a) Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

    b) Additional information that the auditor may request from management for the purpose of the audit; and

    c) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Further, if management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

In addition, if the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement.

In the instant case, Mr. Ram should not accept the appointment as statutory auditor of XYZ Private Limited due to limitation imposed on his scope of work.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

M/s Sati and Associates were appointed as the statutory auditors of Power King Limited for the audit of financial year 2021-22. Power King Limited has a power generating plant in Sikkim. At the time of accepting the engagement, it was decided among the engagement partner (CA Sati) and the management that since CA Sati and his team is doing the audit of a client having power plant in Sikkim for the first time, it will be the duty of the management to update the audit team regarding all the taxes and statutes applicable to units situated in Sikkim. Which of the following is correct in this regard?

(a) The engagement team, being the auditor of Sikkim based power plant for the first time can always rely on the management's information and can work accordingly.

(b) The engagement team should understand the Power King Limited business environment and should obtain knowledge about the laws and statutes applicable in this case.

(c) The engagement team should not accept the audit of such power plant situated in Sikkim of which he has no prior knowledge.

(d) The engagement team can very well accept the audit of Power King Limited and with respect to aspects related to Sikkim law he can give disclaimer of opinion, if required. (MTP 1 Mark March 22)

Ans: (b)

Question 2

A small concern has approached CA. Ajeet Nath for audit of accounts for year 2021-22. It later on transpired that preparation of accounts of the concern was outsourced to a third party which was engaged in preparation of books of this concern on a cloud server and was also prepare ng financial statements. The discussion amongst partners regarding agreeing to audit engagement remained inconclusive. Which of the following statements is MOST APPROPRIATE regarding agreeing to audit engagement of small concern?

(a) The management is responsible for preparation of books and financial statements. If management is not willing to acknowledge it, audit engagement should not be accepted.

(b) The third party has prepared the books and financial statements. It should be acknowledged by third party and then audit engagement should be accepted.

(c) It is implied that management is responsible for preparation of books and financial statements. No express acknowledgment from management is necessary. Hence, audit engagement should be accepted.

(d) The management as well as third party should acknowledge joint responsibility for preparation of books and financial statements. Only then, audit engagement should be accepted. (MTP 1 Mark Oct 22)

Ans: (a)

Audit Plan, Audit Programme & Audit Strategy

Question 1

Entertainment Paradise, a movie theatre complex, is the foremost theatre located in Chennai. 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. Its 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.

Entertainment Paradise 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 5 Marks, March 21 & March 22, New SM, PYP 5 Marks Nov '19, RTP May'18, Old & New SM)

Answer 1

Audit Programme of Movie Theatre Complex:

A. Peruse the Memorandum of Association and Articles of Association of the entity.

B. Ensure the object clause permits the entity to engage in this type of business.

C. In the case of income from sale of tickets:

  (i) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly and accurately accounted.

  (ii) Verify the system relating to online booking of various shows and the system of realization of money.

  (iii) Check that there is overall system of reconciliation of collections with the number of seats available for different shows in a day.

D. Verify the internal control system and its effectiveness relating to the income from café, shops, pubs, game zone etc., located within the multiplex.

E. Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.

F. Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.

G. In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement, any payment of advance made to the distributor is also adjusted against the amount due.

H. Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.

I. Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.

J. Verify the insurance premium paid and ensure it covers the entire assets.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Audit Programme of Movie Theatre Complex: Majority of the Examinees wrote extremely good answer while a few Examinees gave irrelevant points about capital expenditure and other audit procedure besides various taxes and balance sheet item.

Question 2

XY 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 2017	2.5%
Aug 2017	2.7%
Sep 2017	2.4%
Oct 2017	8.1% (MTP 5 Marks April 18 & April 22)

Or

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 5 Marks, April 18)

Answer 2

Audit Plan to locate the Abnormal Wastage of Raw Material: To locate the reasons for the abnormal wastage, the auditor should first of all assess the general requirements as under:

(i) Procure a list of raw materials, showing the names and detailed characteristics of each raw material.

(ii) Obtain the standard consumption figures, and ascertain the basis according to which normal wastage figures have been worked out. Examine the break-up of a normal wastage into that in process, storage and handling stages. Also obtain control reports, if any, in respect of manufacturing costs with reference to predetermined standards.

(iii) Examine the various records maintained for recording separately the various lots purchased and identification of each lot with actual material consumption and for ascertaining actual wastage figures therein.

(iv) Obtain reports of Preventive Maintenance Programme of machinery to ensure that the quality of goods manufacture is not of sub-standard nature or leads to high scrappage work.

(v) Assess whether personnel employed are properly trained and working efficiently.

(vi) See whether quality control techniques have been consistent or have undergone any change.

(vii) Examine inventory plans and procedures in report of transportation storage efficiency, deterioration, pilferage and whether the same are audited regularly.

(viii) Examine whether the basis adopted for calculating wastage for September is the same as was adopted for the other three months.

(ix) Obtain a statement showing break up of wastage figures in storage, handling and process for the four months under reference and compare the results of the analysis for each of the four months.

In addition, some specific reasons for abnormal wastage in process may be considered by the auditor are as under:

(i) Examine laboratory reports and inspection reports to find out if raw materials purchased were of a poor quality or were of sub-standard quality. This will be most useful if it is possible to identify the wastage out of each lot that has been purchased.

(ii) Machine breakdown, power failure, etc. may also result into loss of materials in process. Check the machine utilization statements.

(iii) A high rate of rejections in the finished lots may also be responsible for abnormal wastage; therefore, examine the inspectors' reports in respect of inspection carried out on the completion of each stage of work or process.

(iv) It is possible that the wastage may have occurred because the particular lot out of which issues were made was lying in the store for a long time, leading to deterioration in quality or because of a change in the weather which may have led to the deterioration. Compare the wastage figures.

(v) Abnormal wastage in storage and handling may arise due to the following reasons:

(1) Write offs on account of reconciliation of physical and book inventories: In case of periodical physical inventory taking, such write offs will be reflected only in the month such reconciliation takes place.

(2) Accidental, theft or fire losses in storage: The auditor should examine the possibility of these for the purpose.

(vi) Examine whether any new production line was taken up during the month in respect of which standard input-output ratio is yet to be set-up.

OR

The Internal Audit Programme in connection with Plant and Machinery and Tools and dies may be on the following lines:

(i) Internal Control Aspects: The following may be incorporated in the audit programme to check the internal control aspects-

(a) Maintaining separate register for hired assets, leased asset and jointly owned assets.

(b) Maintaining register of fixed asset and reconciling to physical inspection of fixed asset and to nominal ledger.

(c) All movements of assets are accurately recorded.

(d) Authorization be obtained for –

(1) a declaring a fixed asset scrapped.

(2) selling a fixed asset.

(e) Check whether additions to fixed asset register are verified and checked by authorized person.

(f) Proper recording of all additions and disposal.

(g) Examining procedure for the purchase of new fixed assets, including written authority, work order, voucher and other relevant evidence.

(h) Regular review of adequate security arrangements.

(i) Periodic inspection of assets is done or not.

(j) Regular review of insurance cover requirements over fixed assets.

(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 capitalized.

(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 (a) whether Movement Register for movable equipment's 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 authorization, 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 scrutinize the programme for an actual periodical servicing and overhauling of machines and to examine the extent of utilization of maintenance department services.

(x) Review of Obsolescence: To scrutinize 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.

AUDIT PLANNING, STRATEGY & EXECUTION

(xi) Review of R&D: To review R&D activity and ascertain the extent of its relevance to the operations of the organization, maintenance of machinery efficiency and prevention of early obsolescence.

Question 3

'The areas covered in comprehensive audit vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations.' You are required to list down some of the broad areas to be examined in comprehensive audit. (MTP 4 Marks, April 18, RTP May 19)

Answer 3

Areas to be Examined: The areas covered in comprehensive audit will naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations. Some of the broad areas are listed below-

- Comparison of overall capital cost of the project with the approved planned costs.
- Production or operational outputs vis-à-vis underutilization of the installed capacity.
- Systems of project formulation and implementation.
- Planned rate of return.
- Cost control measures.
- Research and development programmes.
- System of repairs and maintenance.
- Adequate purchase policies.
- Effective and economical procedures.
- Project planning.
- Undue waste, unproductive time for men and machines, wasteful utilization or even non- utilization of resources.

Question 4

Mr. S & Mr. J are a senior and junior articled assistant respectively, in a renowned audit firm. Both were assigned statutory audit of a manufacturing company. Mr. S instructed his junior to draft an audit plan by taking reference from a similar client (a partnership f irm) who was engaged in the same business. Mr. J was confused as to how that reference could suit in this case, since the nature and extent of planning would vary for both clients. After few days, the audit work commenced. During the course of the audit, certain events took place, which made Mr. J to rethink about the audit plan initially designed. He approached Mr. S and enquired about when would an audit plan require a change. Comment about both the situations face by Mr. J in the above situation. (MTP 5 Marks Oct 21)

Answer 4

SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in accordance with Standards on Auditing" states that in order to achieve the overall objectives of the audit, the auditor shall use the objectives stated in relevant SAs in planning and performing the audit. Without a careful plan, the overall objective of an audit may not be achieved. The audit planning is necessary to conduct an effective audit, in an efficient and timely manner. So far as the nature of planning is concerned, it would vary according to-

(i) Size and Complexity of the Auditee - If the size and complexity of organization of which a u d i t is to be conducted is large, then much more planning activities would be required as compared to an entity whose size and complexity is small.

(ii) Past Experience & Expertise - The key engagement team members' previous experience & expertise also contributes towards variation in planning activities.

(iii) Change in Circumstances - Another factor contributing towards variation in planning activities is change in circumstances.

Changes to Audit Planning: The auditor should update and change the overall audit strategy and audit plan as necessary during the course of the audit. The auditor may need to modify the overall audit strategy and audit plan due to the factors such as (i) result of unexpected events, (ii) changes in conditions, or (iii) the audit evidence obtained from the results of audit procedures.

Further, the auditor would also have to modify the nature, timing & extent of further audit procedures, based on the revised considerations of assessed risks. This may be the case when information coming to the auditor differs significantly from the information when he planned the audit process.

In addition to the above, there may be possibilities of change in law, notifications, government policies, which warrants updating of overall audit strategy and audit plan.

Question 5

You have been appointed as auditor of ARHAM Ltd. After having determined the audit objectives, now you have been requested to draft audit criteria. What are the sources that you will use while doing the task? (MTP 5 Marks Oct 21)

Answer 5

Determining Audit Criteria - Audit criteria are the standards used to determine whether a program meets or exceeds expectations. It provides a context for understanding the results of the audit. Audit criteria are reasonable and attainable standards of performance against which economy, efficiency and effectiveness of programmes and activities can be assessed.

The audit criteria may be sought to be obtained from the following sources:

(i) procedure manuals of the entity.

(ii) policies, standards, directives and guidelines.

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(iii) criteria used by the same entity or other entities in similar activities or programmes.

(iv) independent expert opinion and know how.

(v) new or established scientific knowledge and other reliable information.

(vi) general management and subject matter literature and research papers.

Question 6

(a) Key phases in the audit execution stage are Execution Planning, Risk and Control Evaluation, Testing and Reporting. Explain. (RTP Nov'18)

Answer 6

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

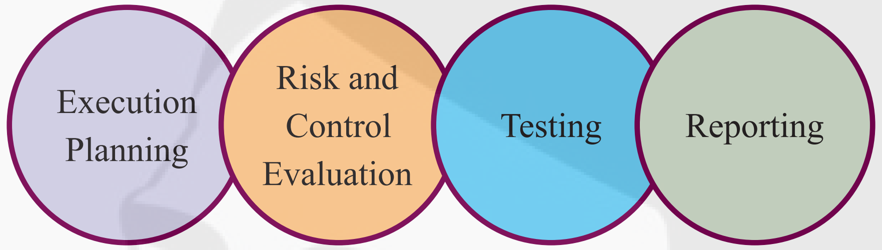

Image showing Stages of Audit Execution

1. **Execution Planning:** Prior to commencement of an audit engagement, it is important to lay down the roadmap for audit execution to ensure timely and quality audit results. The auditors need to plan their work in order to carry out the audit in an effective, efficient and timely manner. A detailed audit program is prepared laying down the audit objectives, scope and audit approach.

   The manpower requirement, audit team qualifications, and the time element, etc. are some of the important considerations during execution planning. In order to plan effectively, the auditor may need some more information about the audit area. A preliminary survey would help in gathering the required information.

2. **Risk and Control Evaluation:** For each segment of audit, the auditors should conduct a detailed risk and control assessment i.e. list the risks that must be reviewed in that segment, capture for each risk the controls that exist or those that are needed to protect against the risk and show for each control, the work steps required to test the effectiveness of the controls. While making Risk & Control assessment it is necessary to borne in mind Materiality levels as the same is linked with Audit Risks.

3. **Testing:** Once a comprehensive understanding is gained of the key risks and the controls to be evaluated in a given audit area, the auditors should test the operating effectiveness of the controls to determine whether controls are operating as designed. There are multiple test methods which can be used to arrive at the conclusions on the effectiveness of the controls

4. **Reporting:** SA 700, "Forming an Opinion and Reporting on Financial Statements" establishes standards on the form and content of the auditor's report issued as a result of an audit performed by an auditor of the financial statements of an entity. 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 financial statements. This review and assessment involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements such as compliance of Provisions & Enactments of the Company Law, Accounting Standards framed by ICAI, latest Guidelines etc.

   The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole. A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding of the auditor's report and to identify unusual circumstances when they occur. A statute governing the entity or a regulator may require the auditor to include certain matters in the audit report or prescribe the form in which the auditor should issue his report.

5. **Other Important Considerations:** In addition to above, there are certain other consideration which auditor is required to take care while executing the audit such as using the work of other auditor, using the work of an auditor's expert etc.

Question 7

Write a short note on : Contents of an audit plan. (RTP Nov 20)

Answer 7

Contents of an Audit Plan: The auditor shall develop an audit plan that shall include a description of-

(i) 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".

(ii) 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".

(iii) 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.

Question 8

A professional accountant is often required to give certificates or report for special purposes required by various authorities and statute and he needs to take careful evaluation of such engagement. However, issuing such special purpose certificates or reports has some inherent limitations which could limit his review and evaluation. Enumerate some of the limitations associated with such special purpose report or certificates. (PYP 5 Marks, May '19)

Answer 8

Inherent Limitations: A practitioner is expected to provide either a reasonable assurance (about whether the subject matter of examination is materially misstated) or a limited assurance (stating that nothing has come to the practitioner's attention that causes the practitioner to believe that the subject matter is materially misstated) since it is difficult to reduce engagement risk to zero due to inherent limitations of the audit. The inherent limitations could arise from:

(i) the nature of financial reporting;

(ii) the use of selective testing;

(iii) the inherent limitations of internal controls;

(iv) the fact that much of the evidence available to the practitioner is persuasive rather than conclusive;

(v) the nature of procedures to be performed in a specific situation;

(vi) the use of professional judgment in gathering and evaluating evidence and forming conclusions based on that evidence;

(vii) in some cases, the characteristics of the underlying subject matter when evaluated or measured against the criteria; and

(viii) the need for the engagement to be conducted within a reasonable period of time and at a reasonable cost.

Therefore, whenever a practitioner is required to give a "certificate" or a "report" for special purpose, the practitioner needs to undertake a careful evaluation of the scope of the engagement, i.e., whether the practitioner would be able to provide reasonable assurance or limited assurance on the subject matter.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Inherent Limitations: Examinees exhibit lack of understanding of the question and failed to answer the same correctly.

Question 9

CA. Raj is the auditor of a multiplex cinema house. He has observed during the course of the audit, that the existing venue has undergone renovation. The auditorium was split into smaller ones and additional auditoriums were constructed. CA. Raj, who finalised the audit plan and audit programme wanted to reconsider the same during the course of the audit. Discuss a few circumstances where the audit programme would have to be suitably altered by the auditor. (PYP 4 Marks Nov 22)

Answer 9

In the given case of multiplex cinema house, CA Raj observed that existing venue undergone renovation, being split into smaller ones and additional auditoriums were constructed. Since CA Raj developed the audit program keeping in view a multiplex cinema house but during the audit, circumstances have changed significantly and hence CA Raj should suitably alter the audit program.

Given below are a few circumstances where in the audit programme would have to be suitably altered:

(1) If the audit procedures were designed for a certain volume of turnover and sub- sequently the volume have substantially increased. Also, when there have been significant changes in the accounting organisation, procedures and personnel sub- sequent to the audit procedures.

(2) Where during the course of an audit, it has been discovered that internal control procedures were not as effective as assumed at the time the audit programme was framed.

(3) Where there has been an extraordinary increase in the amount of book debts or that in the value of stocks as compared to that in the previous year.

(4) When a suspicion has aroused during the course of audit or information has been received that assets of the company have been misappropriated.

It may be noted that the audit plan and related programme should be reconsidered as the audit progresses. Such re-consideration is based on the auditor's review of internal control, his preliminary evaluation thereof and the result of his compliance and substantive procedures.

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MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

BVM & Associates is an audit firm that employs large number of audit assistants. CA Mahesh, a partner pays extreme attention to briefing the audit assistants every day while the audit is continuing. All audit assistants are required to document their notes in the daily briefing and accordingly conduct the audit.

CA Mahesh has made it very clear that any assistant who does not document the notes taken and the steps taken accordingly will be reprimanded as it will mean that the assistants are not creating their audit programmes on the job. The practice deployed by CA Mahesh can be termed as?

(a) Unacceptable as CA Mahesh being the auditor should be providing the audit programme and he cannot expect the team to take daily notes instead of performing the audit.

(b) Appropriate and in line with SA 230 as the audit programme must be prepared on the basis of documentation of auditor's briefing notes.

(c) Acceptable but incomplete as CA Mahesh has not given any audit programme to the audit assistants to follow.

(d) Inappropriate as CA Mahesh should not only provide the audit programme but also make sure that audit programme is formally approved by all partners of the firm. (MTP 2 Marks, Mar 19)

Ans: (c)

Question 2

CA Sameer, after developing the audit strategy for Menka Ltd., develops an audit plan but finds a need to revise the materiality levels set earlier and therefore a deviation from the already set audit strategy is felt necessary. In this case, he should

(a) Continue with the Audit Plan without considering the Audit Strategy

(b) Drop the audit and withdraw from the engagement

(c) First Modify the audit strategy and thereafter prepare the audit plan according to the modified strategy.

(d) Devise a new audit plan and then, change the strategy as per the Revised Plan. (MTP 1 Marks, Oct 19)

Ans: (c)

SA 600 – Using the Work of Another Auditor

Question 1

Seeta Ltd is the Subsidiary Company of Geeta Ltd. Ram & Associates has been appointed as auditor of Geeta Ltd. for the financial year 2019-20 and Hanuman & Associates has been appointed as auditor of Seeta Ltd. for the year 2019-20. Explain the role of Ram & Associates and Hanuman & Associates as auditors of the parent company and subsidiary company respectively. (MTP 4 Marks March '23, MTP 4 Marks, Oct 20)

Answer 1

Role of Auditor in case of Parent Company and Subsidiary Company: As per SA 600 "Using the Work of Another Auditor", there should be sufficient liaison between the principal auditor (hereinafter referred as auditor of Parent Company and the other auditor (hereinafter referred as auditor of Subsidiary Company).

Role of Principal Auditor (Ram & Associates- Auditor of Parent Company):

(i) It is necessary to issue written communication(s) as a principal auditor to the other auditor.

(ii) The principal auditor should advise the other auditor of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

(iii) When considered necessary by him, the principal auditor may require the other auditor to answer a detailed questionnaire regarding matters on which the principal auditor requires information for discharging his duties.

Role of Other Auditor (Hanuman & Associates- Auditor of Subsidiary Company):

(i) The other auditor, knowing the context in which his work is to be used by the principal auditor, should co-ordinate with the principal auditor. For example, by bringing to the principal auditor's immediate attention to any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc.

(ii) He should ensure compliance with the relevant statutory requirements.

(iii) The other auditor should respond to the questionnaire sent by Principal Auditor on a timely basis.

Question 2

PQ Limited, a listed entity, headquartered in Mumbai and is having 15 branches all over India. The Company is in the business of buying paddy grown by farmers directly and processing to produce final products for selling in domestic as well as international markets. PQ Limited appointed four firms of Chartered Accountants for audit of its head office and branches. Your firm is one of those firms. It was agreed that your firm will act as Principal auditor. 'What factors will be considered by you while accepting the position of Principal auditor ? (PYP 5 Marks July 21)

AUDIT PLANNING, STRATEGY & EXECUTION

Answer 2

Factors to be considered while accepting the position of Principal auditor -

SA 600 – Using the work of Another Auditor -

While accepting the position of Principal Auditor, the auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor.

For this purpose, the auditor would consider:

(a) the materiality of the portion of the financial information which the principal auditor audits;

(b) the principal auditor's degree of knowledge regarding the business of the components;

(c) the risk of material misstatements in the financial information of the components audited by the other auditor; and

(d) the performance of additional procedures as set out in this SA regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Even though examinees correctly referred to SA 600 but majority of them misunderstood the question and wrongly discussed on the areas for relying on the work of other auditor instead of explaining the factors to be considered while accepting the position of Principal Auditor.

Question 3

CA H was appointed as a Statutory Auditor of MNL Limited, a listed company, which has three subsidiaries namely M Ltd., N Ltd., L Ltd. and also 15 branches across India. Auditors are duly appointed for the subsidiaries and branches as well. With regard to the determination of materiality during the audit of consolidated financial statements, what should be the considerations of CA H?

How he should deal in his report if there are observations (for instance modification and/or emphasis of matter in accordance with SA 705/706) made by component auditors? (PYP 5 Marks May '22)

Answer 3

CA. H should consider the requirement of SA 600, "Using the Work of Another Auditor", if he decides to use the work of another auditor in relation to the audit of consolidated financial statements and he should comply with the requirements of SA 600.

In carrying out the audit of the standalone financial statements, the computation of materiality for the purpose of issuing an opinion on the standalone fi nancial statements of each component would be done component-wise on a standalone basis.

However, with regard to determination of materiality during the audit of consolidated financial statements (CFS), the auditor should consider the following:

(i) The auditor is required to compute the materiality for the group as a whole. This materiality should be used to assess the appropriateness of the consolidation adjustments (i.e. permanent consolidation adjustments and current period consolidation adjustments) that are made by the management in the preparation of CFS.

(ii) The parent auditor can also use the materiality computed on the group level to determine whether the component's financial statements are material to the group to determine whether they should scope in additional components, and consider using the work of other auditors as applicable.

(iii) The principal auditor also computes materiality for each component and communicates to the component auditor, if he believes is required for true and fair view on CFS.

However, while considering the observations (for instance modification and /or emphasis of matter in accordance with SA 705/706) of the component auditor in his report on the standalone financial statements, the principles of SA 600 needs to be considered i.e. the parent auditor should comply with the requirements of SA 600, "Using the Work of Another Auditor".

Question 4

B is the Principal Auditor of ABC Co. Ltd., with 8 branches audited by 8 Branch Auditors. B wanted to ensure that the works of Branch Auditors were adequate for the purpose of his audit. Hence he insisted on Branch Auditors to get familiar with a check list he prepared for branches and, besides, required them to share the working papers compiled by them for his review and return. Is Principal Auditor within his right in asking for such sharing of working papers? (PYP 5 Marks, May '18)

Answer 4

Using the Work of Another Auditor: When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India has dealt with these issues in SA 600, "Using the Work of another Auditor". It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component.

Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

(1) advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit; and

(2) advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor.

The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor. Further, SA 230 issued by ICAI on Audit Documentation, and "Standard on Quality Control (SQC) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements", issued by the Institute, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel."

In the light of aforesaid, principal auditor was not within his right for asking for such sharing of working papers. It depends upon the discretion of auditor.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

CA Ajay was appointed as the statutory auditor of TUV Ltd. at Delhi. TUV Ltd has a branch office at Pune. A branch auditor, CA Suresh, was appointed to conduct the audit of the Pune branch of TUV Ltd. CA Ajay provided CA Suresh with a questionnaire regarding the details of the branch office of certain specific accounts and balances to be filled in by CA Suresh in which indication of material misstatements are involved. However, CA Suresh denied to fill such questionnaire as he explained that CA Ajay, as the principal auditor has no such right. Which is the relevant SA and which of the following course of action is correct in this regard?

(a) SA 600 is the relevant SA; CA Ajay is correct in asking for information from CA Suresh through a questionnaire.

(b) SA 610 is the relevant SA; CA Suresh is correct in denying filling such questionnaire as a principal auditor can refer to branch auditor's report or other branch records but cannot ask the branch auditor to provide any specific information by filling a questionnaire.

(c) SA 600 is the relevant SA; CA Suresh is correct in denying filling such questionnaire as CA Ajay instead of asking CA Suresh to send the filled up questionnaire, should himself verify the specific branch details as indication of material misstatement is there.

(d) SA 610 is the relevant SA; CA Ajay should seek management's permission before asking the branch auditor for any information (MTP 1 Marks, Oct 20)

Ans: (c)

AUDIT PLANNING, STRATEGY & EXECUTION

SA 610 – Using the Work of Internal Auditors

Question 1

(Concept included in Chapter 16 Internal Audit)

OPQ Ltd is in the software consultancy business. The company had large balance of accounts receivables in the past years which have been assessed as area of high risk. For the year ended 31 March 2019, in respect of the valuation of accounts receivable, the statutory auditor was assigned with the checking of accuracy of the aging of the accounts receivables and provision based on ageing, to the internal auditor providing direct assistance to him. Comment. (MTP 4 Marks, Oct 19 & April 19, RTP May'19)

Answer 1

As per SA 610 Using the Work of Internal Auditor, the external auditor (Statutory Auditor) shall not use internal auditors to provide direct assistance to perform procedures that:

a. Involve making significant judgments in the audit;

b. Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited;

c. Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or

d. Relate to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.

In the given case where the valuation of accounts receivable is assessed as an area of higher risk, the statutory auditor could assign the checking of the accuracy of the aging to an internal auditor providing direct assistance. However, because the evaluation of the adequacy of the provision based on the aging would involve more than limited judgment, it would not be appropriate to assign that latter procedure to an internal auditor providing direct assistance.

Question 2

Moon Ltd. of which you are the Statutory Auditor, have an internal audit being conducted by an outside agency. State the factors that weigh considerations in opting to make use of direct assistance of the internal auditors for the purpose of statutory audit. (PYP 4 Marks, May '18)

Answer 2

Determining the Nature and Extent of Work that Can Be Assigned to Internal Auditors Providing Direct Assistance: SA 610 'Using the work of Internal Auditor' Deals about the concept of direct assistance of internal auditor. In determining the nature and extent of work that may be assigned to internal auditors and the nature, timing and extent of direction, supervision and review that is appropriate in the circumstances, the external auditor shall consider:

(1) The amount of judgment involved in:

(i) Planning and performing relevant audit procedures; and

(ii) Evaluating the audit evidence gathered;

(2) The assessed risk of material misstatement; and

(3) The external auditor's evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors who will be providing such assistance.

If using internal auditors to provide direct assistance is not prohibited by law or regulation, and the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance.

The external auditor's evaluation of the existence and significance of threats to the internal auditors' objectivity shall include inquiry of the internal auditors regarding interests and relationships that may create a threat to their objectivity.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Considerations in making use of direct assistance of Internal Auditors: Examinees answered referring SA 610 but examinees failed to emphasize that external auditor shall evaluate the existence and significance of threats of objectivity of the internal auditors.

Question 3

(Concept Included in Chapter 16 Internal Audit)

ABC Ltd. is engaged in the business of trading and manufacturing of readymade garments. The company has large balances of accounts receivables as on March 31, 2022, which has been assessed as the area of high risk in the audit planning stage. For the year ended March 31, 2022, in respect of the valuation of accounts receivables, the Statutory Auditor has assigned the checking of the accuracy of the ageing of the accounts receivables and provision made towards doubtful receivables, to the internal auditor. Please advise the statutory auditor, the areas in which direct assistance from internal auditor cannot be taken. Also, comment in this scenario, whether statutory auditor can take internal auditor's assistance. (PYP 5 Marks Nov 22)

Answer 3

Direct Assistance from Internal Auditor: As per SA 610 "Using the Work of Internal Auditor", the external auditor shall not use internal auditors to provide direct assistance to perform procedures that:

(i) Involve making significant judgments in the audit;

(ii) Relate to higher assessed risks of material misstatement where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathered is more than limited;

(iii) Relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance by the internal audit function; or

(iv) Relate to decisions the external auditor makes in accordance with this SA regarding the internal audit function and the use of its work or direct assistance.

Therefore, the amount of judgment involved, and the risk of material misstatement are also relevant in determining the work that may be assigned to internal auditors providing direct assistance.

In the given situation of ABC Ltd., in circumstances where the valuation of accounts receivable is assessed as an area of higher risk, the external auditor could assign the checking of the accuracy of the aging to an internal auditor providing direct assistance.

However, because the evaluation of the adequacy of the provision based on the aging would involve more than limited judgment, it would not be appropriate to assign that latter procedure to an internal auditor providing direct assistance.

Question 4

CA. Amboj, a practicing chartered accountant has been appointed as an internal auditor of Textile Ltd. He conducted the physical verification of the inventory at the year-end and handed over the report of such verification to CA. Kishor, the statutory auditor of the Company, for his view and reporting. Can CA. Kishor rely on such report? (MTP 4 Marks, Oct 18)

Answer 4

Using the Work of Internal Auditor: As per SA 610 "Using the Work of Internal Auditors", while determining whether the work of the internal auditors can be used for the purpose of the audit, the external auditor shall evaluate-

(a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors;

(b) The level of competence of the internal audit function; and

(c) Whether the internal audit function applies a systematic and disciplined approach, including quality control.

Further, the external auditor shall not use the work of the internal audit function if the external auditor determines that:

(a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;

(b) The function lacks sufficient competence; or

(c) The function does not apply a systematic and disciplined approach, including quality control.

In the instant case, CA. Kishor should ascertain the internal auditor's scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible he should also test check few items and he can also observe the procedures performed by the internal auditors.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise. The final responsibility to express opinion on the financial statement remains with the statutory auditor.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

M/s Viaan Viraj & associates are the statutory auditors of ABC Ltd. for the FY 2019 -20. The company has a strong internal control team. During the course of audit, CA Viaan, the engagement partner found that the company has factories all across the country. In order to verify the wages expenses at all the factories, CA Viaan decided to use the Internal Audit Team of the company. He accordingly discussed the same with Mr. Gaurank, the Chief Internal Auditor of ABC Ltd. to provide him a report on the wages expenses across all factories. Which of the following requirements as per SA 610 are required to be fulfilled by CA Viaan prior to using the direct assistance of the Internal Audit Team of the company?

(a) CA Viaan should obtain written agreement from the management of ABC Ltd. that the internal audit team will be allowed to follow the statutory auditors' instructions.

(b) CA Viaan should obtain written agreement from Mr. Gaurank that his team will keep the matters confidential.

(c) Both a & b

(d) CA Viaan can use the direct assistance of the Internal Audit Team after discussing the same with the management. No prior written agreement is required (MTP 1 Marks, Oct 20)

Ans: (a)

AUDIT PLANNING, STRATEGY & EXECUTION

SA 620 – Using the Work of an Auditor's Expert

Question 1

KRP Ltd., at its annual general meeting, appointed Mr. X, Mr. Y and Mr. Z as joint auditors to conduct auditing for the financial year 2015-16. For the valuation of gratuity scheme of the company, Mr. X, Mr. Y and Mr. Z wanted to refer their own known Actuaries. Due to difference of opinion, all the joint auditors consulted their respective Actuaries. Subsequently, major difference was found in the actuary reports. However, Mr. X agreed to Mr. Y's actuary report, though, Mr. Z did not. Mr. X contends that Mr. Y's actuary report shall be considered in audit report due to majority of votes. Now, Mr. Z is in dilemma.

You are required to decide the responsibility of auditors Mr. X and Mr. Z, in case, report made by Mr. Y's actuary, later on, found faulty. (MTP 5 Marks, March 18 & April '23, RTP Nov'18, Old & New SM)

Answer 1

Using the work of an Auditor's Expert: As per SA 620 "Using the Work of an Auditor's Expert", the expertise of an expert may be required in the actuarial calculation of liabilities associated with insurance contracts or employee benefit plans etc., however, the auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert.

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence as per SA 500.

Further, in view of SA 620, if the expert's work involves use of significant assumptions and methods, then the relevance and reasonableness of those assumptions and methods must be ensured by the auditor and if the expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data in the circumstances must be verified by the auditor.

In the instant case, Mr. A, Mr. B and Miss C, jointly appointed as an auditor of PRS Ltd., referred their own known Actuaries for valuation of gratuity scheme. Actuaries are an auditor's expert as per SA 620.

Mr. B's referred actuary has provided the gratuity valuation report, which later on found faulty. Further, Miss C being not agreed with Mr. B's report, submitted separate audit report specifically for such gratuity valuation.

In such situation, it was duty of Mr. A, Mr. B and Miss C, before using the gratuity valuation report of Actuary, to ensure the relevance and reasonableness of assumptions and methods used. They were also required to examine the relevance, completeness and accuracy of source data used for such report before expressing their opinion.

Mr. A and Mr. B will be held responsible for grossly negligence and using such faulty report without examining the adequacy of expert actuary's work whereas Miss C will not be held liable for the same due to separate opinion expressed by her.

Question 2

X Ltd had a net worth of INR 1300 crores because of which Ind AS became applicable to them. The company had various derivative contracts – options, forward contracts, interest rate swaps etc. which were required to be fair valued for which company got the fair valuation done through an external third party. The statutory auditors of the company involved an auditor's expert to audit valuation of derivatives. Auditor and auditor's expert were new to each other i.e. they were working for the first time together but developed a good bonding during the course of the audit . The auditor did not enter into any formal agreement with the auditor's expert. Please advise. (5 Marks Oct 18, MTP 5 Marks, Mar 19 & March '21, RTP May'19, RTP May'23, Old & New SM)

Answer 2

As per SA 620, Using the work of an Auditor's Expert, the nature, scope and objectives of the auditor's expert's work may vary considerably with the circumstances, as may the respective roles and responsibilities of the auditor and the auditor's expert, and the nature, timing and extent of communication between the auditor and the auditor's expert. It is therefore required that these matters are agreed between the auditor and the auditor's expert.

- In certain situations, the need for a detailed agreement in writing is required like - The auditor's expert will have access to sensitive or confidential entity information.
- The matter to which the auditor's expert's work relates is highly complex.
- The auditor has not previously used work performed by that expert.
- The greater the extent of the auditor's expert's work, and its significance in the context of the audit.

In the given case, considering the complexity involved in the valuation and volume of derivatives and also due to the fact that the auditor and auditor's expert were new to each other, auditor should have signed a formal agreement/ engagement letter with the auditor's expert in respect of the work assigned to him.

Question 3

Mr. Shreyansh, while performing the audit of Red Rock & Silver Sand Limited which was involved in phosphorus mining, decided to appoint an auditor's expert for the valuation of environmental liabilities and site clean-up costs. Red Rock & Silver Sand Limited re- appointed Mr. Sheetal as an independent expert for this engagement. For the last five years, management has been reappointing Mr. Sheetal. Mr. Sheetal calculated the environmental liabilities pertaining to completed mining sites and the sites which will be discarded in the near future and a provision for clean-up costs. This provision was accepted by management. Mr. Shreyansh, after performing the inquiries with management, was of the opinion that the objectivity of the independent expert cannot be questioned just because he was appointed by management as

their expert. Hence, there is no need to raise a question on the objectivity of Mr. Sheetal or on his work performed for the company. However, the audit partner was of the opinion that the audit team needs to evaluate the objectivity of an expert engaged by the entity, irrespective of the fact that he was appointed as an independent expert. Kindly guide the audit partner and Mr. Shreyansh with respect to requirements pertaining to evaluating the objectivity of the management expert. (RTP Nov '23)

Answer 3

As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, have regard to the significance of that expert's work for the auditor's purposes evaluate the competence, capabilities and objectivity of that expert.

A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats and may be created either by external structures (for example, the management's expert's profession, legislation or regulation), or by the management's expert's work environment (for example, quality control policies and procedures). Although safeguards cannot eliminate all threats to a management expert's objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- Financial interests.
- Business and personal relationships.
- Provision of other services.

In the current case, Red Rock & Silver Sand Limited re-appointed Mr. Sheetal for this engagement as an independent expert. The audit team was of the view that the objectivity of the independent expert cannot be questioned just because he was appointed by management as their expert. However, the audit partner had a contrary view.

Hence, the audit team should evaluate the objectivity of an expert engaged by the entity as the threat to objectivity, created by being an employee of the entity, will always be present. An expert appointed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity. As a result, audit partner is correct in his view.

Question 4

HAM Ltd. is engaged in the business of manufacturing of medicines. The manufacturing process requires raw materials such as hydrochloric acid, caustic soda and other chemicals for the manufacturing of various drugs. The Company has maintained large stock of raw materials of all types of chemicals being used. The nature of raw material is such that its physical verification requires the involvement of an expert. Management hired their expert for the stock taking and auditors also involved their expert for the same purpose.

The auditor observed that the work of the auditor's expert was not adequate for the auditor's purposes and he could not resolve the matter through additional audit procedures which included further work performed by both the auditor's expert and the auditor.

Based on above, the auditor knows that it would be right to express a modified opinion in the auditor's report because he has not obtained sufficient appropriate audit evidence. But he was reluctant in doing so and issued a clean audit report and included the name of the expert in his report to reduce his responsibility for the audit opinion expressed.

Comment with respect to relevant Standard of Auditing relating to the action of the auditor of issuing clean audit report. (PYP 5 Marks May '23, MTP 5 Marks, April 19)

Answer 4

As per SA 620, "Using the work of an Auditor's Expert", if the auditor concludes that the work of the auditor's expert is not adequate for the auditor's purposes and the auditor cannot resolve the matter through the additional audit procedures, which may involve further work being performed by both the expert and the auditor, or include employing or engaging another expert, it may be necessary to express a modified opinion in the auditor's report in accordance with SA 705 because the auditor has not obtained sufficient appropriate audit evidence.

In addition, the auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the audit opinion.

If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion. In such circumstances, the auditor may need the permission of the auditor's expert before making such a reference.

In the given case, the auditor cannot reduce his responsibility by referring the name of auditor's expert and thereby issuing a clean report. The auditor should have issued a modified report and could have given reference to the work of an auditor's expert in that report if such reference was relevant to understanding of a modification to the auditor's opinion but even in that case the auditor should have indicated in his report that such reference of an auditor's expert does not reduce his responsibility for that opinion.

AUDIT PLANNING, STRATEGY & EXECUTION

Question 5

State what may be the evaluative or review procedures that the Statutory Auditor may do before concluding as to relevance and reasonableness of Auditor's Expert work for using it for his audit purposes. (PYP 5 Marks, Nov '18)

Answer 5

Evaluating the Adequacy of the Auditor's Expert's Work: As per SA 620 Using the work of an Auditor's Expert, the auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence, etc.

Specific procedure to evaluate the adequacy of the auditor's expert's work are –

• Enquiries of the auditor's expert.

• Reviewing the auditor's expert's working papers and reports

• Corroborative procedure such as-

(a) Observing the auditor's expert's work

(b) Examining the published data, such as statistical reports from reputed source

(c) Confirming the relevant matters with third parties

(d) Performing detailed analytical procedure to see whether principles of materiality aspects considered

(e) Re performing calculations

• Discussions with another expert with relevant expertise when, for example, the findings or the conclusion of the auditor's expert are not consistent with other audit evidence.

Discussing the expert's report with the management

Question 6

CA Dabu has been appointed as an auditor of M/s MAP Technocraft Ltd. to conduct statutory audit. While conducting audit, he came across some difficulties which the management could not explain to him properly and, therefore, he decided to take services of Mr. Jay, an engineering consultant. Mr. Jay performed his work and submitted details to CA Dabu. State the specific procedure which CA Dabu should follow to evaluate the adequacy of work performed by Mr. Jay. (PYP 5 Marks, May '19)

Answer 6

Evaluating the Adequacy of the Auditor's Expert's Work: As per SA 620 on "Using the Work of an Auditor's Expert", specific procedures to evaluate the adequacy of the auditor's expert's work for the auditor's purposes may include:

(i) Inquiries of the auditor's expert.

(ii) Reviewing the auditor's expert's working papers and reports.

(iii) Corroborative procedures, such as:

• Observing the auditor's expert's work;

• Examining published data, such as statistical reports from reputable, authoritative sources;

• Confirming relevant matters with third parties;

• Performing detailed analytical procedures; and

• Re-performing calculations.

(iv) Discussion with another expert with relevant expertise when, for example, the findings or conclusions of the auditor's expert are not consistent with other audit evidence.

(v) Discussing the auditor's expert's report with management.

Therefore, as per SA 620 on "Using the Work of an Auditor's Expert", the auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

(i) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence;

(ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and

(iii) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, the auditor shall:

(i) Agree with that expert on the nature and extent of further work to be performed by that expert;

or

(ii) Perform further audit procedures appropriate to the circumstances.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

An auditor's expert may be either an auditor's internal or an external expert. Which of the following cannot be an auditor's internal expert?

(a) Partner of the Auditor's Firm

(b) Temporary Staff of the Auditor's Firm

(c) Permanent Staff of Auditor's Network Firm

(d) A Prospective CA, soon to join the Auditor's Firm as a Partner. (MTP 1 Marks, Oct 19)

Ans: (d)

Question 2

Which among the following is not a factor for determining the necessity to use an auditor's expert to assist in obtaining sufficient appropriate audit evidence?

(a) The use of a management's expert by the management in preparing the financial statements

(b) The presence of an internal audit function and verification of the subject matter by them.

(c) The nature and significance of matter including its complexity.

(d) The risk of material misstatement in the matter. (MTP 1 Marks, May 20)

Ans: (b)

SA 540 – Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

Question 1

(Includes concepts of SA 580- Written Representation)

Statutory auditor of O Ltd requested the management for a written representation in respect of obsolescence of inventory and warranty obligations recognized by the company in its financial statements. The management denied the representation on the ground that during the course of audit, all the required procedures were performed by the auditor and after obtaining sufficient appropriate audit evidence, auditor has issued a clean report. Please comment. (MTP 4 Marks, Mar 19)

Answer 1

As per SA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures, the auditor shall obtain written representations from the management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognized or disclosed in the financial statements may include representations:

- About the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.
- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- That disclosure related to accounting estimates are complete and appropriate under the applicable financial reporting framework.
- That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.
- For those accounting estimates not recognised or disclosed in the financial statements, written representations may also include representations about:
- The appropriateness of the basis used by management for determining that the recognition or disclosure criteria of the applicable financial reporting framework have not been met.
- The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework, for those accounting estimates not measured or disclosed at fair value.

Thus, management's contention on the ground that during the course of audit, all the required procedures were performed by the auditor and after obtaining sufficient appropriate audit evidence, auditor has issued a clean report, for not providing written representation is not correct. The management should provide written representations to the auditor.

AUDIT PLANNING, STRATEGY & EXECUTION

Further as per SA 580 Written Representation, if management does not provide one or more of the requested written representations, the auditor shall

(a) Discuss the matter with management;

(b) Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

(c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with SA 705.

Question 2

Adeshvar Pvt Ltd is engaged in the business of real estate. The auditor of the company requested the information from the management to review the outcome of accounting estimates (like estimated costs considered for percentage completion etc) included in the prior period financial statements and their subsequent re-estimation for the purpose of the current period.

The management has refused the information to the auditor saying that the review of prior period information should not be done by the auditor. Please advise. (MTP 4 Marks Nov 21, MTP 5 Marks Mar'19 & Mar'21, PYP 5 Marks May '23, RTP May'19, RTP May'23, Old & New SM)

Answer 2

As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.

The outcome of an accounting estimate will often differ from the accounting estimate recognized in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time.

In the given case, the management is not correct in refusing the relevant information to the auditor.

Question 3

(Includes concepts of SA 580- Written Representation)

Mr. L while conducting the audit of ABC Ltd., observed that a substantial amount is recognized in respect of obsolescence of inventory and warranty obligation in the financial statements. Mr. L wants to obtain written representation from the management to determine whether the assumptions and estimates used are reasonable. Guide Mr. L with reference to the relevant Standard on Auditing. (PYP 5 Marks, NOV-19, Old SM)

Answer 3

Written Representations: **As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"**, the auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

- **SA580, "Written Representations"** discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognized or disclosed in the financial statements may include representations:

(i) About the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.

(ii) That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.

(iii) That disclosure related to accounting estimates are complete and appropriate under the applicable financial reporting framework.

That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Written Representations: Majority of the Examinees did not mention SA 540 but wrongly quoted SA 501 - Audit evidence and explained SA 580 unnecessarily. Those who mentioned SA 540 could not give the correct points asked for.

Question 4

CA Harry is appointed as a Statutory Auditor of Delist Limited for the financial year 2021-22. M/s Delist Limited is a listed entity at National Stock Exchange and the financial statements are to be drawn up in compliance with Ind AS. M/s Delist Limited made certain fair value accounting estimates on complex financial instruments which are not traded in an active and open market. CA Harry is concerned with identification and assessment of the risks of material misstatement for accounting estimates. Guide him with regard to the estimation making process adopted by management with reference to the relevant Standard on Auditing. (PYP 4 Marks May '22)

Answer 4

As per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", CA. Harry shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates:

The estimation making process adopted by the management including-

(1) The method, including where applicable the model, used in making the accounting estimates.

(2) Relevant controls.

(3) Whether management has used an expert?

(4) The assumption underlying the accounting estimates.

(5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and

(6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.

Question 5

M/s ABC Limited is engaged in the business of construction of infrastructure and housing projects. While preparing the financial statements for the year ended 31.03.2023, management has made various accounting estimates and confirmed to the auditor that all necessary accounting estimates have been recognised, measured and disclosed in the financial statements are in accordance with the applicable financial reporting framework. The auditor during the course of audit observed some changed circumstances giving rise to the need for an accounting estimate. Inquiries of same were sought from the management. Can you list down some circumstances, change of which will result in inquiries from the management? (PYP 4 Marks May '23)

Answer 5

(a) **As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures"**, inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. SA 315 deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment processes.

Question 6

While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements? (MTP 4 Marks Apr'21, MTP 5 Marks Mar'18, Old & New SM)

Answer 6

As per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates:

(i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.

(ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

(iii) The estimation making process adopted by the management including-

(1) The method, including where applicable the model, used in making the accounting estimates.

(2) Relevant controls.

(3) Whether management has used an expert?

(4) The assumption underlying the accounting estimates.

(5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and

(6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.

Question 7

M/s. HK & Co. was appointed as an auditor of GSB Limited, a company operating its business in telecom sector. As per spectrum allocation agreement with Government, GSB Limited is required to pay certain percentage of its annual revenue as license fee. GSB Limited paid the license fee on its core business for last two years. At the end of third year, the communication was received from Government that it needs to pay agreed percentage on its total revenues and not only on core business revenues. Matter was disputed and went to court of law. On prudence basis, GSB Limited made a provision on estimated business in its books of accounts of agreed percentage on non-core business receipts also. The amount of provision was of such huge amount that the GSB Limited's profit and loss account for that quarter reflected loss due to that provision. How you as an auditor can evaluate this accounting estimate which involves significant risk and what if Management has not addressed the effects of estimation uncertainty on provision made? (PYP 4 Marks, Jan '21, MTP 4 Marks March 22 & April '23)

Answer 7

In the given case, HK & Co. was appointed as an auditor of GSB Ltd., operating in Telecom sector. GSB Ltd paid the license fee on its core business revenue whereas Govt required it to pay on non-core business receipts as well. Consequently, the amount of provision was of such a huge amount that GSB Ltd.'s profit and loss account reflected a loss due to that provision. As an auditor evaluation would be done as under: For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of SA 330, the auditor shall evaluate the following:

(i) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

(ii) Whether the significant assumptions used by management are reasonable.

(iii) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

(iv) If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

Match the following terms to their definitions:

i.	Accounting Estimates	1.	The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.
ii.	Estimation uncertainty	2.	A lack of neutrality by management in the preparation and presentation of information.
iii.	Management bias	3.	An approximation of a monetary amount in the absence of a precise means of measurement.
iv.	Measurement objective for fair value Accounting Estimates	4.	To forecast the outcome of one or more transactions, events or conditions.

(a) (i)-3, (ii)-1, (iii) - 2, (iv)- 4.

(b) (i)-2, (ii)-1, (iii) - 1, (iv)- 4.

(c) (i)-1, (ii)-3, (iii) - 2, (iv)- 4.

(d) (i)-4, (ii)-1, (iii) - 2, (iv)- 1. (RTP May 22)

Ans: (a)

AUDIT PLANNING, STRATEGY & EXECUTION

SA 520 – Analytical procedures

Question 1

In audit of DEF Limited, the Auditor had made use of certain analytical procedures with regard to certain key data in the Statement of Profit and Loss. The results obtained showed inconsistencies with other relevant information. State the course of action that the Auditor should take to ensure that the risk of material misstatement would be contained to a low level fixed as per materiality level. (PYP 4 Marks, Nov '18)

Answer 1

Investigating Results of Analytical Procedures: As per SA 520, "Analytical Procedures", if analytical procedures performed in accordance with this SA identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences by:

(i) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and

(ii) Performing other audit procedures as necessary in the circumstances.

Audit evidence relevant to management's responses may be obtained by evaluating those responses taking into account the auditor's understanding of the entity and its environment, and with other audit evidence obtained during the course of the audit.

The need to perform other audit procedures may arise when, for example, management is unable to provide an explanation, or the explanation, together with the audit evidence obtained relevant to management's response, is not considered adequate.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Investigating results of Analytical Procedure: Examinees failed to exhibit knowledge of SA 520 Analytical Procedures and gave answer in general terms.

AUDIT PLANNING, STRATEGY & EXECUTION

Question 1

While auditing Z Ltd., you observe certain material financial statement assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements?

Answer 1

As per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatements for accounting estimates:

(i) The requirements of the applicable financial reporting framework relevant to the accounting estimates, including related disclosures.

(ii) How Management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed, in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

(iii) The estimation making process adopted by the management including-

(1) The method, including where applicable the model, used in making the accounting estimates.

(2) Relevant controls.

(3) Whether management has used an expert?

(4) The assumption underlying the accounting estimates.

(5) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and

(6) Whether and, if so, how the management has assessed the effect of estimation uncertainty.

Question 2

KRP Ltd., at its annual general meeting, appointed Mr. X, Mr. Y and Mr. Z as joint auditors to conduct audit for the financial year 2020-21. For the valuation of gratuity scheme of the company, Mr. X, Mr. Y and Mr. Z wanted to refer their own known Actuaries. Due to difference of opinion, all the joint auditors consulted their respective Actuaries. Subsequently, major difference was found in the actuarial reports.

However, Mr. X agreed to Mr. Y's actuary report, though, Mr. Z did not. Mr. X contends that Mr. Y's actuary report shall be considered in audit report due to majority of votes. Now, Mr. Z is in dilemma. Explain the responsibility of auditors, in case, report made by Mr. Y's actuary, later on, was found faulty.

Answer 2

Using the work of an Auditor's Expert: As per SA 620 "Using the Work of an Auditor's Expert", the expertise of an expert may be required in the actuarial calculation of liabilities associated with insurance contracts or employee benefit plans etc., however, the auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of the work of an auditor's expert.

The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence as per SA 500.

Further, in view of SA 620, if the expert's work involves use of significant assumptions and methods, then the relevance and reasonableness of those assumptions and methods must be ensured by the auditor and if the expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data in the circumstances must be verified by the auditor.

In the instant case, Mr. X, Mr. Y and Mr. Z, jointly appointed as auditors of KRP Ltd., referred their own known Actuaries for valuation of gratuity scheme. Actuaries are an auditor's expert as per SA 620. Mr. Y's referred actuary has provided the gratuity valuation report, which later on was found faulty. Further, Mr. Z is not in agreement with this report, therefore, he submitted a separate audit report specifically for such gratuity valuation.

In such situation, it was duty of Mr. X, Mr. Y and Mr. Z, before using the gratuity valuation report of Actuary, to ensure the relevance and reasonableness of assumptions and methods used. They were also required to examine the relevance, completeness and accuracy of source data used for such report before expressing their opinion.

Mr. X and Mr. Y will be held responsible for gross negligence and using such faulty report without examining the adequacy of expert actuary's work whereas Mr. Z will not be held liable for the same due to separate opinion expressed by him.

Question 3

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?

Answer 3

Development of an overall 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:

(i) Terms of his engagement and any statutory responsibilities

(ii) Nature and timing of reports or other communications.

(iii) Applicable Legal or Statutory requirements.

(iv) Accounting policies adopted by the clients and changes, if any, in those policies.

(v) The effects of new accounting and auditing pronouncement on the audit.

(vi) Identification of significant audit areas.

(vii) Setting of materiality levels for the audit purpose.

(viii) 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.

(ix) Degree of reliance to be placed on the accounting system and internal control.

(x) Possible rotation of emphasis on specific audit areas.

(xi) Nature and extent of audit evidence to be obtained.

(xii) Work of the internal auditors and the extent of reliance on their work, if any in the audit.

(xiii) Involvement of other auditors in the audit of subsidiaries or branches of the client and involvement of experts.

(xiv) Allocation of works to be undertaken between joint auditors and the procedures for its control and review.

(xv) Establishing and coordinating staffing requirements.

Question 4

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?

Answer 4

Formulation of Audit Strategy: While formulating the audit strategy for a company, following factors may be considered -

General Factors:

Overall audit strategy would involve-

(i) Determination of Characteristics of Audit: Identify the characteristics of the engagement that defines its scope.

(ii) Reporting Objectives: Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required.

(iii) Team's Efforts: Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.

(iv) 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.

(v) Nature, timing and Extent of Resources: Ascertain the nature, timing and extent of resources necessary to perform the engagement.

Specific Factors for Online Shopping:

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:

(i) The classes of transactions in the entity's operations that are significant to the financial statements;

(ii) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

(iii) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;

(iv) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;

(v) Controls surrounding journal entries, including non-standard journal entries used to record nonrecurring, unusual transactions or adjustments.

Question 5

During the audit of FMP Ltd, a listed company, Engagement Partner (EP) completed his reviews and also ensured compliance with independence requirements that apply to the audit engagement. The engagement files were also reviewed by the Engagement Quality Control Reviewer (EQCR) except the independence assessment documentation. Engagement Partner was of the view that matters related to independence assessment are the responsibility of the Engagement Partner and not Engagement Quality Control Reviewer. Engagement Quality Control Reviewer objected to this and refused to sign off the documentation. Please advise as per SA 220.

Answer 5

As per SA 220, Engagement Partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, Engagement Partner shall:

- Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action.

Engagement Partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. As per SA 220, "Quality Control for Audit of Financial Statements", for audits of financial statements of listed entities, Engagement Quality Control Reviewer (EQCR), on performing an engagement quality control review, shall also consider the engagement team's evaluation of the firm's independence in relation to the audit engagement. In the given case, Engagement Partner is not right. The independence assessment documentation should also be given to Engagement Quality Control Reviewer for his review.

Question 6

AKJ Ltd is a small-sized 30 years old company having business of manufacturing of pipes. Company has a plant based out of Dehradun and have their corporate office in Delhi. Recently the company appointed new firm of Chartered Accountants as their statutory auditors.

The statutory auditors want to enter into an engagement letter with the company in respect of their services but the management has contended that since the statutory audit is mandated by law, engagement letter may not be required. Auditors did not agree to this and have shared a format of engagement letter with the management for their reference before getting that signed. In this respect management would like to understand that as per SA 210 (auditing standard referred to by the auditors), if the agreed terms of the engagement shall be recorded in an engagement letter or other suitable form of written agreement, what should be included in terms of agreed audit engagement letter?

Answer 6

As per SA 210 'Agreeing the Terms of Audit Engagements', the auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.

The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

(i) The objective and scope of the audit of the financial statements;

(ii) The responsibilities of the auditor;

(iii) The responsibilities of management;

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(iv) Identification of the applicable financial reporting framework for the preparation of the financial statements; and

(v) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

Question 7

A Pvt Ltd is engaged in the business of real estate. The auditor of the company requested the information from the management to review the outcome of accounting estimates (like estimated costs considered for percentage completion etc.) included in the prior period financial statements and their subsequent re-estimation for the purpose of the current period.

The management has refused the information to the auditor saying that the review of prior period information should not be done by the auditor. Please advise.

Answer 7

As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", the auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re- estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.

The outcome of an accounting estimate will often differ from the accounting estimate recognized in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time.

In the given case, the management is not correct in refusing the relevant information to the auditor.

Question 8

X Ltd had a net worth of INR 1300 crores because of which Ind AS became applicable to them. The company had various derivative contracts – options, forward contracts, interest rate swaps etc. which were required to be fair valued for which company got the fair valuation done through an external third party. The statutory auditors of the company involved an auditor's expert to audit valuation of derivatives. Auditor and auditor's expert were new to each other i.e., they were working for the first time together but developed a good bonding during the course of the audit. The auditor did not enter into any formal agreement with the auditor's expert. Please advise.

Answer 8

As per SA 620, Using the work of an Auditor's Expert, the nature, scope and objectives of the auditor's expert's work may vary considerably with the circumstances, as may the respective roles and responsibilities of the auditor and the auditor's expert, and the nature, timing and extent of communication between the auditor and the auditor's expert. It is therefore required that these matters are agreed between the auditor and the auditor's expert.

In certain situations, the need for a detailed agreement in writing is required like -

- The auditor's expert will have access to sensitive or confidential entity information.
- The matter to which the auditor's expert's work relates is highly complex.
- The auditor has not previously used work performed by that expert.
- The greater the extent of the auditor's expert's work, and its significance in the context of the audit.

In the given case, considering the complexity involved in the valuation and volume of derivatives and also due to the fact that the auditor and auditor's expert were new to each other, auditor should have signed a formal agreement/ engagement letter with the auditor's expert in respect of the work assigned to him.

Question 9

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. Its 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 programmer initially in respect of its revenue and expenditure considering the above mentioned facts along with other relevant points relating to a complex.

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Answer 9

Audit Program me of Movie Theatre Complex:

(i) Peruse the Memorandum of Association and Articles of Association of the entity.

(ii) Ensure the object clause permits the entity to engage in this type of business.

(iii) In the case of income from sale of tickets:

(1) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly and accurately accounted.

(2) Verify the system relating to online booking of various shows and the system o f realization of money.

(3) Check that there is overall system of reconciliation of collections with the number of seats available for different shows in a day.

(iv) Verify the internal control system and its effectiveness relating to the income from café, shops, pubs, game zone etc., located within the multiplex.

(v) Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.

(vi) Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.

(vii) In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement, any payment of advance made to the distributor is also adjusted against the amount due.

(viii) Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.

(ix) Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.

(x) Verify the insurance premium paid and ensure it covers the entire assets.

Question 10

XWL Limited was engaged in dealing in commodity futures trading based in Surat. CA P, based at Delhi, was auditor of the company. The auditor did not even once visit office of the company and failed to understand the nature of business of the company. All the papers and account books were received on emails and audit was concluded.

There were also included in his working papers checklists which had a requirement of test checking of cost of raw material consumed & cost of stores and spares. There was nothing in his working papers showing understanding of nature of business of company. What does it reflect upon planning of audit by CAP?

Answer 10

SA 300 requires the auditor to plan the audit in such a manner that it is performed effectively. It also requires auditor to establish overall audit strategy including identifying the characteristics of the engagement, facilitating him to define its scope and planning of nature, timing and extent of audit procedures required to be performed to achieve the objective of audit.

SA 300 further requires the auditor to document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to such plans.

In the given situation, auditor didn't even once visit the company and failed to understand about business of the company. Therefore, he has flouted requirement of SA 300 to plan the audit in such a manner that it is performed effectively. The auditor has to plan the audit commensurate to the nature and complexity of the business of the entity and identify and assess the risk of material misstatement.

Further, working papers of auditor also do not show his understanding of nature of business which is again a blatant violation of requirement of SA 300 which requires the auditor to document the overall audit strategy, the audit plan and any significant changes made during the audit engagement to such plans.

Inclusion of a checklist in working papers having requirement of test checking of cost of raw material consumed & cost of stores and spares shows that it was a general checklist and specifics of business were never understood and audit was not planned to be conducted in an effective manner in accordance with requirements of SA 300.

Question 11

CA. Pradyuman is planning for audit of a listed company headquartered in NOIDA. While doing this exercise, he has made a list of various procedures intended to be performed by him during the course of audit. He has further made up his mind to decide about sample size at time of performing various planned procedures. Is above approach proper?

Answer 11

SA 300 states that audit plan shall include description about nature, timing and extent of audit procedures.

The extent of audit procedures also includes deciding about sample sizes to be tested for performing audit procedures. Therefore, the said approach is not proper. Various procedures planned to be undertaken should also include considerations relating to sample sizes to be tested.

Question 12

CA. Nikita is conducting audit of a leading society engaged in promoting awareness regarding usefulness of internet among the disadvantaged sections of society through easily understandable means and methods. The society is also registered under FCRA, 2010 for receipt of foreign contributions. During the course of audit, she embarked upon extensive procedures relating to verification of receipt of foreign contributions to rule out "round-tripping" in comparison to procedures originally thought of. She is documenting various procedures performed by her including relevant audit findings.

However, she doesn't not feel need for putting into writing about how she planned the whole exercise.

Does she require refreshening of her knowledge?

Answer 12

SA 300 requires auditor to document audit plan and significant changes made during the audit engagement to the audit plan. It also requires auditor to document reasons for such changes.

The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance.

Further, changes to audit plan along with reasons thereof due to embarking upon extensive procedures related to verification of foreign contributions in comparison to what was originally envisaged need to be documented.

Failure to document audit plan could entail risk of not conducting audit according to professional standards in a qualitative manner.

Question 13

CA. Sourabh is engagement partner conducting statutory audit of BBI Bank for SBT & Associates. The bank has 1034 branches spread all over the country which are audited by branch auditors. In respect of one large branch audited by a branch auditor, there were errors in NPA classification of many advances which were not pointed out by branch auditor in his report through memorandum of changes and NIL memorandum of changes was reported electronically.

During overall review of financial statements of bank by statutory auditor, the above said errors did not come into light. The statutory auditor had also called soft copies of internal inspection report and concurrent audit reports of above branch as part of overall review procedures. However, these reports did not point towards any irregularities in such accounts.

Would statutory auditor of bank be liable for above lapses? What precautions have to be taken by him while expressing opinion considering possibilities of such situations?

Answer 13

SA 600 states that the principal auditor would not be responsible in respect of the work entrusted to the other auditors, except in circumstances which should have aroused his suspicion about the reliability of the work performed by the other auditors. When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditors, his report should state clearly the division of responsibility for the financial information of the entity by indicating the extent to which the financial information of components audited by the other auditors have been included in the financial information of the entity, e.g., the number of divisions/branches/subsidiaries or other components audited by other auditors.

In the given situation, nothing has come to light of statutory auditor which would arouse his suspicion about reliability of work performed by branch auditor. Therefore, he would not be responsible for work performed by branch auditor.

Further, it should be clearly stated in the report that 1034 branches of bank have been audited by branch auditors.

Question 14

CA. Keshavraj is conducting statutory audit of a listed company "Live with Nature Limited". The company is engaged in producing environment-friendly niche products for new-born babies. There is also a well functioning internal audit department in the company. On perusal of internal audit reports, he finds that not only verification of inventories was attended by internal auditor at regular intervals during the year, workings were also made in respect of inventory valuation as at year end.

He has also attended inventory count at end of financial year and no prima facie adverse inferences were drawn by him. However, ongoing through inventory reports, he gathers that inventories are being held for considerably long period before being sold. The internal audit reports have not taken this aspect into consideration. Should he choose to rely upon inventory valuation work performed by internal auditor?

Answer 14

For a particular account balance, class of transaction or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor will need to perform more procedures directly and accordingly, make less use of the work of the internal audit function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in SA 200, the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the external auditor will need to perform more of the work directly.

In the given situation, inventories are being held for considerably long period before being sold. As company is dealing in niche products for new-born babies, there is a risk of inventory obsolescence due to changes in customer preferences. It carries a significant risk of material misstatement and requires more judgment on part of statutory auditor in planning and performing procedures.

In such circumstances, statutory auditor needs to perform procedures directly like comparing net realizable value of products with costs to verify completeness of provisions, recomputing of provisions for obsolete stocks etc.

Therefore, in the given situation, he should perform procedures directly in accordance with SA 610.

Question Illustration 15

CA. Amboj, a practicing-chartered accountant has been appointed as an internal auditor of Textile Ltd. He conducted the physical verification of the inventory at the year end and handed over the report of such verification to CA. Kishore the statutory auditor of the Company, for his view and reporting. Can CA. Kishor rely on such report?

Using the Work of Internal Auditor As per SA 610 "Using the Work of Internal Auditors", while determining whether the work of the internal auditors can be used for the purpose of the audit, the external auditor shall evaluate-

(a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors;

(b) The level of competence of the internal audit function; and

(c) Whether the internal audit function applies a systematic and disciplined approach, including quality control.

Further, the external auditor shall not use the work of the internal audit function if the external auditor determines that:

(a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;

(b) The function lacks sufficient competence; or

(c) The function does not apply a systematic and disciplined approach, including quality control.

In the instant case, CA. Kishore should ascertain the internal auditor's scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible, he should also test check few items and he can also observe the procedures performed by the internal auditors.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order, he has to decide otherwise. The final responsibility to express opinion on the financial statement remains with the statutory auditor.

Question ILLUSTRATION 16

While doing audit, Ram, the Auditor requires reports from experts for the purpose of Audit evidence. What types of reports/opinions he can obtain and to what extent he can rely upon the same?

Using the Work of an Auditor's Expert's per SA 620, "Using the Work of an Auditor's Expert", during the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert.

While doing audit, Ram, the auditor can obtain the following types of reports, or options or statements of an expert for the purpose of audit evidence:

(i) The valuation of complex financial instruments, land and buildings, plant and machinery, jewelry, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.

(ii) The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.

(iii) The estimation of oil and gas reserves.

(iv) The valuation of environmental liabilities, and site clean-up costs.

(v) The interpretation of contracts, laws and regulations.

(vi) The analysis of complex or unusual tax compliance issues.

When the auditor intends to use the work of an expert, he shall evaluate the adequacy of the auditor's expert's work, including the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence; if that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and if that expert's work involves the use of source data that is significant to his work, the relevance, completeness, and accuracy of that source data.

If the auditor determines that the work of the auditor's expert is not adequate for the auditor's purposes, he shall agree with that expert on the nature and extent of further work to be performed by that expert; or perform further audit procedures appropriate to the circumstances

Integrated Case Scenario

CA. Anoothi has been offered appointment as auditor of an NSE listed company. She has already ticked checkboxes relating to her independence vis-à-vis company and integrity of promoters and key management personnel. Being satisfied on this count and after sending formal engagement letter to the company, she is in midst of planning activities for company's audit. Owner of country's one of topmost writing instrument brands, above said company is in business of producing ball pens, gel pens, markers, folders and such general stationery products.

Business profile of the company including its brief history, detail of its key managerial persons and brief description of company's activities was obtained by her. She has also studied reports relating to growth of India's stationery market due to greater demand and impact of government driven schemes like Sarv Shiksha Abhiyaan (SSAB). sides, she has also obtained risk management policy of the company which contained company's strategy to contain various risks.

On perusal of financial statements of company, it is noticed that the company's inventories as at close of financial year stood at Rs. 200 crore which constitutes about 25% of its total assets. She is planning to identify significant audit risks pertaining to valuation of inventories.

She is also considering about materiality level for financial statements as a whole.

Keeping in view above, answer the following questions:

1. The compliance with independence requirements and verification of integrity of promoters and key management personnel has been ensured by CA. Anoothi. In this regard, which of the following statements is likely to be a complete statement?

(a) Such activities are required to performed strictly in terms of requirements and procedures outlined in code of ethics issued by ICAI.

(b) Such activities are required to be performed in respect of an audit engagement in accordance with SA 220 and these preliminary engagement activities are specifically identified in SA 210.

(c) Such activities are required to performed in respect of an audit engagement in accordance with SA 220 and these preliminary engagement activities form part of planning an audit in accordance with SA 300.

(d) Such activities are required to be performed in terms of requirements and procedures outlined in code of ethics issued by ICAI and are specifically identified in SA 210.

Ans: (c)

2. The auditor has obtained risk management policy of the company. Which of the following statements is most appropriate in this regard?

(a) The understanding of company's risk management policy is required by auditor. It may help the auditor in identifying risks of material misstatement that management failed to identify.

(b) The understanding of company's risk management policy is not required by auditor. It deals with business risks of company. Audit risk is not influenced by company's business risks.

(c) The understanding of company's risk management policy is required by auditor. However, it cannot help the auditor in identifying risks of material misstatement that management failed to identify.

(d) The understanding of company's risk management policy is sufficient for an auditor to develop an audit plan.

Ans: (a)

AUDIT PLANNING, STRATEGY & EXECUTION

3. Which of the following is not likely to be a procedure for auditor to understand the company?

(a) Performing an online search to identify press reports relating to the company

(b) Reviewing any new SEBI and stock exchange requirements

(c) Reviewing whether fresh moneys were raised from public

(d) Seeking confirmation letters from bankers regarding outstanding balances

Ans: (d)

4. Considering auditor's intention to identify significant audit risks pertaining to inventory valuation, which of the following statements is likely to be true?

(a) Procedures planned to identify significant audit risks pertaining to inventory valuation forms part of overall audit plan.

(b) Procedures planned to identify significant audit risks pertaining to inventory valuation forms part of overall audit strategy.

(c) Procedures planned to identify significant audit risks pertaining to inventory valuation forms part of tests of controls.

(d) Procedures planned to identify significant audit risks pertaining to inventory valuation forms part of tests of details.

Ans: (a)

5. In relation to materiality levels for financial statements as a whole, which of the following statements is most appropriate?

(a) Materiality has to be decided by auditor after identification and assessment of risks of material misstatements.

(b) Materiality has to be decided by auditor prior to identification and assessment of risks of material misstatements.

(c) Materiality has to be decided by auditor after performing risk assessment procedures.

(d) Materiality has to be decided by auditor at time of designing tests of controls and substantive procedures.

Ans: (b)

4
CHAPTER

MATERIALITY, RISK ASSESSMENT AND INTERNAL CONTROL

SA 315 and SA 330 – Risk Assessment

Question 1

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. (MTP 5 Marks ,Mar 19, RTP May 19, New SM)

Answer 1

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.

Risk Assessment

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.

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:

- 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.
- Existence of internal control that, if tested, could reduce the need/scope for other substantive procedures.
- The potential for substantive analytical procedures that would reduce the need/scope for other types of procedures.
- The need to incorporate an element of unpredictability in procedures performed.
- The need to perform further audit procedures to address the potential for management override of controls or other fraud scenarios.

The need to perform specific procedures to address "significant risks" that have been identified.

Audit procedures designed to address the assessed risks could include a mixture of:

- Tests of the operational effectiveness of internal control; and
- Substantive procedures such as tests of details and analytical procedures

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:

- If there had been a change in the assessed level of risk;
- Whether conclusions drawn from work performed are appropriate; and
- 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:

- Audit findings should be reported to management and those charged with governance; and
- An audit opinion should be formed, and a decision made on the appropriate wording for the auditor's report.

MATERIALITY, RISK ASSESSMENT AND INTERNAL CONTROL

Question 2

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%. On 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%. Analyze the Risk of Mater ial Misstatement and find out the overall Audi t Risk. (MTP 4 Marks, Oct 20, MTP 5 Marks Apr'19, Old & New SM)

Answer 2

According to 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.

Audit Risk has two components namely: Risk of material Misstatement and Detection Risk. The relationship can be defined as follows.

Audit Risk = Risk of material Misstatement x Detection Risk

Risk of material Misstatement: - Risk of Material Misstatement is anticipated risk that a material Misstatement may exist in Financial Statement before start of the Audit. It has two components namely Inherent risk and Control risk.

The relationship can be defined as

Risk of material Misstatement = Inherent risk X control risk

Inherent risk: it is a 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 which is 40% in the given case.

Control risk: it is a risk that there may be chances of material Misstatement even if there is a control applied by the management and it has prevented defalcation to 75%.

Hence, control risk is 25% (100%-75%)

Risk of material Misstatement: Inherent risk X control risk i.e. 40% X 25 % = 10%

Chances of material Misstatement are reduced to 10% by the internal control applied by management.

Detection risk: It is a risk that a material Misstatement remained undetected even if all Audit procedures were applied, Detection Risk is 100-60=40%

In the given case, overall Audit Risk can be reduced up to 4% as follows: Audit Risk: Risk of Material Misstatement X Detection Risk = 10X 40% = 4%

Question 3

ZOB Limited is planning to be listed. The management of company has pulled up its socks and decided to implement "Enterprise Risk Management Program" for identifying and assessing various risks. Differentiating scope of such a program from internal control framework, discuss what does

"Risk Assessment Process" is likely to include in such a program. Also identify any two such widely available ERM frameworks. (MTP 5 Marks Oct '23)

Answer 3

The scope of an Enterprise Risk Management program is much broader than an internal control framework and encompasses both internal and external factors that are relevant to business strategy, governance, business process and transaction and activity level. The focus of an internal control framework is primarily around financial reporting, operations and compliance risks associated with an account balance, business process, transaction and activity level, which form a sub-set of the overall enterprise risks.

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.

One of the most critical components of Enterprise Risk Management is the risk assessment process. The risk assessment process involves considerations for: -

- Risk identification
- Assessment criteria including qualitative and quantitative factors
- Definition of key performance and risk indicators;
- Risk appetite
- Risk scores, scales and maps
- Assess risks
- Use of data & metrics
- Prioritise risk
- Benchmarking

Two most widely used ERM frameworks are: -

COSO Enterprise Risk Management – Integrated Framework developed by the Committee of Sponsoring Organisations (COSO) to address the changes in business environment.

ISO 31000 Risk Management standard published by the International Organization for Standardization.

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It is a risk Management standard published by the International Organization for Standardization and provides guidelines on managing risk faced by organizations. The application of these guidelines can be customized to any organization and its context.

Question 4

In the course of audit of Z Ltd, its auditor wants to rely on audit evidence obtained in previous audit in respect of effectiveness of internal controls instead of retesting the same during the current audit. As an auditor discuss the factors that may warrant a re-test of controls. (MTP Oct 19, RTP May 22 & Nov 18)

Answer 4

As per SA 330 on "The Auditor's Responses to Assessed Risks", changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance.

The auditor's decision on whether to rely on audit evidence obtained in previous audits for control is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment.

Factors that may warrant a re-test of controls are-

(i) A deficient control environment.

(ii) Deficient monitoring of controls.

(iii) A significant manual element to the relevant controls.

(iv) Personnel changes that significantly affect the application of the control.

(v) Changing circumstances that indicate the need for changes in the control.

(vi) Deficient general IT -controls.

Question 5

While conducting a statutory audit of "Hope Solutions Limited", CA Y has assessed the risk of material misstatement to be low at the financial statement level and at the assertion level due to a stable, established and relatively less risky business and extremely satisfactory internal controls operating in the company. However, despite the low assessed risk of material misstatement, he chooses to send external confirmation requests to third parties for confirmation of certain material contracts entered into with them by the company. By doing so, he intends to obtain evidence regarding certain assertions contained in the financial statements of the company. Do you think his approach is in accordance with Standards on Auditing? Justify your answer with reasons. (MTP 5 Marks Oct '23)

Answer 5

SA 330 states that irrespective of the assessed risk of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure. In the given situation, the auditor has assessed the risk of material misstatement to be low.

However, despite such assessment, substantive procedures have to be performed.

SA 330 further states that the auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties.

Despite the low assessed risk of material misstatement, substantive procedures have to be performed due to the following reasons: -

(i) The auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement and

(ii) there are inherent limitations to internal control, including management override.

It is also in accordance with the spirit of professional skepticism. Therefore, as discussed above, the approach of CA Y is in accordance with Standards on Auditing.

Question 6

While commencing the statutory audit of Alex Co. Ltd., what would you consider as an auditor to assess risk of material misstatement and responses to such risks? (RTP May 18)

Answer 6

Considerations of Auditor for Assessing the Risk of Material Misstatement: As per SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment", the auditor shall identify and assess the risks of material misstatement at the financial statement level; and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures. For this purpose, the auditor shall:

(i) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;

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

(ii) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and

(iii) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Auditor's Responses to the Assessed Risk of Material Misstatement: According to SA 330 "The Auditor's Responses to Assessed Risks", the auditor shall design and implement overall responses to address the assessed risks of material misstatement. In designing the audit procedures to be performed, the auditor shall:

Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:

(1) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure; and

(2) Whether the risk assessment takes into account the relevant controls, thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively; and Obtain more persuasive audit evidence the higher the auditor's assessment of risk.

Question 7

General steps in the conduct of risk based audit. (RTP Nov 20)

Answer 7

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

Step 1 Understand auditee operations to identify and prioritize risks: Understanding auditee operations involves processes for reviewing and understanding the audited organization's risk management processes for its strategies, framework of operations, operational performance and information process framework, in order to identify and prioritize the error and fraud risks that impact the audit of financial statements. The environment in which the auditee operates, the information required to monitor changes in the environment, and the process or activities integral to the audited entity's success in meeting its objectives are the key factors to an understanding of agency risks.

Likewise, a performance review of the audited entity's delivery of service by comparing expectations against actual results may also aid in understanding agency operations.

Step 2 Assess auditee management strategies and controls to determine residual audit risk: Assessment of management risk strategies and controls is the determination as to how controls within the auditee are designed. The role of internal audit in promoting a sound accounting system and internal control is recognized, thus the SAI should evaluate the effectiveness of internal audit to determine the extent to which reliance can be placed upon it in the conduct of substantive tests.

Step 3 Manage residual risk to reduce it to acceptable level: Management of residual risk requires the design and execution of a risk reduction approach that is efficient and effective to bring down residual audit risk to an acceptable level. This includes the design and execution of necessary audit procedures and substantive testing to obtain evidence in support of transactions and balances. More resources should be allocated to areas of high audit risks, which were earlier known through the analytical procedures undertaken.

Step 4 Inform auditee of audit results through appropriate report: The results of audit shall be communicated by the auditor to the audited entity. The auditor must immediately communicate to the auditee reportable conditions that have been observed even before completion of the audit, such as weaknesses in the internal control system, deficiencies in the design and operation of internal controls that affect the organization's ability to record, process, summarize and report financial data.

Steps for Risk Identification:

Understand auditee operations to identify and prioritize risks → Assess auditee management strategies and controls to determine residual audit risk → Manage residual risk to reduce it to acceptable level → Inform auditee of audit results through appropriate report

- Assess the significance of the assessed risk, impact of its occurrence and also revise the materiality accordingly for the specific account balance.
- Determine the likelihood for assessed risk to occur and its impact on our auditing procedures.
- Document the assertions that are effected.
- 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.
- Identify the degree of Significant risks that would require separate attention and response by the auditor. Planned audit procedures should directly address these risks.
- Enquire and document the management's response.
- 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.
- Consider any unique characteristics of the risk.
- 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.
- 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.
- As per amendment

Question 8

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 22)

Answer 8

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.

(a) 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:

(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.

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Question 9

(Includes concepts of SA 550 Related Parties)

While formulating the audit plan and responding to the risks of material misstatement identified and assessed in related party transaction and relationships, Ms. K the engagement manager of the audit team of ABC Limited, decided to rely upon the internal controls placed for identification and disclosure of related party relationships and transactions in accordance with the applicable financial reporting framework.

You are requested to guide Ms. K regarding the necessity to test the controls to obtain sufficient and appropriate audit evidence. Also guide, whether Ms. K can use the audit evidence obtained, regarding operative effectiveness of control on identification and disclosure of related party relationships and transactions, in the interim period. (RTP Nov '21)

Answer 9

As per SA 550, "Related Parties", according to para on "Responses to the risks of material misstatement associated with related party relationships and transactions", the auditor should design and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions.

Further, as per SA 330, "The Auditor's Responses to Assessed Risks", the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when:

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

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

In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. Moreover, the auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to when the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, and the timing of test of controls over significant risks, in order to provide an appropriate basis for the auditor's intended reliance.

When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:

(a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and

(b) Determine the additional audit evidence to be obtained for the remaining period.

In the current case, Ms. K shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls as she intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures.

Further, she is also required to obtain the audit evidence about significant changes to those controls subsequent to the interim period along with the additional audit evidence to be obtained for the remaining period in accordance with the requirements of Standards on Auditing as discussed above.

Question 10

The identified risks are assessed by Auditor as to its significance on account of its likely impact, by way of material misstatement appearing in financial statements or by affecting internal control system. What may be the points of indication that may direct the Auditor to judge that the risks identified may be significant? (PYP 4 Marks, Nov '18, PYP 5 Marks Jan'21)

Answer 10

Points of Indication that may direct the Auditor to Judge that the Risks Identified may be Significant: As per SA 315"Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment", as part of the risk assessment the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

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

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

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

(iii) The complexity of transactions;

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

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

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

When the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Indication to judge that risk are significant: Majority of the examinees have no idea about the topic.

Question 11

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. (PYP 5 Marks, Nov '19, Old SM)

Answer 11

Entity's Risk Assessment Process: 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.

New accounting pronouncements: Adoption of new accounting principles or changing accounting principles may affect risks in preparing

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Entity's Risk Assessment Process: Few Examinees could write correct answer to the point while most of the Examinees erred in mentioning about various types of Risks viz.

Inherent Risk, Detection Risk and Control Risk.

Question 12

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 4 Marks, April 21, MTP 4 Marks Mar'23, New SM Illustration)

Answer 12

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.

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 analyses 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.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

The acceptable detection risk needs to be ______ in order to reduce the audit risk to __ in the area of inventories management and handling.

(a) low in order to reduce audit risk to an acceptably high level.

(b) high in order to reduce audit risk to an acceptably high level.

(c) low in order to reduce audit risk to an acceptably low level.

(d) high in order to reduce audit risk to an acceptably low level. (MTP 1 Marks, March 21)

Ans: (c)

Question 2

Speak Ltd. is showing a commission expense of ₹ 2 crore during the month of October 2023. The auditor has made an effort to understand the business process that makes up this financial statement line item as to how it is initiated, recorded, approved, posted and reported. During this exercise, he finds that there is a difference of ₹ 1,50,000/- in the commission recorded as per the Sanchar Software (source) and commission as reflected in SAP accounts (destination).

What is the kind of risk assessment carried out by the auditor in the given case?

(a) It is an evaluation of risks and controls at process level.

(b) It is a direct entity level control evaluation.

(c) It is an indirect entity level control evaluation.

(d) There is no risk assessment as such carried out by the auditor. (MTP 1 Mark Sep ’23)

Ans: (a)

Internal Control

Question 1

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:

2015-16 -20 Crores

2016-17 25 Crores

2017-18 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 4 Marks, Aug’18)

Answer 1

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:

a. **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.

b. **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.

c. **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.

Question 2

BSF Limited is engaged in the business of trading leather goods. You are the internal auditor of the company for the year 2018-19. In order to review internal controls of the Sales Department of the company, you visited the Department and noticed the work division as follows:

a. An officer was handling the sales ledger and cash receipts.

b. Another official was handling dispatch of goods and issuance of Delivery challans.

c. One more officer was there to handle customer/ debtor accounts and issue of receipts.

As an internal auditor, you are required to briefly discuss the general condition pertaining to the internal check system prevalent in internal control system. Do you think that there was proper division of work in BSF Limited? If not, why? (MTP 5 Marks, Oct 19 & April 22, RTP Nov 19, Old & New SM)

Answer 2

The general condition pertaining to the internal check system may be summarized as under:

a no single person should have complete 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 a year.

d. Persons having physical custody of assets must not be permitted to have access to the books of accounts.

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 should be exercised and wide deviations observed should be reconciled.

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.

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In the given scenario, Company has not done proper division of work as:

(i) the receipts of cash should not be handled by the official handling sales ledger and

(ii) delivery challans should be verified by an authorized official other than the officer handling despatch of goods.

Question 3

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. (MTP 4 Marks, May' 20 & Oct 18, RTP May 20 & Nov 18, Old & New SM)

Answer 3

Important Points to be kept in Mind While Drafting Letter of Weakness: 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. A description of the deficiencies and an explanation of their potential effects; and

b. Sufficient information to enable those charged with governance and management to understand the context of the communication.

In other words, the auditor should communicate material weaknesses to the management or the audit committee, if any, on a timely basis. This communication should be, preferably, in writing through a letter of weakness or management letter. Important points with regard to such a letter are as follows

i. The letter lists down the area of weaknesses in the system and offers suggestions for improvement.

ii. It should clearly indicate that it discusses only weaknesses which have come to the attention of the auditor as a result of his audit and that his examination has not been designed to determine the adequacy of internal control for management.

iii. This letter serves as a valuable reference document for management for the purpose of revising the system and insisting on its strict implementation.

iv. 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

Question 4

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 4 Marks, March 21, Old & New SM)

Answer 4

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

a. Whether all transactions are recorded;

b. Whether recorded transactions are real;

c. Whether all recorded transactions are properly valued;

d. Whether all transactions are recorded timely;

e. Whether all transactions are properly posted;

f. Whether all transactions are properly classified and disclosed;

g. Whether all transactions are properly summarized.

Question 5

Yex Ltd. has five entertainment centers to provide facilities for public especially for children and youngsters at 5 different locations in the peripheral of 200 kms. Collections are made in cash. Specify the adequate control system towards collection of money. (MTP 4 Marks, April 18, Old & New SM)

Answer 5

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 Yex Co. Ltd., following system should be adopted -

(i) Printing of tickets: Serially numbered pre-printed tickets should be used and designed in such a way that any type of ticket used cannot be duplicated by others in order to avoid forgery. Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover. The separate series of the serial should be used for such denomination.

(ii) Ticket sales: The sale of tickets should take place from the Central ticket office at each of the 5 centres, preferably through machines. There should be proper control over the keys of the machines.

(iii) Daily cash reconciliation: Cash collection at each office and machine should be reconciled with the number of tickets sold. Serial number of tickets for each entertainment activity/denomination will facilitate the reconciliation.

(iv) Daily banking: Each day's 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 preferably in joint custody for which the daily cash in hand report should be signed by the authorized persons.

(v) Entrance ticket: Entrance tickets should be cancelled at the entrance gate when public enters the centre.

(vi) Advance booking: If advance booking of facility is made available, the system should ensure that all advance booked tickets are paid for.

(vii) Discounts and free pass: The discount policy of the Y Co. Ltd. should be such that the concessional rates, say, for group booking should be properly authorized and signed forms for such authorization should be preserved.

(viii) Surprise checks: Internal audit system should carry out periodic surprise checks for cash counts, daily banking, reconciliation and stock of unsold tickets etc.

Question 6

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 basis system of control has been violated? Also advise the other general conditions pertaining to such system which needs to be maintained and checked by the management. (MTP 5 Marks, March 18, Old & New SM, RTP May 20)

Answer 6

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.

The general condition pertaining to the internal check system may be summarized as under-

(i) No single person should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.

(ii) Staff duties should be rotated from time to time so that members do not perform the same function for a considerable length of time.

(iii) Every member of the staff should be encouraged to go on leave at least once a year.

(iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

(v) 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.

(vi) Mechanical devices should be used, where ever practicable to prevent loss or misappropriation of cash.

(vii) Budgetary control should be exercised and wide deviations observed should be reconciled.

(viii) 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.

(ix) 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.

(x) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

Question 7

During the course of the audit of Tirthankara Limited, CA. Shreyansh Manager in the audit team identified that there is significant risk in lease transactions due to complex cross-border sale and lease back arrangements. This significant risk or risk of material misstatement was not identified in management's risk assessment process. Upon various inquiries with Management regarding their risk assessment process, it was identified and concluded by the audit team that the management's risk assessment process is not effective to identify all the significant risks. CA. Shreyansh decided that this in combination with other potential deficiencies in internal control constitutes significant deficiencies in internal control and hence, is required to be communicated to those charged with governance. However, the engagement partner had a different view regarding the audit of Tirthankara Limited. According to him, the only matter that is identified and poses significant deficiencies due to their magnitude is only required to be communicated. Matters of potential misstatements that are not actual misstatements cannot be termed as significant deficiencies. You are required to guide CA. Shreyansh with respect to examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency. (MTP 4 Marks Oct '22)

Answer 7

As per SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", significant deficiency in internal control is defined as a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. Also, the significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may therefore exist even though the auditor has not identified misstatements during the audit. Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.

- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.

Question 8

While conducting statutory audit of MPT Limited, a listed company, CA Z has understood various IT controls relating to data centre and network operations, system software acquisition, change and maintenance, program change, access security and application system acquisition, development and maintenance operating in the company. Besides, he has also gained knowledge of application controls designed to ensure the integrity of accounting records.

Which one of the internal control components of the company is referred to in the above description? Besides activities gathered from the above description, give examples of any other two activities relevant for an audit included in the above identified "component of internal control" of the company. (MTP 4 Marks Oct '23)

Answer 8

CA Z has gained an understanding of various IT controls operating in the company including General IT controls and application controls. Such activities form part of "control activities", which is one of the components of internal control of an organization.

Control activities are the policies and procedures that help ensure management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels. Examples of specific control activities include those relating to the following:

Performance reviews

These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.

Physical controls

Controls that encompass:

- The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
- The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).

Question 9

Prabhu Ltd., a manufacturing concern wants 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? (RTP May 18)

Answer 9

Internal Control System and its Inherent Limitations: As per Guidance Note on Audit of Internal Financial Control over Financial Reporting, internal controls are a system consisting of specific policies and procedures designed to provide management with reasonable assurance that the goals and objectives it believes important to the entity will be met.

"Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. To state whether a set of financial statements presents a true and fair view, it is essential to benchmark and check the financial statements for compliance with the framework. The Accounting Standards specified under the Companies Act, 1956 (which are deemed to be applicable as per Section 133 of the 2013 Act, read with Rule 7 of Companies (Accounts) Rules, 2014) is one of the criteria constituting the financial reporting framework on which companies prepare and present their financial statements under the Act and against which the auditors evaluate if the financial statements present a true and fair view of the state of affairs and the results of operations of the company in an audit of the financial statements carried out under the Act.

The fundamental therefore is that effective internal control is a process effected by people that supports the organization in several ways, enabling it to provide reasonable assurance regarding risk and to assist in the achievement of objectives.

Fundamental to a system of internal control is that it is integral to the activities of the company, and not something practiced in isolation.

An internal control system:

- Facilitates the effectiveness and efficiency of operations.
- Helps ensure the reliability of internal and external financial reporting.
- Assists compliance with laws and regulations.
- Helps safeguarding the assets of the entity.

Limitations of Internal Control - Internal control, no matter how effective, can provide an entity with only reasonable assurance and not absolute assurance about achieving the entity's operational, financial reporting and compliance objectives. Internal control systems are subject to certain inherent limitations, such as:

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- Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.
- The fact that most internal controls do not tend to be directed at transactions of unusual nature. The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and misunderstanding of instructions.
- The possibility of circumvention of internal controls through collusion with employees or with parties outside the entity.
- The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.
- Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

Question 10

During the course of audit of Treasure Ltd., CA Gautam 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 Gautam with well-defined set of the Standard Operating Procedures in the assessment and evaluation of control. (RTP May '23, PYP 5 Marks, May '19, PYP 5 Marks Dec'21)

Answer 10

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

(i) **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.

(ii) **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.

(iii) **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

(iv) **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.

(v) 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.

(vi) 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.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Standard Operating Procedure : Majority of the examinees lack knowledge of Standard Operating Procedures of assessment and evaluation of control. Therefore, failed to answer correctly.

Dec'21-

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Standard Operating Procedures in the assessment and evaluation of control: Many examinees discussed the concept of internal control and various areas in which internal controls are required to be implemented instead of mentioning a well -defined set of the Standard Operating Procedures in the assessment and evaluation of control.

Question 11

Auditors are required to obtain an understanding of internal control relevant to the audit when identifying and assessing its effectiveness and risk of material misstatement. During the audit of Acharya Ltd., you observed that significant deficiency exists in the internal control system, and you want to ascertain the same. Elucidate the various indicators of significant deficiencies which will help you in assessing the efficiency of internal control system of the organization. (RTP May '23, PYP 5 Marks Jan'21)

Answer 11

In the given case of Acharya Ltd, Auditors, while conducting audit has come across significant deficiency existing in the internal control system and also auditors wanted to ascertain that deficiency.

As per SA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management ", Indicators of significant deficiencies in internal control include, for example:

(i) Evidence of ineffective aspects of the control environment, such as:

(a) Indications that significant transactions in which management is financially interested are not being appropriately scrutinised by those charged with governance.

(b) Identification of management fraud, whether or not material, that was not prevented by the entity's internal control.

(c) Management's failure to implement appropriate remedial action on significant deficiencies previously communicated.

(ii) Absence of a risk assessment process within the entity where such a process would ordinarily be expected to have been established.

(iii) Evidence of an ineffective entity risk assessment process, such as management's failure to identify a risk of material misstatement that the auditor would expect the entity's risk assessment process to have identified.

(iv) Evidence of an ineffective response to identified significant risks (e.g., absence of controls over such a risk).

(v) Misstatements detected by the auditor's procedures that were not prevented, or detected and corrected, by the entity's internal control.

(vi) Disclosure of a material misstatement due to error or fraud as prior period items in the current year's Statement of Profit and Loss.

(vii) Evidence of management's inability to oversee the preparation of the financial statements.

Question 12

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. (MTP 4 Marks, Nov '18)

Answer 12

Basic Assumption about Elements of Good Control in Standardized Internal Control Questionnaire: In the use of standardized internal control questionnaire, certain basic assumptions about elements of good control are taken into account. These are -

(i) Certain procedures in general used by most business concerns are essential in achieving reliable internal control. This is a time-tested assumption. Deposit 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 are examples of widely used practices which are considered good internal control practices.

Besides, basic operations giving rise to these practices exist in all businesses irrespective of their nature.

(ii) Organizations are such that permit an extensive division of duties and responsibilities. The larger the organization, the greater is the scope of such division.

(iii) Employees concerned with accounting function are not assigned any custodial function.

(iv) No single person is thrust with the responsibility of completing a transaction all by himself.

(v) There should always be evidence to identify the person who has done the work whether involving authorization, implementation or checking.

(vi) The work performed by each one is expected to come under review of another in the usual course of routine.

(vii) There is proper documentation and recording of the transactions.

Question 13

CA. N has been appointed as an auditor of TRP Ltd. While conducting the audit he has identified some deficiencies in the Internal control. He needs to determine whether a deficiency or combination of deficiencies in internal control constitutes a "significant deficiency" and has to communicate them in writing to those charged with Governance and management on a timely basis.

Guide CA. N with some examples of matters to be considered while determining 'significant deficiency' in internal control with reference to relevant SA. (PYP 5 Marks, Nov '20)

Answer 13

As per SA 265 "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management", significant deficiency in internal control means a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgement, is of sufficient importance to merit the attention of those charged with governance.

Examples of matters that CA N, auditor of TRP Ltd may consider in determining whether a deficiency or combination of deficiencies in internal control constitutes a significant deficiency include:

(1) The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.

(2) The susceptibility to loss or fraud of the related asset or liability.

(3) The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.

(4) The financial statement amounts exposed to the deficiencies.

(5) The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.

(6) The importance of the controls to the financial reporting process; for example:

- General monitoring controls (such as oversight of management).
- Controls over the prevention and detection of fraud.
- Controls over the selection and application of significant accounting policies.
- Controls over significant transactions with related parties.
- Controls over significant transactions outside the entity's normal course of business.
- Controls over the period-end financial reporting process (such as controls over nonrecurring journal entries).

(7) The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.

(8) The interaction of the deficiency with other deficiencies in internal control.

Question 14

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. (PYP 5 Marks July 21, MTP 5 Marks Sep'23)

Answer 14

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;

(viii) 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.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Few examinees mentioned internal control objectives instead of accounting control objectives.

Question 15

Mr. K has been appointed as statutory auditor of SK Limited for issuing an audit opinion on financial statements and internal controls over financial reporting (ICFR) for the year ended March 31, 2022 under the Companies Act, 2013. Guide Mr. K to prepare a checklist in the form of Questions for testing internal control over cash and bank balances. When forming an opinion on ICFR is it necessary for Mr. K to test the transactions only at the balance sheet date? (PYP 5 Marks May '22)

Answer 15

In the given case of SK Limited, the appointed auditor Mr. K would prepare checklist for testing internal control over cash and bank balances. An illustrative set of Questions to be Answered by the audit staff is as follows:

Have you checked that the cashier -

(i) is not responsible for opening the incoming mails;

(ii) does not authorise any of the ledgers;

(iii) does not authorise any expenditure or receipt;

(iv) does not sign cheques;

(v) takes his annual leave regularly;

(vi) inks and balances the cash book every day;

(vii) verifies physical cash balance with the book figure daily at the end of the day;

(viii)prepares monthly bank reconciliation statement;

(ix) holds no other funds or investment;

(x) holds no unnecessary balance in hand;

(xi) does not pay money without looking into compliance with proper procedure and due authorisation; and

(xii) has tendered proper security or has executed a fidelity bond?

In the given situation, Mr. K is Statutory Auditor of SK Limited for issuing opinion on financial statements and internal control over financial reporting. He should surely test transactions during the financial year and not just as at the balance sheet date, though the extent of testing at or near the balance sheet date may be higher. From the discussion given above, it can be concluded that it would not be necessary for Mr. K to test the transactions only at the balance sheet date.

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Question 16

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. . (PYP 4 Marks, May '18, PYP 4 Marks Nov'22)

Answer 16

Entity Level Risks and Controls: There are direct entity level controls and indirect entity level controls.

(i) Direct ELCs operate at a level higher than business activity or transaction level such as a business process or sub-process level, account balance level, at a sufficient level of precision, to prevent, detect or correct a misstatement in a timely manner.

Examples include:

• Business performance reviews;

• Monitoring of effectiveness of controls activities by Internal Audit function;

(ii) Indirect ELCs do not relate to any specific business process, transaction or account balance and hence, cannot prevent or detect misstatements. However, they contribute indirectly to the effective operation of direct ELC and other control activities.

Examples include:

• Company code of conduct and ethics policies;

• Human resource policies;

• Employee job roles & responsibilities.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Entity Level Risks and Control: It seems that examinees were unaware of the topic. Very few examinees could comprehend and explain Direct ELCs and indirect ELCs with examples. Some examinees misunderstood the question and explained wrongly the types of audit Risk Viz., Inherent Risk, Control Risk, Detection Risk.

Question 17

Explain the concept of Integrated framework issued by Committee of the Sponsoring Organizations of the Tredway 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. (PYP 5 Marks, Jan '21)

Answer 17

Concept of COSO:

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.

Five Components of COSO are as follows:

(i) Control Environment

(ii) Risk Assessment

(iii) Control Activities

(iv) Information and Communication

(v) 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. The Framework lists three categories of objectives as below:

1. **Operations Objectives** – related to the effectiveness and efficiency of the entity's operations, including operational and financial performance goals, and safeguarding assets against loss.
2. **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.
3. **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.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

Which of the following is an example of Direct Entity level control

(a) Company code of conduct and ethics policies.

(b) Human resource policies.

(c) Job roles & responsibilities of employees.

(d) Monitoring of effectiveness of controls activities by Internal Audit function. (MTP 1 Mark March 22, MTP 1 Mark Mar'23)

Ans: (d)

Question 2

Chandana Private Limited is engaged in trading of parts of machineries used in boiler plants.

Company has seen growth of 58% in the sales and management expecting similar growth in next 3 financial years and is planning to onboard new dealers in order to achieve management goal.

Purchase department also expects to develop new suppliers in order to meet customer demands.

Internal auditor of the company has identified frequent changes in the bank account and other master details of suppliers. At this expansion planning phase, company has no defined control to provid e assurance on said supplier master changes. Management agreed to develop the process of monthly detailed review of supplier master changes done in supplier master by Finance assistant in order to ensure authorized changes in supplier master.

One of the members from the Management would like to know that above controls falls under which category:

(a) Automated control.

(b) Preventive control.

(c) Detective control.

(d) Compensating control. (MTP 1 Mark Oct 22)

Ans: (c)

Question 3

Factors that the auditor may consider in determining the appropriate level of detail for communication of significant deficiencies under SA 265 depends upon:

I. Nature, size and complexity of the entity

II. Nature of the significant deficiencies identified

III. Estimated time required by management to resolve the deficiency

IV. Fees charged from the client

(a) I and II.

(b) I, II and III.

(c) III and IV.

(d) Only II. (MTP 1 Mark Oct 21)

Ans: (a)

Question 4

The management of Prabhu Ltd. has developed a strong internal control in its accounting system in such a way that the work of one person is reviewed by another. Since no individual employee is allowed to handle a task alone from the beginning to the end, the chances of early detection of frauds and errors are high. CA. Viharsh has been appointed as an auditor of the company for current Financial Year 2022-23. Before starting the audit, she wants to evaluate the internal control system of Prabhu Ltd. To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, CA. Viharsh decided to use internal control questionnaire to know and assimilate the system and evaluate the same. Which of the following questions need not be framed under internal control questionnaire relating to purchases?

(a) Are authorized signatories for purchases limited to elected officials?

(b) Are payments approved only on original invoices?

(c) Does authorized officials thoroughly review the documents before signing cheques?

(d) Are monthly bank reconciliations implemented for each and every bank account of the company? (MTP 1 Mark Sep '23)

Ans: (d)

Question 5

Which of the following is an example of Direct Entity level control

(a) Ethics policy

(b) Human resource policy

(c) Business performance reviews

(d) Job roles & responsibilities of employees (MTP 1 Mark Mar'22, RTP May 19)

Ans: (c)

Question 6

ABC Pvt Ltd had turnover of ₹ 39 crores as at 31 March 2018. The Company had taken a loan of ₹ 39 crores from various banks and financial institutions during the year ended 31 March 2018. These loans were paid by the Company before 31 March 2018. The Company is of the view that the auditors' reporting on adequacy and operating effectiveness of internal financial controls (IFC) under Section 143(3)(i) of the Companies Act, 2013 would not be required. The auditors of the Company have a different view. What should be correct option?

(a) The turnover of ABC Pvt Ltd is below required threshold and hence IFC will not be applicable.

(b) The turnover of ABC Pvt Ltd is below required threshold and loan amount was fully paid before year end i.e. 31 March 2018. Hence IFC will not be applicable.

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(c) The turnover of ABC Pvt Ltd is below required threshold but loan amount was above required threshold. Irrespective of the fact that loan was outstanding as at 31 March 2018 or not, IFC would be applicable.

(d) In the given case because of the repayment of the loan before year end i.e. 31 March 2018, applicability of IFC becomes optional. (RTP May 19, MTP 1 Mark Mar'23)

Ans: (c)

Question 7

COBIT is_____________________________

(a) best practice IT governance and management framework published by Information Systems Audit and Control Association (ISACA). It provides the required tools, resources and guidelines that are relevant to IT governance, risk, compliance and information security.

(b) one of the most popular frameworks for improving critical infrastructure cyber security published by National Institute of Standards and Technology (NIST).

(c) the most widely adopted information security standard for the payments card industry issued by Payment Card Industry Security Standards Council (PCI SSC).

(d) set of best practice processes and procedures for IT services management in a company like change management, incident management, problem management, IT operations and IT asset management in accordance with ISO 20000. (MTP 1 Mark Oct '23)

Ans: (a)

SA 320 – Materiality in Planning and Performing an Audit

Question 1

Mr. X was appointed as the auditor of M/s Easy go Ltd. and intends to apply the concept of materiality for the financial statements as a whole. Please guide him as to the factors that may affect the identification of an appropriate benchmark for this purpose. (MTP 5 Marks, Aug 18)

Answer 1

SA 320 "Materiality in Planning and Performing an Audit" prescribes the use of Benchmarks in Determining Materiality for the Financial Statements as a Whole.

Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

(i) The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);

(ii) Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);

(iii) The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;

(iv) The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and

(v) The relative volatility of the benchmark.

Question 2

Yashu & Co., Chartered Accountants have come across in the course of audit of a company that certain machinery had been imported for production of new product. Although the Auditors have applied the concept of materiality for the Financial Statements as a whole, they now want to re - evaluate the materiality concept for this transaction involving foreign exchange. Give your views in this regard. (MTP 5 Marks, April 19, Old SM, PYP 5 Marks, May 18)

Answer 2

Re-evaluation of the Materiality Concept: In the instant case, Yashu & Co., as an auditor has applied the concept of materiality for the financial statements as a whole. But they want to re - evaluate the materiality concept on the basis of additional information of import of machinery for production of new product which draws attention to a particular aspect of the company's business.

As per SA 320 "Materiality in Planning and Performing an Audit", while establishing the overall audit strategy, the auditor shall determine materiality for the financial statement as a whole. He should set

the benchmark on the basis of which he performs his audit procedure. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than the materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

The auditor shall revise materiality for the financial statements in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

If the auditor concludes a lower materiality for the same, then he should consider the fact that whether it is necessary to revise performance materiality and whether the nature, timing and extent of the further audit procedures remain appropriate.

Thus, Yashu & Co. can re-evaluate the materiality concepts after considering the necessity of such revision.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Revaluation of Materiality Concept: Examinees failed to discuss that auditor shall determine the materiality level to be applied to particular classes of transactions, account balances or disclosures and the auditor should consider to revise performance materiality and whether the nature, timing and extent of audit procedures are appropriate.

Question 3

CA. B was appointed as the auditor of ABC Limited for the financial year 22032.2D-uring the course of planning for the audit, CA. B intends to apply the concept of materiality for the financial statements as a whole. Please guide him with respect to tractors that may affect the identification of an appropriate benchmark for this purpose.

What benchmark should be adopted by CA. B, if ABC Limited is engaged in:

(i) the manufacture and sale of air conditioners and is having regular profits.

(ii) the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic. (New SM, PYP 5 Marks Nov 22)

Answer 3

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole: As per SA 320, determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);

- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

In case if ABC Limited is engaged in manufacture and sale of air conditioner, and is having regular profits: CA. B, the auditor may consider profit before tax /Earnings.

In case if ABC Limited is engaged in the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic: CA. B, the auditor may consider Revenue or Gross Profit as benchmarking. Alternatively, CA B, the auditor may consider the criteria relevant for audit of the entities doing public utility programs/ projects, Total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/ project activity. Where an entity has custody of the assets, assets may be an appropriate benchmark.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

The amount of materiality initially determined needs to be revised as the audit progresses:

(a) If there is a delay in the audit.

(b) In the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.

(c) Only in the event of becoming aware of information during the audit that would have caused the auditor to have determined a higher amount (or amounts) initially.

(d) Only in the event of becoming aware of information during the audit that would have caused the auditor to have determined a lower amount (or amounts) initially. (MTP 1 Mark April 22)

Ans: (b)

Question 2

"Performance materiality" means the amount or amounts set by the auditor at than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements _________ materiality for the financial statements as a whole.

(a) higher, exceeds.

(b) less, exceeds.

(c) less, falls below.

(d) higher, falls below. (MTP 1 Mark Oct '23)

Ans: (b)

Question 1

CA. B was appointed as the auditor of ABC Limited for the financial year 22032.2D-uring the course of planning for the audit, CA. B intends to apply the concept of materiality for the financial statements as a whole. Please guide him with respect to tractors that may affect the identification of an appropriate benchmark for this purpose.

What benchmark should be adopted by CA. B, if ABC Limited is engaged in:

(i) the manufacture and sale of air conditioners and is having regular profits.

(ii) the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic.

Answer 1

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole: As per SA 320, determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.

Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue.

In case if ABC Limited is engaged in manufacture and sale of air conditioner, and is having regular profits:

CA. B, the auditor may consider profit before tax /Earnings.

In case if ABC Limited is engaged in the construction of large infrastructure projects and incurred losses in the previous two financial years, due to pandemic: CA. B, the auditor may consider Revenue or Gross Profit as benchmarking. Alternatively, CA B, the auditor may consider the criteria relevant for audit of the entities doing public utility programs/ projects, Total cost or net cost (expenses less

revenues or expenditure less receipts) may be appropriate benchmarks for that particular program/ project activity.

Where an entity has custody of the assets, assets may be an appropriate benchmark.

Question 2

What are the components of an internal control framework?

Answer 2

There are five components of an internal control framework. They are as follows:

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

Question 3

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.

Answer 3

Important Points to be kept in Mind While Drafting Letter of Weakness: 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 -

(i) A description of the deficiencies and an explanation of their potential effects; and

(ii) Sufficient information to enable those charged with governance and management to understand the context of the communication.

In other words, the auditor should communicate material weaknesses to the management or the audit committee, if any, on a timely basis. This communication should be, preferably, in writing through a letter of weakness or management letter. Important points with regard to such a letter are as follows-

(1) The letter lists down the area of weaknesses in the system and offers suggestions for improvement.

(2) It should clearly indicate that it discusses only weaknesses which have come to the attention of the auditor as a result of his audit and that his examination has not been designed to determine the adequacy of internal control for management.

(3) This letter serves as a valuable reference document for management for the purpose of revising the system and insisting on its strict implementation.

(4) 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.

Question 4

Explain briefly the Flow Chart technique for evaluation of the Internal Control system.

Answer 4

The flow charting technique can also be resorted to for evaluation of the internal control system. As distinct from a narrative form, it provides the most concise and comprehensive way for reviewing the internal controls and the evaluator's findings. In a flow chart, narratives, though cannot perhaps be totally banished are reduced to the minimum and by that process, it can successfully bring the whole control structure, especially the essential parts thereof, in a condensed but wholly meaningful manner. It gives a bird's eye view of the system and is drawn up as a result of the auditor's review thereof. It should, however, not be understood that details are not reflected in a flow chart. Every detail relevant from the control point of view and the details about how an operation is performed can be included in the flow chart. Essentially a flow chart is a diagram full with lines and symbols and, if judicious use of them can be made, it is probably the most effective way of presenting the state of internal controls in the client's organization.

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-

(i) at what point a document is raised internally or received from external sources;

(ii) the number of copies in which a document is raised or received;

(iii) the intermediate stages set sequentially through which the document and the activity pass;

(iv) distribution of the documents to various sections, department or operations;

(v) checking authorization and matching at relevant stages;

(vi) filing of the documents; and

(vii) final disposal by sending out or destruction.

As a matter of fact, a very sound knowledge of internal control requirements is imperative for, adopting flow-charting technique for evaluation of internal controls; also, it demands a highly analytical mind to be able to see clearly the inter division of a job and the appropriate control at relevant points.

It has been stated earlier that flow charts should be made section-wise or department-wise. The suggestion has been made to ensure readability and intelligibility of the flow charts.

Question 5

As auditor of Z 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?

Answer 5

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

(i) Whether all transactions are recorded;

(ii) Whether recorded transactions are real;

(iii) Whether all recorded transactions are properly valued;

(iv) Whether all transactions are recorded timely;

(v) Whether all transactions are properly posted;

(vi) Whether all transactions are properly classified and disclosed;

(vii) Whether all transactions are properly summarized.

Question 6

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 basis system of 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.

Answer 6

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 is 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.

The general condition pertaining to the internal check system may be summarized as under-

(i) No single person should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.

(ii) Staff duties should be rotated from time to time so that members do not perform the same function for a considerable length of time.

(iii) Every member of the staff should be encouraged to go on leave at least once a year.

(iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

(v) 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.

(vi) Mechanical devices should be used, where ever practicable to prevent loss or misappropriation of cash.

(vii) Budgetary control should be exercised and wide deviations observed should be reconciled.

(viii) 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.

(ix) 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.

(x) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

Question 7

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%. Analyze the Risk of Material Misstatement and find out the overall Audit Risk.

Answer 7

According to 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.

Audit Risk, has two components: Risk of material Misstatement and Detection Risk. The relationship can be defined as follows.

Audit Risk = Risk of material Misstatement X Detection Risk

Risk of material Misstatement: - Risk of Material Misstatement 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: it is a 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 which is 40% in the given case.

Control risk: it is a risk that there may be chances of material Misstatement even if there is a control applied by the management and it has prevented defalcation to 75%.

Hence, control risk is 25% (100%-75%)

Risk of material Misstatement: Inherent risk X control risk i.e. 40% X 25 % = 10%

Chances of material Misstatement are reduced to 10% by the internal control applied by management. Detection risk: It is a risk that a material Misstatement remained undetected even if all Audit procedures applied, Detection Risk is 100-60=40%

In the given case, overall Audit Risk can be reduced up to 4% as follows: Audit Risk: Risk of Material Misstatement X Detection Risk = 10X 40% = 4%

Question 8

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.

Answer 8

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.

Risk Assessment

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.

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:

- 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.
- Existence of internal control that, if tested, could reduce the need/scope for other substantive procedures.
- The potential for substantive analytical procedures that would reduce the need/scope for other types of procedures.
- The need to incorporate an element of unpredictability in procedures performed.
- The need to perform further audit procedures to address the potential for management override of controls or other fraud scenarios.

The need to perform specific procedures to address "significant risks" that have been identified.

Audit procedures designed to address the assessed risks could include a mixture of:

- Tests of the operational effectiveness of internal control; and
- Substantive procedures such as tests of details and analytical procedures

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:

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- If there had been a change in the assessed level of risk;
- Whether conclusions drawn from work performed are appropriate; and
- 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:

- Audit findings should be reported to management and those charged with governance; and
- An audit opinion should be formed, and a decision made on the appropriate wording for the auditor's report.

Question 9

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.

Answer 9

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 -

(i) Printing of tickets: Serially numbered pre-printed tickets should be used and designed in such a way that any type of ticket used cannot be duplicated by others in order to avoid forgery. Serial numbers should not be repeated during a reasonable period, say a month or year depending on the turnover.

The separate series of the serial should be used for such denomination.

(ii) Ticket sales: The sale of tickets should take place from the Central ticket office at each of the 5 centers, preferably through machines. There should be proper control over the keys of the machines.

(iii) Daily cash reconciliation: Cash collection at each office and machine should be reconciled with the number of tickets sold. Serial number of tickets for each entertainment activity/denomination will facilitate the reconciliation.

(iv) Daily banking: Each day's 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 preferably in joint custody for which the daily cash in hand report should be signed by the authorized persons.

(v) Entrance ticket: Entrance tickets should be cancelled at the entrance gate when public enters the center.

(vi) **Advance booking:** If advance booking of facility is made available, the system should ensure that all advance booked tickets are paid for.

(vii) **Discounts and free pass:** The discount policy of the Y Co. Ltd. should be such that the concessional rates, say, for group booking should be properly authorized and signed forms for such authorization should be preserved.

(viii) **Surprise checks:** Internal audit system should carry out periodic surprise checks for cash counts, daily banking, reconciliation and stock of unsold tickets etc.

Question 10

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

Answer 10

Communication and enforcement of 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. 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

Question 11

Your engagement team is seeking advice from you as engagement partner regarding steps for risk identification. Elaborate.

Answer 11

- Assess the significance of the assessed risk, impact of its occurrence and also revise the materiality accordingly for the specific account balance.
- Determine the likelihood for assessed risk to occur and its impact on our auditing procedures.
- Document the assertions that are affected.
- 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.
- Identify the degree of Significant risks that would require separate attention and response by the auditor. Planned audit procedures should directly address these risks.
- Enquire and document the management's response.

- 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.
- Consider any unique characteristics of the risk.
- 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.
- 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.

Question 12

BSF Limited is engaged in the business of trading leather goods. You are the internal auditor of the company for the year 2019-20. 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.

As an internal auditor, you are required to briefly discuss the general condition pertaining to the internal check prevalent in internal control system. Do you think that there was proper division of work in BSF Limited? If not, why?

Answer 12

The general condition pertaining to the internal check system may be summarized as under:

(i) no single person should have complete control over any important aspect of the business operation. Every employee's action should come under the review of another person.

(ii) Staff duties should be rotated from time to time so that members do not perform the same function for a considerable length of time

(iii) Every member of the staff should be encouraged to go on leave at least once a year.

(iv) Persons having physical custody of assets must not be permitted to have access to the books of accounts.

(v) 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.

(vi) Mechanical devices should be used, wherever practicable to prevent loss or misappropriation of cash.

(vii) Budgetary control should be exercised, and wide deviations observed should be reconciled

(viii) 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.

(ix) 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.

(x) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

In the given scenario, Company has not done proper division of work as:

(i) the receipts of cash should not be handled by the official handling sales ledger and

(ii) delivery challans should be verified by an authorized official other than the officer handling dispatch of goods.

Question 13

CA. R is conducting statutory audit of a Divisional office (DO) of a public sector insurance company. On going through delegation of powers laid down by company's head office, it is noticed that surveyors in claims under property insurance policies beyond estimated amounts of ₹30 lac are to be appointed by Divisional Claims Committee (DCC). However, ongoing through surveyor appointment details of 10 such claims during the year, 5 instances have come to his notice where above delegation of powers has not been followed and appointments were made by Divisional manager in place of DCC.

In the beginning, the auditor had assessed risks of material misstatement to be low. Describe why above finding would change auditor's assessment in relation to above.

Answer 13

Evaluation of internal controls influences auditor's assessment of risks of material misstatement. Risks of material misstatement also consists of control risk.

In the given situation of statutory audit of a Divisional office of a public sector insurance company, it is noticed that procedure relating to delegation of powers has not been followed and surveyor appointments have been made in violation of laid down procedures. It is a serious violation and shows that controls are not operating effectively as laid down by company management.

Such deviations from established controls may lead auditor to conclude that control risk needs to be revised. Revision of control risk assessment is likely to lead to revision in risks of material misstatement. It may also result in modification of nature, timing and extent of planned substantive procedures.

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Question 14

You have recently been appointed as an auditor of NGO working in the field of "upholding democracy" for the first time. The last year accounts of NGO were unaudited and its activities were limited at a small scale. However, it is only in the current year that NGO has received substantial donations including foreign funds. The said NGO is also crowdfunding its donations. The government has now legislative power to cancel FCRA certificate of NGO. Since it is working in field which encompasses political and social fields, accusations and counter-accusations are flying thick and fast.

What factors you may consider for assessing audit risk?

Answer 14

For assessing audit risk, auditor shall consider all components of audit risk. The said NGO is working in a political-cum-social field which can make its activities inherently risky. Crowdfunding donations may have to be seen in relation to constitution of NGO which may make these risky. Since the NGO is in receipt of foreign funds, it may make transactions inherently risky. The credibility and integrity of persons behind NGO is important. Shady NGOs can be involved in money laundering activities and may be involved in mis utilizing funds from donors. Since last year accounts were unaudited, it also increases inherent risk due to probable effect of misstatements, if any, of last year. Non-compliance with strict laws has the potential to make activities of NGO inherently risky.

Since NGO has received substantial donations in current year and its activities were on a relatively small scale during last year, formal controls may not be in place. Lack of formal controls may lead to noncompliance with laws. Non-compliance with FCRA can have serious consequences including cancelling such certificate of NGO. Therefore, control risk could be high.

Further, audit for NGO has been accepted for the first time. There may be a lack of understanding of activities of NGO. It may lead to higher detection risk due to inappropriate sampling procedures or faulty application of audit procedures.

Question 15

RK Living Limited is engaged in manufacturing and processing of textile fabrics. It purchases its raw material from a company based in Silvassa taxable @ 12%. It takes about 3-4 days for raw materials to reach the company's plant. Recently, the company has revamped its internal control system for recording its transactions. You have also assumed charge as head of internal audit department of the company few days before.

It is noticed that information system requires booking of purchases in purchase ledger and stock records from date of purchase invoice only. How you would deal with above matter as internal auditor of the company?

Answer 15

Internal audit involves continuous and critical appraisal of functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity including its strategic risk management and internal control system.

Internal audit also involves evaluation of internal control to provide assurance to management regarding design, implementation and operating effectiveness of control.

In the given situation, information system requires booking of purchases in purchase ledger and stock records from date of invoice. Such a control system is likely to present a distorted picture of stocks f the company. It would show stocks of raw material as received whereas these goods could be in transit.

Therefore, design of the control itself is faulty which allows booking from date of purchase invoice only.

Further, such a system can have implications with respect to GST laws.

The internal auditor should report above matter asking management for corrective action.

Question 16

A company as part of its internal control set up has a system under which quarterly budgeted targets in respect of sales are analyzed with respect to actual performance achieved. It also involves fixing responsibilities of different product departmental heads and taking timely correction. In case of product departmental heads not achieving quarterly budgeted targets, they have to give a detailed justification for the same and also lay down how shortfalls would be compensated in ensuing quarters.

Identify and explain component of internal control alluded to in above scenario.

Answer 16

The above referred component of internal control is "Control activities". Control activities that may be relevant to an audit include policies and procedures that pertain to "performance reviews".

Such control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial– to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.

The control activities pertaining to analysis of budgeted target of sales with respect to actual performance, fixing of responsibilities and taking timely corrective action falls in nature of performance reviews. Such performance reviews are part of control activities which is a component of internal control.

Question 17

CA. S is statutory auditor of a listed company. On reviewing internal controls of the company, he is of the view that there can be possible situations where insurance premiums for keeping insurance policies current in respect of various assets of company may have become due and payable but internal control systems established by the company may not be able to capture it.

Elaborate how he should proceed to deal with the above matter.

Answer 17

A deficiency in internal control exists when: -

(i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis or

(ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

In above situation, there is a possibility that internal control systems established by the company may not be able to capture insurance premiums which may have become due and payable. It is a significant deficiency as failure to keep insurance policies current would render assets of the company uninsured. It may lead to losses for the company in case of any eventuality.

Further, in accordance with SA 265, the significance of a deficiency or a combination of deficiencies in internal control depends not only on whether a misstatement has actually occurred, but also on the likelihood that a misstatement could occur and the potential magnitude of the misstatement. Significant deficiencies may, therefore, exist even though the auditor has not identified misstatements during the audit.

The susceptibility to loss of an asset is a factor in determining whether a deficiency constitutes significant deficiency in internal control.

The auditor shall communicate in writing significant deficiency in internal control to those charged with governance and include in the written communication of significant deficiencies in internal control: -

(a) A description of the deficiencies and an explanation of their potential effects and

(b) Sufficient information to enable those charged with governance and management to understand the context of the communication.

Case Study

Following is extract of information taken from draft financial statements of Find me Limited engaged in manufacturing of bicycles put up before you for audit for year 2022-23: - (₹ In lacs)

Particulars	2022-23	2021-22
Revenue from operations	35000	25000
Cost of sales	26950	20000
Gross Profit	8050	5000
Operating expenses	3825	3825
Finance costs	225	275
Depreciation and amortization expenses	1200	1300
Profit before tax	2800	(400)
Tax expense – current tax	750	0
Deferred tax	(50)	(385)
Total tax expense	700	(385)
Profit after tax	2100	15
Trade receivables	6000	3000
Inventories	10000	6000

The company has not made any substantial additions in its plant capacity during year 2022-23. It has reduced its dealer network and is approaching customers directly using its online platform. Encouraging response has been received from customers and sales have gathered momentum through online platform.

You are planning to use analytical procedures as risk assessment procedures. Keeping in view above, answer the following questions: -

1. The revenue from operations of company has increased by 40% in year -232a2s compared to last year. There are no additions in plant capacity. Which of the following statements is most appropriate in this regard?

a) There is audit risk that revenue from operations is overstated.

b) There is audit risk that revenue from operations is not overstated.

c) There is audit risk that fresh customers of company do not make payments.

d) There is audit risk that company is overutilizing its plant capacity leading to rapid plant obsolescence.

Ans: (a)

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2. The operating expenses of financial ye2ar021-22 and 2022-23 are same. Which of the following statements is most appropriate in overall context of case study?

a) Operating expenses figures of two years can be same. There is no audit risk involved.

b) It is an anomaly. However, there is no audit risk involved.

c) There is audit risk that previous year figures need to be revised under Companies Act.

d) There is audit risk that previous year figures have been presented in place of current year figures in draft financial statements.

Ans: (d)

3. Trade receivables turnover ratio has increased from 1.44months in year 2202 1to- more than 2 months in year 202-23. Identify the most appropriate statement.

a) In direct distribution through online platform, trade receivables turnover ratio is estimated to be high. Therefore, there is no audit risk involved.

b) In direct distribution through online platform, trade receivables turnover ratio should have fallen. Therefore, there is no audit risk involved.

c) In direct distribution through online platform, trade receivables turnover ratio should have fallen. It is possible that some of the dealers may not be meeting their commitments of past contracts. Therefore, there is audit risk that trade receivables could be undervalued.

d) In direct distribution through online platform, trade receivables turnover ratio should have fallen. It is possible that some of the dealers may not be meeting their commitments of past contracts. Therefore, there is audit risk that trade receivables could be overvalued.

Ans: (d)

4. The gross profit ratio of company has increased by 3% during year 220322i-n comparison to last year.

Which of the following statements is most appropriate?

a) There is audit risk that there is overstatement of cost of sales.

b) There is audit risk that margins with customers may have increased.

c) There is audit risk that closing inventories may be undervalued.

d) There is audit risk that cost of sales may not be completely recorded.

Ans: (d)

5. Inventory turnover ratio has increased from 2.88 months in year 2021-22 to about 3.42 months in year 20222-3. Which of the following statements is likely to be in accordance with overall context of case study?

a) Revenue jump in current year may have led to need for raising inventory holding levels.
   Therefore, there is audit risk pertaining to misstatement of inventories.

b) Raising of inventory levels may raise locked up funds in inventories. There is audit risk that it can lead to rise in costs.

c) Revenue jump in current year may have led to need for raising inventory holding levels.
   However, there is also a risk that some of inventories with dealers could have become obsolete.
   It leads to audit risk that inventories may be overvalued.

d) There is audit risk on account of both the factors stated at [b] & [c].

Ans: (c)

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5 CHAPTER AUDIT EVIDENCE

SA 500 – Audit Evidence

Question 1

The auditor of CROX Ltd. accepted the gratuity liability valuation based on the certificate issued by a qualified actuary. However, the auditor noticed that the retirement age adopted is 65 years as against the existing retirement age of 60 years. The company is considering a proposal to increase the retirement age to 65 years. Comment. (MTP 5 Marks, April 18, 4 Marks, Oct 20) (PYP 5 Marks ,May 18)

Answer 1

Evaluating the Work of Management's Expert: As per SA 500 "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes,

(a) Evaluate the competence, capabilities and objectivity of that expert;

(b) Obtain an understanding of the work of that expert; and

(c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

The auditor may obtain information regarding the competence, capabilities and objectivity of a management's expert from a variety of sources, such as personal experience with previous work of that expert; discussions with that expert; discussions with others who are familiar with that expert's work; knowledge of that expert's qualifications; published papers or books written by that expert.

Aspects of the management's expert's field relevant to the auditor's understanding may include what assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.

The auditor may also consider the following while evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion:

(i) The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;

(ii) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and

(iii) If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

In the instant case, CROX Ltd. accepted the gratuity liability valuation based on the certificate issued by an expert i.e., a qualified actuary who is management's expert. Here basis for computation and valuation is taken as age 65 years by the actuary, which is not correct as company is considering proposal to increase the retirement age from existing age to 65 years. Therefore, assumptions and methods used by the management's expert are not appropriate for financial reporting purposes. Hence, auditor may qualify the report accordingly.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Evaluating work of Management's Expert: Few examinees failed to give required answer instead they gave general answers on valuation of inventory.

Question 2

ABC Ltd. appointed Mr. Anand for the actuarial calculation of liabilities associated with insurance contracts and employee benefit plans. These calculations and valuations are then adopted by management in preparing the financial statements. Kindly guide Mr Sushil, the statutory auditor of ABC Ltd, on the use of information prepared by management's appointed expert as audit evidence. Also, explain Mr. Sushil the matters that can impact the nature, timing and extent of audit procedures regarding information to be used as audit evidence which has been prepared using the work of a management's expert. (MTP 4 Marks Sep '23)

Answer 2

As per SA 500, "Audit Evidence", when information to be used as audit evidence has been prepared using the work of a management expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes:

(i) Evaluate the competence, capabilities and objectivity of that expert;

(ii) Obtain an understanding of the work of that expert; and

(iii) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Further, the nature, timing and extent of audit procedures in relation to the requirement relating to information to be used as audit evidence prepared using the work of a management's expert may be affected by such matters as:

(i) The nature and complexity of the matter to which the management's expert relates.

(ii) The risks of material misstatement in the matter.

(iii) The availability of alternative sources of audit evidence.

(iv) The nature, scope and objectives of the management's expert's work.

(v) Whether the management's expert is employed by the entity or is a party engaged by it to provide relevant services.

(vi) The extent to which management can exercise control or influence over the work of the management's expert.

(vii) Whether the management's expert is subject to technical performance standards or other professional or industry requirements.

(viii)The nature and extent of any controls within the entity over the management's expert's work.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

The audit team has obtained the following results from the trade receivables circularization of Nemi Co for the year ended 31 March 2023.

Customer	Balance as per sales ledger	Balance as per customer confirmation	Comment
	₹	₹	
AM Co.	2,25,000	2,25,000	
AN Co.	3,50,000	2,75,000	Invoice raised on 29 March 2023
AO Co.	6,20,000	4,80,000	Payment made on 30 March 2023
AP Co.	5,35,000	5,35,000	A balance of ₹ 45,000 is currently being disputed by AP Co.
AR Co.	1,78,000	No reply	

Which of the following statements in relation to the results of the trade receivables circularization is TRUE?

(a) No further audit procedures need to be carried out in relation to the outstanding balances with AM Co. and AP Co.

(b) The difference in relation to AN Co. represents a timing difference and should be agreed to a pre - year-end invoice.

(c) The difference in relation to AO Co. represents a timing difference and should be agreed to pre - year-end bank statements.

(d) Due to the non-reply, the balance with AR Co. cannot be verified and a different customer balance should be selected and circularized. (MTP 1 Mark Sep '23)

Ans: (b)

Question 2

You are an audit senior at Ghaisas & Co and are currently performing the final audit of Bingham Co. for the year ended 31 March 2018. The company is a manufacturer and retailer of table lamps. The current audit senior is ill, and you have been asked to complete the audit of payroll in their absence. On arrival at the head office of Bingham Co, you determine the following data from a review of the current year and prior year audit files:

- As at 31 March 2017, the company had 350 employees
- On 1 April 2017, 10% of staff were made redundant, effective immediately, due to discontinuation of a product line
- On 1 June 2017, all remaining staff received a 5% pay rise
- Over the course of the year, sales levels met performance targets which resulted in a fixed bonus of Rs.8,000 being paid to each employee on 31 March 2018.

The following audit evidence has been gathered relating to the accuracy of wages and salaries for Bingham Co.

(1) Proof in total calculation performed by an audit team member

(2) Written representation from the directors of Bingham Co confirming the accuracy of wages and salaries

(3) Verbal confirmation from the finance director of Bingham Co confirming the accuracy of wages and salaries

(4) Recalculation of the gross and net pay for a sample of employees by an internal audit team member of Bingham Co.

What is the order of reliability of the audit evidence starting with the MOST RELIABLE first?

(a) Audit evidence - 1, 2, 3, 4

(b) Audit evidence - 1, 4, 2, 3

(c) Audit evidence - 4, 1, 2, 3

(d) Audit evidence - 4, 1, 3, 2 (MTP 2 Marks, Mar 19)

Ans: (b)

Question 3

While investigating the matters relating to possible misappropriation of cash, cashier says that every day cash is counted and reviewed by the Finance Head. Your specimen review indicates that daily cash summary was not signed off by the Finance Head. In this situation you should: -

(a) Conclude that cashier is not telling truth.

(b) Consider extending investigation procedures like corroborative enquiry with Finance Head, review of appropriate daily cash summaries etc.

(c) Conclude that Finance Head is not a responsible person.

(d) Conclude that daily cash summary is not relevant for investigation (MTP 1 Marks, May 20)

Ans: (b)

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Question 4

Andromeda Limited issued a prospectus in respect of an IPO which had the auditor's report on the financial statements for the year ended 31st March, 2021. The issue was fully subscribed. During this year, there was an abnormal rise in the profits of the company for which it was found later that it was because of Dealer dumping technique used by the company to inflate the sales. Upon further investigation it was identified that the Whole-time director and other top officials of the company were involved in the scheme. On discovery of this fact, the company offered to refund all moneys to the subscribers of the shares and sued the auditors for the damages alleging that the auditors failed to examine and ascertain any satisfactory explanation for steep increase in the rate of profits and related accounts.

The company emphasized that the auditor should have proceeded with suspicion and should not have followed selected verification. In response, the auditors were able to prove that they found internal controls to be satisfactory based on the samples which were selected for testing design and operating effectiveness and did not find any circumstance to arouse suspicion. Further, they were able to prove to the satisfaction that the sampling performed for substantive procedures was also appropriate as per sampling guidelines and was sufficient to reflect the population.

The company was not able to prove that auditors were negligent in performance of their duties. You are required to advise on the same.

(a) The stand of the company was correct in this case. Considering the nature of the work, the Auditors should have proceeded with suspicion and should not have followed selected verification.

(b) The approach of the auditors appears to be reasonable in this case. The auditors found internal controls to be satisfactory and also did not find any circumstance to arouse suspicion and hence they performed their procedures on the basis of selected verification.

(c) In the given case, the auditors should have involved various experts along with them to help them on their audit procedures. Prospectus is one area wherein management involves various experts and hence the auditors should also have done that. In the given case, by not involving the experts the auditors did not perform their job in a professional manner. If they had involved experts like forensic experts etc, the manipulation could have been detected. Hence the auditors should be held liable.

(d) In case of such type of engagements, the focus is always on the management controls. If the controls are found to be effective, then an auditor can never be held liable in respect of any deficiency or misstatement or fraud.(MTP 1 Mark Nov 21 ,Oct 19 & March 22)

Ans: (b)

Question 5

The audit team has obtained the following results from the trade receivables circularization of Oak Co for the year ended 31 March 2018.

Customer	Balance as per sales ledger	Balance as per customer confirmation	Comment
	₹	₹	
M Co.	2,25,000	2,25,000	
N Co.	3,50,000	2,75,000	Invoice raised on 29 March 2023
O Co.	6,20,000	4,80,000	Payment made on 30 March 2023
P Co.	5,35,000	5,35,000	A balance of ₹ 45,000 is currently being disputed by P Co.
R Co.	1,78,000	No reply	

Which of the following statements in relation to the results of the trade receivables circularization is TRUE?

(a) No further audit procedures need to be carried out in relation to the outstanding balances with M Co. and P Co.

(b) The difference in relation to N Co. represents a timing difference and should be agreed to a preyear-end invoice

(c) The difference in relation to O Co. represents a timing difference and should be agreed to pre- year end bank statements

(d) Due to the non-reply, the balance with R Co. cannot be verified and a different customer balance should be selected and circularized (MTP 1 Marks, April 19 & April 21)

Ans: (b)

Question 6

BC Ltd. is the business of manpower consulting. The company has a huge cash and bank balance including fixed deposits with banks. During the course of audit of the financial statements of the company for the year ended 31 March 2017, auditors circulated independent bank balance confirmations. The auditors received all the balance (covering fixed deposits) confirmations independently. Auditors observed that the fixed deposits balances as per the independent balance confirmation did not match with the books balances in some cases. Management produced the fixed deposit certificates to the auditors wherein the balances of fixed assets matched with the balances as per the books. How should the auditor deal with this matter?

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(a) Auditor should qualify the audit report in respect of differences in book balances of fixed deposits vis a vis independent balance confirmations.

(b) Auditor should consider the fixed deposit certificates produced by the management and basis that any differences in book balances of fixed deposits vis a vis independent balance confirmations should be ignored.

(c) Auditor should consider the documentation provided by the management i.e. the fixed deposit certificates, however, independent balance confirmations is also required to be considered by the auditor which shows various difference. The auditor should obtain balance confirmations again.

(d) Auditor should consider the documentation provided by the management i.e. the fixed deposit certificates, however, independent balance confirmations is also required to be considered by the auditor which shows various difference. The auditor should look to perform alternate procedures and basis that the matter should be looked at. (MTP 2 Marks, April 19)

Ans: (d)

Question 7

You are the audit manager of Ranker & Co are responsible for the audit work to be managed for the fixed assets of the company. Ranker & Co has 5 properties amounting to Rs.11.5 crore. One of the important tasks ahead for you is to confirm the ownership of these properties.

Which of the following would provide the most persuasive evidence of the ownership?

(a) To conduct a physical inspection of all the properties located at different areas.

(b) To ask the management registration documents of these properties and inspect and verify them.

(c) To check whether all the properties are recorded properly in the fixed asset register and depreciation has been calculated correctly.

(d) Enquire with the management if these properties are insured and review the insurance documentation. (MTP 1 Marks April 21)

Ans: (b)

Question 8

Below is an extract from the list of supplier statements as at 31st March 2022 held by the Company and corresponding payables ledger balances at the same date along with some commentary on the noted differences:

Supplier	Statement balance `'000	Payables ledger balance `'000
Shubh Company	78	66
Labh Company	235	205

The difference in the balance of Shubh Company is due to an invoice which is under dispute due to defective goods which were returned on 30th March 2022. Which of the following audit procedures should be carried out to confirm the balance owing to Shubh Company?

(I) Review post year-end credit notes for evidence of acceptance of return.

(II) Inspect pre year-end goods returned note in respect of the items sent back to the supplier.

(III) Inspect post year-end cash book for evidence that the amount has been settled.

(a) 1, 2 and 3.

(b) 1 and 3 only.

(c) 1 and 2 only.

(d) 2 and 3 only. (MTP 1 Mark Sep '22, RTP May'21)

Ans: (c)

Question 9

JIN Ltd issued a prospectus in respect of an IPO which had the auditor's report on the financial statements for the year ended 31 March 2022. The issue was fully subscribed.

During this year, there was an abnormal rise in the profits of the company for which i t was found later on that it was because of manipulated sales in which there was participation of Whole-time director and other top officials of the company. On discovery of this fact, the company offered to refund all moneys to the subscribers of the shares and sued the auditors for the damages alleging that the auditors failed to examine and ascertain any satisfactory explanation for steep increase in the rate of profits and related accounts.

The company emphasized that the auditor should have proceeded with suspicion and should not have followed selected verification. The auditors were able to prove that they found internal controls to be satisfactory and did not find any circumstance to arouse suspicion.

The company was not able to prove that auditors were negligent in performance of their duties. Which of the following is correct:

a. The stand of the company was correct in this case. Considering the nature of the work, the Auditors should have proceeded with suspicion and should not have followed selected verification.

b. The approach of the auditors looks reasonable in this case. The auditors found internal controls to be satisfactory and also did not find any circumstance to arouse suspicion and hence they performed their procedures on the basis of selected verification.

c. In the given case, the auditors should have involved various experts along with them to help them on their audit procedures. Prospectus is one area wherein management involves various experts and hence the auditors should also have done that. In the given case, by not involving the experts the auditors did not perform their job in a professional manner. If they had involved experts like forensic experts etc., the manipulation could have been detected. Hence the auditors should be held liable.

d. In case of such type of engagements, the focus is always on the management controls. If the controls are found to be effective, then an auditor can never be held liable in respect of any deficiency or misstatement or fraud. (MTP 1 Mark March '23)

Ans: (b)

Question 10

You are the audit senior in charge of the audit of Swadhyay Co. and have been informed by your audit manager that during the current year a fraud occurred at the client. A payroll clerk sets up fictitious employees and the wages were paid into the clerk's own bank account. This clerk has subsequently left the company, but the audit manager is concerned that additional frauds have ta ken place in the wages department. Which of the following audit procedures would be undertaken during the audit of wages as a result of the manager's assessment of the increased risk of fraud?

(1) Discuss with the payroll manager the nature of the payroll fraud, how it occurred and the financial impact of amounts incorrectly paid into the payroll clerk's bank account.

(2) Review the supporting documentation to confirm the total of the fraudulent payments made and assess the materiality of this misstatement.

(3) Review and test the internal controls surrounding setting up of and payments to new joiners to assess whether further frauds may have occurred.

(4) Review the legal action taken by the management against the payroll clerk who was involved in the fraud and see whether he is punished for his actions.

(a) Audit procedures 1,2,3.

(b) Audit procedures 2,3,4.

(c) Audit procedures 1,3,4.

(d) Audit procedures 1,2,4. (MTP 2 Marks Oct'19, MTP 1 Mark April '23)

Ans: (a)

Question 11

The following inherent limitations in an audit affect the auditor's ability to detect material misstatements except:

a) Test and sampling.

b) Audit process permeated by judgement.

c) Poor corporate governance.

d) Audit evidence. (MTP 1 Mark Sep '22)

Ans: (c)

SA 501 – Audit Evidence-Specific Considerations for Selected Items

Question 1

The Engagement Partner of the audit team of High Inventory Limited assessed that the inventory is material with respect to the audit of the financial statement for the current period. Upon inquiring with the management, the Engagement Partner identified that the management will be performing an annual physical inventory count at all the warehouses where the entity stores and maintains its inventory. Moreover, management confirmed in its written representation that they will be performing a 100% physical count of inventory for the current period.

As a result, the engagement Partner decided not to perform any physical count of inventory as it will be a duplication of the work. Moreover, he decided that the written representation from management stating "the inventory exists and is in appropriate physical condition" will be sufficient and appropriate with respect to audit evidence to conclude that the inventory balance in the financial statement is free from any material misstatement. In the light of SA 501, evaluate whether the decision taken by the Engagement Partner is appropriate or not. (MTP 5 Marks Oct '22)

Answer 1

As per SA 501," Audit Evidence - Specific Considerations for Selected Items", when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

i. Attendance at physical inventory counting, unless impracticable, to

1. Evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting.
2. Observe the performance of management's count procedures.
3. Inspect the inventory; and.
4. Perform test counts; and

ii. Performing audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results Attendance at physical inventory counting involves:

iii. Inspecting the inventory to ascertain its existence and evaluate its condition and perform test counts.

iv. Observing compliance with management's instructions and the performance of procedures

v. for recording and controlling the results of the physical inventory count; and

vi. Obtaining audit evidence as to the reliability of management's count procedures.

Hence in the given case, the approach of Engagement Partner is not appropriate as when inventory

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is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. This should be done by performing various audit procedures which also includes attending physical count, observing the count, inspecting the inventory and reperforming physical counts.

Question 2

Your firm has been appointed as the statutory auditors of GBM Private Limited for the financial year 2018-19. While verification of company's inventories as on 31st March 2019, you found that the significant amount of inventories belonging to the company are held by other parties. However, the company has kept all the records of the inventories maintained by other parties. What is your duty as an auditor in order to ensure that third parties are not such with whom the stock should not be held and the stock as disclosed in company's records actually belongs to them? (RTP Nov 19)

Answer 2

Inventory under the Custody and Control of a Third Party: As per SA 501, "Audit Evidence—Specific Considerations for Selected Items" when inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

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

(ii) Perform inspection or other audit procedures appropriate in the circumstances, for example where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.
- Requesting confirmation from other parties when inventory has been pledged as collateral.

Question 3

RIM Private Ltd is engaged in the business of manufacturing of water bottles and is experiencing significant increase in turnover year on year. During the financial year ended 31 March 2019, the company carried out a detailed physical verification of its inventory and property, plant and equipment. You are the auditor of RIM Private Ltd. The inventory as at the end of the year was

₹ 2.25 crores. Due to unavoidable circumstances, you could not be present at the time of annual physical verification. Under the above circumstances how would you ensure that the physical verification conducted by the management was in order?(RTP May'20, Old SM)

Answer 3

As per SA 501 **"Audit Evidence – Additional Considerations for Specific Items"**, the auditor should perform audit procedures, designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting. SA 501 is additional guidance to that contained in SA 500, **"Audit Evidence"**, with respect to certain specific financial statement amounts and other disclosures.

If the auditor is unable to be present at the physical inventory count on the date planned due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded. The auditor would also verify the procedure adopted, treatment given for the discrepancies noticed during the physical count. The auditor would also ensure that appropriate cut off procedures were followed by the management. He should also get management's written representation on (a) the completeness of information provided regarding the inventory, and (b) assurance with regard to adherence to laid down procedures for physical inventory count.

By following the above procedure, it will be ensured that the physical verification conducted by the management was in order.

Question 4

(Includes concepts of SA 705- Modification of Opinion)

Coccyx Ltd. supplies navy uniforms across the country. The Company has 3 warehouses at different locations throughout the India and 5 warehouses at the borders. The major stocks are generally supplied from the borders. Coccyx Ltd. appointed M/s OPAQE & Co. to conduct its audit for the financial year 2020-21. Mr. P, partner of M/s OPAQE & Co., attended all the physical inventory counting conducted throughout the India but could not attend the same at borders due to some unavoidable reason.

You are required to advise M/s OPAQE & Co.,

(I) How sufficient appropriate audit evidence regarding the existence and condition of inventory may be obtained?

(II) How is an auditor supposed to deal when attendance at physical inventory counting is impracticable? (RTP May 21 & May 18, New SM)

Answer 4

(I) Special Consideration with Regard to Inventory: As per SA 501 "Audit Evidence- Specific Considerations for Selected Items", when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

Attendance at physical inventory counting, unless impracticable, to:

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

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

(iii) Inspect the inventory; and

(iv) Perform test counts; and

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

(II) Attendance at Physical Inventory Counting Not Practicable: In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

Further, where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

In some cases, though, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 on Modifications to the Opinion in the Independent Auditor's Report, requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

Question 5

Moon Ltd. is a dealer in electronic appliances. The Company has a centralized ware house at the outskirts of Mumbai. The Auditors of the company M/s J K Associates normally attend the physical verification of stocks carried out by the Management at the end of the financial year. However, on account of certain disturbances in the region, the physical inventory counting could not be carried out at the year end. The stock taking is decided to be done by management at some other date subsequently, after a month. In the light of the above facts:

Enumerate the audit procedures to be considered by M/s J K Associates, if physical inventory counting is conducted at a date other than the date of the financial statements with reference to the relevant Standard on Auditing. (PYP 5 Marks, Nov-20)

Answer 5

As per SA 501 "Audit Evidence- Specific Considerations for Selected Items", when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory.

- For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes.
- If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor, J K Associates, shall perform the following procedures:

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

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

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

(iii) Inspect the inventory; and

(iv) Perform test counts; and

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

- In addition to above, auditor shall also perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.
- Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

1. Whether the perpetual inventory records are properly adjusted.
2. Reliability of the entity's perpetual inventory records.
3. Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

Question 6

GHK Associates, Chartered Accountants, conducting the audit of PBS Ltd., a listed company for the year ended 31.03.2020 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GHK Associates want to ensure that methods adopted by management for determining segment information have resulted in disclosure in

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accordance with the applicable financial reporting framework. Guide GHK Associates with 'Examples of Matters' that may be relevant when obtaining an understanding of the methods used by the management with reference to the relevant Standards on Auditing. (PYP 5 Marks, Jan '21, New SM)

Answer 6

The auditors, GHK Associates wanted to ensure and obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by obtaining an understanding of the methods used by management in determining segment information. SA 501 guides in this regard. As per SA 501- "Audit Evidence—Specific Considerations for Selected Items", example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

(i) Sales, transfers and charges between segments, and elimination of inter-segment amounts.

(ii) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.

(iii) The allocation of assets and costs among segments.

(iv) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

Question 7

Mr. Shah is reviewing the anti-fraud controls for a construction company. The company has witnessed a few frauds in the past mainly in the nature of material stolen from the sites and fake expense vouchers.

Mr. Shah is evaluating options for verifying the process in detecting fraud and the corrective action to be taken in such cases. As an expert, you are required to advise Mr. Shah as how inventory fraud occurs and the verification procedure to be followed for detecting the same. (MTP 5 Marks, Oct 19)

Answer 7

Inventory frauds - Inventory frauds are many and varied but here we are concerned with misappropriation of goods and their concealment.

(i) Employees may simply remove goods from the premises.

(ii) Theft of goods may be concealed by writing them off as damaged goods, etc.

(iii) Inventory records may be manipulated by employees who have committed theft so that book quantities tally with the actual quantities of inventories in hand.

Verification Procedure for Defalcation of inventory - It may be of trading stock, raw materials, manufacturing stores, tools or of other similar items (readily) capable of conversion into cash. The loss may be the result of a theft by an employee once or repeatedly over a long period, when the same have not been detected. Such thefts usually are possible through collusion among a number of persons. Therefore, for their detection, the entire system of receipts, storage and despatch of all goods, etc. should be reviewed to localise the weakness in the system.

The determination of factors which have been responsible for the theft and the establishment of guilt would be difficult in the absence of:

(a) a system of inventory control, and existence of detailed record of the movement of inventory, or

(b) availability of sufficient data from which such a record can be constructed.

The first step in such an investigation is to establish the different items of inventory defalcated and their quantities by checking physically the quantities in inventory held and those shown by the Inventory Book.

Afterwards, all the receipts and issues of inventory recorded in the Inventory Book should be verified by reference to entries in the Goods Inward and Outward Registers and the documentary evidence as regards purchases and sales. This would reveal the particulars of inventory not received but paid for as well as that issued but not charged to customers. Further, entries in respect of returns, both inward and outward, recorded in the financial books should be checked with corresponding entries in the Inventory Book. Also, the totals of the Inventory Book should be checked. Finally, the shortages observed on physical verification of inventory should be reconciled with the discrepancies observed on checking the books in the manner mentioned above. In the case of an industrial concern, issue of raw materials, stores and tools to the factory and receipts of manufactured goods in the godown also should be verified with relative source documents.

Defalcations of inventory, sometimes, also are committed by the management, by diverting a part of production and the consequent shortages in production being adjusted by inflating the wastage in production; similar defalcations of inventories and stores are covered up by inflating quantities issued for production. For detecting such shortages, the investigating accountant should take assistance of an engineer. For that he will be more conversant with factors whic h are responsible for shortage in production and thus will be able to correctly determine the extent to which the shortage in production has been inflated. In this regard, guidance can also be taken from past records showing the extent of wastage in production in the past. Similarly, he would be able to better judge whether the material issued for production was excessive and, if so to what extent.

The per hour capacity of the machine and the time that it took to complete one cycle of production, also would show whether the issues have been larger than those required.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

CA. Vishudh is auditor of a company having 15 inventory locations in the country. In view of multiple inventory locations and logistics issues involved, he decides not to attend physical inventory count process of the company. The company management also sends him digital evidence comprising of videos of inventory counting process at different locations as on reporting date with date and time stampings. Besides verifying inventory records, he also performs alternative audit procedures like examining details of subsequent sales of specific inventory items acquired prior to physical inventory counting. Which of following statements is most appropriate in this regard?

(a) The procedure adopted by auditor is in accordance with Standards on Auditing as the auditor has obtained digital evidence with date and time stampings and also performed alternative audit procedures.

(b) The procedure adopted by auditor is in accordance with Standards on Auditing. However, type of digital evidence obtained, and kind of alternative audit procedures performed do not constitute sufficient appropriate audit evidence.

(c) The procedure adopted by auditor is not in accordance with Standards on Auditing as auditor can skip attendance at inventory counting only when attending it is unfeasible.

(d) The procedure adopted by auditor is in accordance with Standards on Auditing as auditor can skip attendance at inventory count due to time, difficulty and logistics issues involved. (RTP Nov '23)

Ans: (c)

Question 2

You have only eight working hours for raw material inventory verification. Based on your observation during these eight hours, you have to form an opinion with respect to the correctness of inventory value calculated by the management. The company uses ERP system for updating and recording raw material inventory. The ERP system of the company has passed all the ITGC checks and inventory rates are calculated by ERP on moving average price (MAP) basis. The company has done ABC analysis of all raw material inventory items and has vast number of items in each category. You will form your opinion based on

(a) Based on ABC analysis, check physical inventory of all "A" class items during allotted time and matching it with ERP stock.

(b) Understand the process of recording of inventory in ERP to ascertain potential weaknesses and checking physical inventory of mostly "A" class items, some "B" class items and some "C" class items.

(c) Check physical inventory of "A" class items as much as possible along with certain "B" class items and certain "C" class items on sample basis in value wise descending order, compare the physical stock with ERP system, and tabulate the result. The exercise should be continued till the end of allotted eight hours.

(d) Check physical stock of only those items, which have standard packaging so that verification is faster considering the eight hour time limit. (RTP May 19)

Ans: (c)

SA 505 – External Confirmations

Question 1

Mr. Rishabh, in the course of audit of PQ Limited, wants to perform external confirmation procedures to obtain audit evidence. Guide Mr. Rishabh, listing out the factors that may assist him in determining whether external confirmation procedures are to be performed as substantive audit procedures. (MTP 5 Marks Sep '23)

Answer 1

Factors that may assist Mr. Rishabh, the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

(i) The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.

(ii) The ability or willingness of the intended confirming party to respond – for example, the confirming party:

- May not accept responsibility for responding to a confirmation request;
- May consider responding too costly or time consuming;
- May have concerns about the potential legal liability resulting from responding;
- May account for transactions in different currencies; or
- May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

(iii) The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

Question 2

During the course of audit of Moon Limited the auditor received some of the confirmation of the balances of trade payables outstanding in the balance sheet through external confirmation by negative confirmation request. In the list of trade payables, there are number of trade payables of small balances except one old outstanding of Rs.25 Lacs, of whom, no confirmation on the credit balance received. Comment with respect to Standard of Auditing. (RTP May 18, Old SM)

Answer 2

External Confirmation: As per SA 505, "External Confirmation", Negative Confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request. Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favor, and less likely to respond otherwise. In the instant case, the auditor sent the negative confirmation requesting the trade payables having outstanding balances in the balance sheet while doing audit of Star Limited. One of the old outstanding of Rs.25 lacs has not sent the confirmation on the credit balance. In case of non response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non response for negative confirmation request does not means that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request. But, if the auditor identifies factors that give rise to doubts about the reliability of the response to the confirmation request, he shall obtain further audit evidence to resolve those doubts.

Question 3

Your firm has been appointed as the statutory auditors of AGM Private Limited for the financial year 2018-19. While verification of company's trade receivables as on 31 st March 2019, accountant of AGM Ltd. has requested you, not to send balance confirmations to a particular group of trade receivables since the said balances are under dispute and the matter is pending in the Court. As a Statutory Auditor, how would you deal in this situation? (RTP May'20, Old SM)

Answer 3

SA 505 **"External Confirmations",** establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. If the management refuses to allow the auditor to a send a confirmation request, the auditor shall:

(i) Inquire as to Management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness,

(ii) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures, and

(iii) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those in charge of governance and also determine its implication for the audit and his opinion.

AUDIT EVIDENCE

Question 4

Never permit Limited refuses to allow you to get direct confirmation of the outstanding balances of trade receivables. You want to ensure on grounds of materiality that at least outstanding above a threshold limit needs to be confirmed and reconciliation is to be carried out before finalizing the audit. If the Company does not relent, how will you respond? (PYP 4 Marks, May 18)

Answer 4

SA 505 **"External Confirmations",** establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. If the management refuses to allow the auditor to as end a confirmation request, the auditor shall:

(i) Inquire as to Management's reasons for the refusal, and seek audit evidence as to their validity and reasonableness,

(ii) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud, and on the nature, timing and extent of other audit procedures, and

(iii) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

- If the auditor concludes that management's refusal to allow the auditor to send a confirmation request is unreasonable or the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall communicate with those incharge of governance in accordance with SA260 "Communication with Those Charged with Governance" and also determine its implication for the audit and his opinion in accordance with SA705 "Modifications to the Opinion in the Independent Auditor's Report".
- A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence the auditor may wish to obtain. The auditor is therefore required to inquire as to the reasons for the limitation. A common reason advanced is the existence of a legal dispute or ongoing negotiation with the intended confirming party, the resolution of which may be affected by an untimely confirmation request. The auditor is required to seek audit evidence as to the validity and reason ableness of there as on because of the risk that management may be attempting to deny the auditor access to audit evidence that may reveal fraud or error.

Question 5

During the audit of Star Ltd. a company engaged in the production of paper, the auditor received certain confirmation for the balances of trade payables outstanding in the balance sheet through external confirmation by "Negative Confirmation Request". In the list of trade payables, there are number of small balances except one which is an old outstanding of ₹ 20 lakhs for which no confirmation was received. Comment with respect to Standards of Auditing relating to the confirmation process and how to deal the non-receipt of confirmation. (PYP 5 Marks Nov 22, New SM)

Answer 5

External Confirmation: As per SA 505, "External Confirmation", negative confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations. The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request.

Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request. Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favour, and less likely to respond otherwise. In the instant case, the auditor sent the negative confirmation requesting the trade payables having outstanding balances in the balance sheet while doing audit of Star Limited. One of the old outstanding of ₹ 20 lakh has not sent the confirmation on the credit balance. In case of non-response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non-response for negative confirmation request does not means that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request.

Question 6

Mr. Agarwal, in the course of audit of PQ Limited, wants to perform external confirmation procedures to obtain audit evidence. Guide Mr. Agarwal, listing out the factors that may assist him in determining whether external confirmation procedures are to be performed as substantive audit procedures. (PYP 5 Marks Dec '21)

Answer 6

Factors that may assist Mr. Agarwal, the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

(i) The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.

(ii) The ability or willingness of the intended confirming party to respond – for example, the confirming party:

- May not accept responsibility for responding to a confirmation request;
- May consider responding too costly or time consuming;
- May have concerns about the potential legal liability resulting from responding;
- May account for transactions in different currencies; or

- May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.

(iii) The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Factors in determining whether external confirmation procedures are to be performed as substantive audit procedures: Majority of the examinees discussed with reference to SA 505, areas where external confirmation is required, positive and negative external confirmation request and design of the external confirmation request instead of writing correct points like the confirming party's knowledge of the subject matter, ability or willingness to respond and the objectivity of the intended confirming party.

SA 510 – Initial Audit Engagements – Opening Balances

Question 1

(Includes concepts of SA 705- Modification of Opinion in Auditor's Report)

In an initial audit engagement, the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements, which may materially affect the current financial statements. Advise, the auditor about the audit procedures to be followed, when financial statements are audited for the first time.

If, after performing the procedure, as an auditor you are not satisfied about the correctness of 'Opening Balances', what approach you will adopt in drafting your audit report? (MTP 6 Marks, Oct '19 & April 18, Old SM)

Answer 1

Audit Procedure for ensuring correctness of Opening Balances: As per SA 510 "Initial Audit Engagements- Opening Balances", the auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by -

a. Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;

b. Determining whether the opening balances reflect the application of appropriate accounting policies; and

c. By evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or performing specific audit procedures to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance.

Approach for drafting Audit Report: SA 705 establishes requirements and provides guidance on circumstances that may result in a modification to the auditor's opinion on the financial statements, the type of opinion appropriate in the circumstances, and the content of the auditor's report when the auditor's opinion is modified. The inability of the auditor to obtain sufficient appropriate audi t evidence regarding opening balances may result in one of the following modifications to the opinion in the auditor's report:

(i) A qualified opinion or a disclaimer of opinion, as is appropriate in the circumstances; or

(ii) Unless prohibited by law or regulation, an opinion which is qualified or disclaimed, as appropriate, regarding the results of operations, and cash flows, where relevant, and unmodified regarding State of Affairs.

If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with SA 705.

Question 2

You have been appointed as the auditor of Good Health Ltd. for 2017-18 which was audited by CA Trustworthy in 2016-17. As the Auditor of the company state the steps you would take to ensure that the Closing Balances of 2016-17 have been brought to account in 2017-18 as Opening Balances and the Opening Balances do not contain misstatements. (MTP 4 Marks, Aug 18)

Answer 2

As per SA 510 "Initial Audit Engagements—Opening Balances", in conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

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

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

Being new assignment audit evidence regarding opening balances can be obtained by perusing the copies of the audited financial statements.

For current assets and liabilities some audit evidence can ordinarily be obtained as part of audit procedures during the current period. For example, the collection/payment of opening balances of receivables and payables will provide audit evidence as to their existence, rights and obligations, completeness, and valuation at the beginning of the period.

In respect of other assets and liabilities such as fixed assets, investments long term debt, the auditor will examine the records relating to opening balances. The auditor may also be able to get confirmation from third parties (e.g., balances of long term loan obtained from banks).

Question 3

(Includes concepts of SA 580- Written Representations)

CA. Mack, a recently qualified practicing Chartered Accountant got his first audit assignment of Captura (P) Ltd. for the financial year 2017-18. He obtained all the relevant appropriate audit evidence for the items related to Statement of Profit and Loss. However, while auditing the Balance Sheet items, CA.

Mack left out obtaining appropriate audit evidence, say, confirmations, from the outstanding Accounts Receivable amounting Rs. 145 lakhs, continued as it is from the last year, on the affirmation of the management that there is no receipts and further credits during the year. CA. Mack, therefore, excluded from the audit programme, the audit of accounts receivable on the understanding that it pertains to the preceding year which was already audited by predecessor auditor. Comment.(MTP 5 Marks, Oct 18 & May 20)

Answer 3

Verification of Accounts Receivable: As per SA 510 "Initial Audit Engagements – Opening Balances", while conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether-

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

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

When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements.

Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures, say, the collection of opening accounts receivable during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In addition, according to SA 580 "Written Representations", the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements; in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent in relation to, or the completeness of, a specific assertion.

Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

AUDIT EVIDENCE

In the given case, the management of Captura (P) Ltd. has restrained CA. Mack, its auditor, from obtaining appropriate audit evidence for balances of Accounts Receivable outstanding as it is from the preceding year. CA. Mack, on believing that the preceding year balances have already been audited and on the statement of the management that there are no receipts and credits during the current year, therefore excluded the verification of Accounts Receivable from his audit programme.

Thus, CA. Mack should have requested the management to provide written representation for their views and expressions; and he should also not exclude the audit procedure of closing balances of Accounts Receivable from his audit programme.

Question 4

CA. Ashutosh has been appointed as an auditor of Awesome Health Ltd. for the financial year 2017-18 which was audited by CA. Amrawati in 2016-17. As the Auditor of Awesome Health Ltd., state the steps that CA. Ashutosh would take to ensure that the Closing Balances of the financial year 2016-17 have been brought to account in 2017-18 as Opening Balances and the Opening Balances do not contain any misstatements. (RTP Nov 18)

Answer 4

Obtaining sufficient appropriate audit evidence while conducting Initial Audit Engagement: According to SA 510 on "Initial Audit Engagements- Opening Balances", the objective of the Auditor while conducting an initial audit engagement with respect to opening balances is to obtain sufficient appropriate audit evidence so that the-

(i) opening balances of the preceding period have been correctly brought forward to the current period;

(ii) opening balances do not contain any misstatement that materially affect the current period's financial statements; and

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

Being a new assignment, audit evidence regarding opening balances can be obtained by perusing the copies of the audited financial statements.

For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures. For example, the collection/ payment of opening accounts receivable/accounts payable during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In respect of other assets and liabilities such as property plant and equipment, investments, long term debts, the auditor will examine the records relating to opening balances. The auditor may also be able to get the confirmation from third parties (e.g., balances of long term loan obtained from banks can be confirmed from the Bank Loan statement).

Question 5

(I) In an initial audit engagement, the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow in cases

(i) when the financial statements are audited for the preceding period by another auditor; and

(ii) when financial statements are audited for the first time.

(II) If, after performing the procedure, you are not satisfied about the correctness of 'Opening Balances'; what approach you will adopt in drafting your audit report in two situations mentioned in (I) above? (RTP May 21)

Answer 5

(i) Financial Statements Audited by another Auditor – Audit Procedure: If the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements such as supporting schedules to the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated.

(ii) Audit of Financial Statements for the First Time – Audit Procedure: When the audit of financial statements is being conducted for the first time, the auditor has to perform auditing procedures to obtain sufficient appropriate audit evidence. Since opening balances represent effect of transaction and events of the preceding period and accounting policies applied in the preceding period, the auditor need to obtain evidence having regard to nature of opening balances, materiality of the opening balances and accounting policies. Since it will not be possible for auditor to perform certain procedures, e.g., observing physical verification of inventories, etc. the auditor may obtain confirmation, etc. and perform suitable procedures in respect of fixed assets, investments, etc. The auditor can also obtain management representation with regards to the opening balances.

(ii) Drafting Audit Report: If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate. Further, If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion.

Question 6

Mr. X has been appointed as an auditor of M/s ABC Ltd., Mr. X wants to be satisfied about the sufficiency and appropriateness of 'Opening Balances' to ensure that they are free from misstatements. Lay down the audit procedure, Mr. X should follow, in the initial audit engagement of M/s ABC Ltd. Also suggest the approach to be followed regarding mention in the audit report if Mr. X is not satisfied about the correctness of 'Opening Balances'? (PYP 4 Marks, Nov '19)

Answer 6

Audit Procedures to be followed in case of initial audit engagement: As per SA 510, the auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:

(i) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;

(ii) Determining whether the opening balances reflect the application of appropriate accounting policies; and

(iii) Performing one or more of the following:

(1) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;

(2) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

(iv) Performing specific audit procedures to obtain evidence regarding the opening balances.

Approach to be followed regarding mention in the Audit Report: If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate. Further, If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Audit Procedures to be followed in case of Initial Audit Engagement - SA-510: Majority of the Examinees could not answer to the point and gave irrelevant answers besides many Examinees omitted the approach to be followed regarding mention in the Audit report.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

SKJ Private Ltd is engaged in the business of construction. The company has also got some real estate projects few years back on which it started the work in the last 2 years. The annual turnover of the company is INR 600 crores and profits of INR 40 crores.

The statutory auditors of the company got rotated by another audit firm due to mandatory audit rotation requirements as per the Companies Act 2013.

The new statutory auditors of the company started audit of the financial statements for the year ended 31 March 2019 in May 2019. The audit team also requested the client to provide certain information on the opening balances to perform their audit procedures. Initially the management did not provide any information to the auditors on the opening balances thinking that this is not within the scope of their work, however, after going through the auditing standards, the management agreed and provided the required information.

Later on, the audit team also started requesting information for the period from 1 April 2019 to 31 May 2019. With this requirement, CFO of the company got very upset and angry and set up a meeting with the senior members of the audit team. CFO raised a concern that the audit team has not been doing the work properly and has been asking for unnecessary information like information on opening balances and then the information for the period after 31 March 2019. The audit partner explained to the CFO that everything requested by the audit team has been as per the auditing standards, however, CFO said that in the earlier years, the previous auditors never asked for such information.

You are requested to give your view in respect of this matter.

(a) The requirement of the auditors for opening balances was valid but for the period after 31 March 2019 is completely wrong as that is out of their scope for the current year's audit. They can ask for those details during the audit of next year.

(b) The concern of the CFO was valid. He has seen the previous auditors not performing such audit procedures and hence the new audit team should also follow the same approach which was followed by previous auditors as that would lead to efficient in audit.

(c) The requirement of the auditors for opening balances as well as for the period after 31 March 2019 is valid. After the requirements of SA 510 and SA 560, audit team is required to perform these procedures.

(d) The audit team should set up a meeting with previous auditors wherein it should be assessed why different approach was followed by the previous auditors. On the basis of that discussion with the previous auditors, next course of action should be decided. (MTP 1 Marks, May 20)

Ans: (c)

AUDIT EVIDENCE

SA 530 – Audit Sampling

Question 1

Chintamani Ltd appoints Chintan & Mani as statutory auditors for the financial year 2021 - 2022.

Chintan & Mani seem to have different opinions on Audit approach to be adopted for audit of Chintamani Ltd. Mani is of the opinion that 100% checking is not required and they can rely on Audit Sampling techniques in order to provide them a reasonable basis on which they can draw conclusions about the entire population.

Chintan is concerned that whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

You are required to guide Chintan about his role if audit sampling has not provided a reasonable basis for conclusions about the population that has been tested in accordance with SA 530, .(RTP Nov'22, New SM)

Answer 1

As per SA 530, "Audit Sampling", the auditor shall evaluate:

(a) The results of the sample; and

(b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

(I) Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or

(II) Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Question 2

While conducting audit of PC Ltd., CA. T decided to use sampling technique to test the trade receivables at the planning stage. He directed his team members to divide the whole population of trade receivables balances to be tested in a few separate groups called 'strata'. He directed to treat each stratum as if it was a separate population and divided the trade receivables balances of PC Ltd. for the Financial Year 2022 -23 into groups on the basis of personal judgment as follows:

SI. No.	Particulars
1.	(a) Balances in excess of ₹ 50,00,000;
2.	(b) Balances in the range of ₹ 40,00,001 to ₹ 50,00,000;
3.	(c) Balances in the range of ₹ 30,00,001 to ₹ 40,00,000;
4.	(d) Balances in the range of ₹ 20,00,001 to ₹ 30,00,000;
5.	(e) Balances in the range of ₹ 10,00,001 to ₹ 20,00,000;
6.	(f) Balances ₹ 10,00,000 and below

From the above mentioned groups, CA. T directed to pick up different percentage of items for examination from each of the group. One of the team members, Mr. Neel, wants to use some other technique of sampling for the above purpose as the conceptof stratification is not clear to him. You are required to explain the concept of stratification and its uses to Mr. Neel.(PYP 5 Marks May '23)

Answer 2

Concept of Stratification: Stratification is the process of dividing a population into sub- populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

Uses of Stratification

1. Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.
2. When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.
3. The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population. For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).
4. If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

AUDIT EVIDENCE

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

While auditing Veer Ltd., CA. Vardhman divided the whole population of trade receivables balances to be tested in a few separate groups called 'strata' and started taking a sample from each of them.

He treated each stratum as if it was a separate population. He divided the trade receivables balances of Veer Ltd. for the Financial Year 2020-21 into groups on the basis of personal judgment as follows:

SI. No.	Particulars
1.	Balances in excess of ₹ 10,00,000;
2.	Balances in the range of ₹ 7,75,001 to ₹ 10,00,000;
3.	Balances in the range of ₹ 5,50,001 to ₹ 7,75,000;
4.	Balances in the range of ₹ 2,25,001 to ₹ 5,50,000;
5.	Balances ₹ 2,25,000 and below

From the abovementioned groups, CA. Vardhman picked up different percentage of items for examination from each of the groups, for example, from the top group i.e. balances in excess of ₹10,00,000, he selected all the items to be examined; from the second group, he opted for 25 % of the items to be examined; from the lowest group, he selected 2% of the items for examination; and so on from rest of the groups. Which one of the following methods of sample selection is he following?

(a) Systematic sampling.

(b) Stratified sampling.

(c) Section sampling.

(d) Selection sampling. (MTP 1 Mark Oct 21)

Ans: (b)

Question 2

Approach to sampling has the following characteristics:

I. Random selection of the sample items; and

II. The use of probability theory to evaluate sample results, including measurement of sampling risk.

(a) Statistical sampling

(b) Non-statistical sampling

(c) Stratified sampling

(d) Haphazard sampling (MTP 1 Mark March 22)

Ans: (a)

Question 3

You are an audit senior of Pendse Accountants and are currently conducting the audit of Stalwart Co for the year ended 31 March 2018. Below is an extract from the list of supplier statements as at 31 March 2018 held by the company and corresponding payables ledger balances at the same date along with some commentary on the noted differences:

	Supplier Statement Balance RS.	Payables ledger balance Rs.
AB Co	90,000	70,000
CD Co	1,85,000	1,15,000

AB Co: The difference in the balance is due to an invoice which is under dispute due to faulty goods which were returned on 29 March 2018.

CD Co: The difference in the balance is due to the supplier statement showing an invoice dated 27 March 2018 for Rs. 70,000 which was not recorded in the financial statements until after the year end.

The payables clerk has advised the audit team that the invoice was not received until 3 April 2018. The audit manager has asked you to review the full list of trade payables and select balances on which supplier statement reconciliations will be performed. Which of the following statement is correct in respect of including or excluding from your sample?

(a) Exclude with material balances at the year-end.

(b) Exclude suppliers which have a high volume of business with Stalwart Co

(c) Include major suppliers with nil balances at the year-end.

(d) Include suppliers where the statement agrees to the ledger (MTP 2 Marks, Mar 19)

Ans: (c)

Question 4

CA P, as part of a statutory audit exercise, is testing a company's internal controls over purchase orders it places for acquiring capital assets. The company places huge orders for the acquisition of capital assets every year, keeping in view the nature of its business and corresponding requirements.

While testing controls in a sample of purchase orders for the acquisition of capital assets, he failed to notice a lack of adherence to certain established parameters for placing such orders. The above situation is indicative of _______

(a) Sampling risk.

(b) Non-sampling risk.

(c) Control risk.

(d) Inherent risk. (MTP 1 Mark Oct '23)

Ans: (b)

SA 550 – Related Parties

Question 1

A firm of a father and a son is receiving Rs. 2 lakhs towards job work done for XYZ Ltd. during the year ended on 31.03.16. The total job work charges paid by XYZ Ltd. during the year are over Rs. 50 lakhs.

The father is Managing Director of XYZ Ltd. having substantial holding. The Managing Director told the auditor that since he is not involved in the activities of the firm and since the amount paid to it is insignificant; there is no need to disclose the transaction. He further contended that such a payment made in the last year was not disclosed. Advise whether Managing Director is right in his approach. (MTP 5 Marks, Aug '18)

Answer 1

Related Party Disclosures: As per definition given in the AS 18 "Related Party Disclosures" parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged.

In the instant case, the managing director of XYZ Ltd. is a partner in the firm with his son which has been paid Rs. 2 lakhs as job work charges. The managing director is having a substantial holding in XYZ Ltd. The case is squarely covered by AS 18. According to AS-18, in the case of related party transactions, the reporting enterprise should disclose the following:

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties."

Further, SA 550 on "Related Parties", also prescribes the auditor's responsibilities and audit procedures regarding related party transactions.

The approach of the managing director is not tenable under the law and accordingly all disclosure requirements have to be complied with in accordance with the AS 18. Auditor should insist to make proper disclosure as per the AS and if management refuses, the auditor shall have to modify his report. Also it has to be seen whether section 184 of the Companies Act, 2013 regarding disclosure of interest by director has been complied with. If it is not complied with, the auditor needs to modify the report.

Question 2

JY & Co. is appointed as auditor of Breeze Ltd. JY & Co. seeks your guidance for reviewing the records and documentation of the company regarding 'related party transactions in the normal course of business'.

Describe the steps to be followed. (MTP 4 Marks, Mar 19)

Answer 2

Review of Records and Documentation Regarding Related Party Transaction: According to SA 550 "Related Parties", during the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

(a) Bank, legal and third party confirmations obtained as part of the auditor's procedures;

(b) Minutes of meetings of shareholders and of those charged with governance; and

(c) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

The auditor may inspect records or documents that may provide information about related party relationships and transactions, for example entity income tax returns, information supplied by the entity to regulatory authorities, shareholder registers to identify the entity's principal shareholders, statements of conflicts of interest from management and those charged with governance, records of the entity's investments and those of its pension plans, contracts and agreements with key management or those charged with governance, significant contracts and agreements not in the entity's ordinary course of business, specific invoices and correspondence from the entity's professional advisors, life insurance policies acquired by the entity, significant contracts re - negotiated by the entity during the period, internal auditors' reports, documents associated with the entity's filings with a securities regulator etc.

Question 3

In the course of audit of QRT Ltd, its statutory auditor wants to be sure of the adequacy of related party disclosures? Kindly guide the auditor in identifying the possible source of related party information. (MTP 4 Marks, Oct 18)

Answer 3

Identification of possible sources for Related Parties' information: As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. However, it is the management, which is primarily responsible for identification of related parties. The duties of an auditor with regard to reporting of related party transaction as required by Accounting Standard 18 "Related Party Disclosures" is given in SA 550.

(i) SA 550 requires that to identify names of all known related parties, the auditor may inspect records or documents that may provide information about related party relations hips and transactions, for example entity income tax returns, information supplied by the entity to regulatory authorities, shareholder registers to identify the entity's principal shareholders, statements of conflicts of interest from management and those charged with governance, records of the entity's investments and those of its pension plans, contracts and agreements with key management or those charged with governance, significant contracts and agreements not in the entity's ordinary course of business, specific invoices and correspondence from the entity's professional advisors, life insurance policies acquired by the entity, significant contracts re-negotiated by the entity during the period, internal auditors' reports, documents associated with the entity's filings with a securities regulator (e.g., prospectuses).

(ii) Some arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions as an arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as the establishment of a business relationship through appropriate vehicles or structures, the conduct of certain types of transactions under specific terms and conditions or the provision of designated services or financial support.

Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include participation in unincorporated partnerships with other parties, agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business, guarantees and guarantor relationships etc.

(iii) Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement. In addition, the auditor needs to be alert for transactions which appear unusual in the circumstances and which may indicate the existence of previously unidentified related parties. Examples of transactions outside the entity's normal course of business may include complex equity transactions, such as corporate restructurings or acquisitions, transactions with offshore entities in jurisdictions with weak corporate laws, the leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged, sales transactions with unusually large discounts or returns, transactions with circular arrangements, for example, sales with a commitment to repurchase, transactions under contracts whose terms are changed before expiry etc.

(iv) Finally, the auditor should also obtain a written representation from the management concerning the completeness of information provided regarding the identification of related parties.

Question 4

You are the Auditor of Power Supply Corporation Limited, a Government Company for the year ended on 31st March 2018. The turnover of the Company for the period was `12,000 crores from sale of power.

During your audit, you found that the Company had procured Spares for Transmitters for `850 crores from abroad through a Corporation by name Procurement and Supply India Limited which is also owned and controlled by Government of India. The Financial Statements of the Power Supply Corporation Limited, prepared incompliance with Ind AS for the year ended on 31/03/2018 did not contain any additional disclosure regarding the procurement of spares as referred to above. To your query as to whether any disclosure regarding Related Party Transaction would be required, the Management of the Corporation replied that no such disclosure would be necessary for transactions between State Controlled Enterprises. Analyze this issue in finalizing the Audit Report. (PYP 5 Marks, Nov'18)

Answer 4

Related Party Disclosures : As per Ind AS24, "Related Party Disclosures", a reporting entity is exempt from the disclosure requirements in relation to related party transactions and outstanding balances, including commitments, with (i) a government that has control or joint control of, or significant influence over, the reporting entity; and (ii) another entity that is a related party because the same government has control or joint control of, or significant influence over, both the reporting entity and the other entity.

If a reporting entity applies the above exemption, it shall disclose the following about the transactions and related outstanding balances refer red to:

(1) The name of the government and the nature of its relationship with the reporting entity (i.e. control, joint control or significant influence);

(2) the following information in sufficient detail to enable users of the entity's financial statements to understand the effect of related party transactions on its financial statements:

(i) the nature and amount of each individually significant transaction; and

(ii) for other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent.

- Further, as per SA550 Related Parties, informing an opinion on the financial statements in accordance with SA700, the auditor shall evaluate whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.
- In the instant case, Power Supply Corporation Limited, a Government Company has procured spares for transmitters for rupees 850 crore from abroad through a corporation namely Procurement and Supply India Limited which is also owned and controlled by Government of India. Even after applying the exemption of Ind AS 24, Power Supply Corporation Limited has to disclose the matters specified above (i.e.name of Government, natures of its relationship with reporting entity, the nature and amount of transaction etc.). Contention of Management of Corporation regarding no requirement of disclosure for transactions between State Controlled Enterprise in not tenable.

EXAMINERS' COMMENTS ON THE PERFORMANCE OF EXAMINEES:

Related Party Disclosure: Examinees were generally aware about Ind AS 24 and related party concept but they were lacking in the knowledge of related party of government organisation.

Question 5

Mr. X, while conducting audit of PQR Ltd, comes across certain transactions which according to him are significant transactions with related parties and identified to be outside the entity's normal course of business. Guide Mr. X with examples of such transactions and to understand the nature of significant transactions outside the entity's normal course of business. (PYP 5 Marks, NOV-20)

Answer 5

In the given case of PQR Ltd, Mr. X, while conducting audit has come across certain significant related party transaction which are identified to be outside the entity's normal course of business. Mr. X wants guidance through examples of such significant transactions which are given in SA550

- As per SA550" Related Parties", examples of transactions outside the entity's normal Course of business may include:

1. Complex equity transactions, such as corporate restructurings or acquisitions.
2. Transactions with offshore entities in jurisdictions with weak corporate laws.
3. The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
4. Sales transactions with unusually large discounts or returns.
5. Transactions with circular arrangements, for example, sales with a commitment to repurchase.
6. Transactions under contracts whose terms are changed before expiry.

Question 6

JKL Limited is engaged in the business of Construction and real estate having various projects across states. M/s YT & Co, Chartered Accountants have been appointed as Statutory Auditors. Audit Team from M/s YT & Co for audit of JKL Limited comprises of CA Z-Engagement Partner, CA Q, a paid assistant and 3 Articled Assistants. During preliminary verification, CA Z observed that huge amount of sub-contract payments were made to M/s JB Associates, a partnership firm in which Director of JKL Limited is a managing partner. The engagement team discussed that SA 315 and SA 240 shall include specific consideration of the susceptibility

of the financial statements to material misstatement due to fraud or error that could result from the JKL Limited's related party relationships and transaction. Highlight the matters that are to be addressed in the discussion by CA Z with engagement team members with reference to the relevant Standard on Auditing. (PYP 5 Marks May '22)

Answer 6

As per SA 550 "Related Parties", the engagement team discussion that SA 315 and SA 240 require shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.

Accordingly matters that are to be addressed in the discussion by CA Z among the engagement team include:

1. The nature and extent of the entity's relationships and transactions with related parties (using, for example, the auditor's record of identified related parties updated after each audit).
2. An emphasis on the importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
3. The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (e.g., a complex organisational structure, use of special - purpose entities for off-balance sheet transactions, or an inadequate information system).
4. The records or documents that may indicate the existence of related party relationships or transactions.
5. The importance that management and those charged with governance attach to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirements), and the related risk of management override of relevant controls.
6. In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:
   (a) how special-purpose entities controlled by management might be used to facilitate earnings management.
   (b) how transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.

AUDIT EVIDENCE

Question 7

(Includes concepts of SA 260- Communication with those charged with governance)

Whilst the Audit team has identified few matters, they need your advice to conclude on the same. Engagement Partner have asked them to review the Board minutes and other secretarial/ regulatory records based on which the following additional matters were brought to the attention of the Partner:-

(i) The long term borrowings from the parent company has no written terms and neither the interest nor the principal has been repaid so far.

(ii) Certain computers were received from the parent company free of cost, the value of which is Rs. 0.23 lac and no accounting or disclosure of the same has been made in the notes to accounts.

(iii) An amount of Rs. 3.25 Lakhs per month is paid to M/s. WE CARE Associates, a partnership firm, which is a 'related party' in accordance with the provisions of the Companies Act, 2013 for the marketing services rendered by them. Based on an independent assessment, the consideration paid is higher than the arm's length pricing by Rs.0.25 Lakhs per month. Whilst the transaction was accounted in the financial statements based on the amounts' paid, no separate disclosure of this related party transaction has been made in the notes to accounts forming part of the financial statements highlighting the same as a 'related party' transaction.

Audit Manager has reported that she had asked certain information relating to another 'related party' transaction (amounting to approx. Rs. 47 lac) but the CFO refused to provide the same since the same is perceived to be confidential and cannot be shared with the Auditors.

You are required to advise about items to be reported to those charged with governance, where applicable, based on your audit findings in the given situation. (MTP 5 Marks, Oct 20)

Answer 7

As per SA 550, Related Parties, communicating significant matters arising during the audit in connection with the entity's related parties helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters. Examples of significant related party matters include, non-disclosure (whether intentional or not) by management to the auditor of related parties or significant related party transactions, which may alert those charged with governance to significant related party relationships and transactions of which they may not have been previously aware; The identification of significant related party transactions that have not been appropriately authorized and approved, which may give rise to suspected fraud; etc.

It may be noted that unless all of those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance significant matters arising during the audit in connection with the entity's related parties.

The auditor is also required to ensure the compliance of Ind AS 24 / AS 18 Related Party Disclosures. In view of above in the given scenario, the auditor is required to prepare a brief summary of following items to be reported to those charged with governance in accordance with SA 260 Communication with Those Charged with Governance:

a. One of related party transaction amounting 3.25 lac per month i.e. in lieu of marketing services has been noticed of which amount Rs. 0.25 lac per month is exceeds the arm's length price has not been disclosed highlighting the same as related party transactions as per Ind- AS 24 / AS 18 Related Party Disclosures.

b. Refusal by CFO of the company to provide the details of related party transaction amounting to rupees 47 lac on the ground that same is perceived to be confidential and cannot be shared with auditors, is not in order, as denying for the related part details of Rs. 47 lac is imposing limitation of scope of auditor in view of SA 705.

c. Receipt of free of cost Computers and long-term borrowing (on no agreed terms and repayment of interest and principal) from the Parent Company need separate disclosure in financial statements as per Ind AS 24 / AS 18 Related Party Disclosures.

Further, in case of all the above cases, the auditor would also need to assess his reporting requirements under the clauses (xiii) of Paragraph 3 of CARO 2020 with respect to related party transactions that whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable Accounting Standards.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

M/s Ram Raj & Associates have been appointed as statutory auditors of Venus Ltd. for the FY 2019 - 20. During the year, the company has entered into some related party transactions. CA Ram, the engagement partner has taken a management representation letter regarding the proper accounting, presentation and disclosure of such related party transactions. Is there any further responsibility of CA Ram with respect to the other procedures to be performed for related party transactions?

(a) No, there is no further responsibility of CA Ram as the best audit evidence for the related party transaction is the management representation letter.

(b) No, there is no further responsibility of CA Ram as the audit firm is responsible for verifying the balances and disclosure of related party transactions. The identification of related party transactions is the responsibility of the management of Venus Ltd.

(c) Yes, the audit firm has the responsibility to perform the audit procedures to identify, assess and respond to the risk of material misstatement arising from the entity's failure to appropriately account for related party relationships, transactions and balances, and obtaining merely management representation letter can be considered to be sufficient appropriate audit evidence.

(d) Yes, the auditor has the responsibility to detect fraud and error with respect to the related party transactions. (MTP 1 Marks, Oct 20)

Ans: (c)

Question 2

As per SA 550 on Related Parties, existence of which relationship indicate the presence of control or significant influence?

(a) Friend of a family member of a person who has the authority and responsibility for planning.

(b) Holding debentures in the entity.

(c) The entity's holding of debentures in other entities.

(d) The entity's holding of equity in other entities. (MTP 1 Mark Oct 21)

Ans: (d)

Question 3

XYZ & Associate Chartered Accountants were appointed auditors for Weknow LLP. The engagement manager of the audit team, while designing the auditor response to assessed risk, concluded that there are no requirements of the applicable financial reporting framework for disclosing the related party transaction in the Firm's Financial Statement and hence the audit team is not required to perform any audit procedures with respect to identification and disclosure of related party relationship and transaction in financial statement. You as an engagement partner guide the engagement manager by selecting the appropriate response from below:

(a) Even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions and should sufficiently be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions achieve a true and fair presentation and are not misleading.

(b) If the applicable financial reporting framework establishes minimal or no related party requirements, then the auditor is not required to obtain an understanding of the entity's related party relationships and transactions.

(c) Even if the applicable financial reporting framework establishes minimal or no related party requirements, the auditor nevertheless needs to obtain an understanding of the entity's related party relationships and transactions and should sufficiently be able to conclude whether the financial statements, as a whole, are free from all the material related party transactions.

(d) Because related parties are not independent of each other, hence auditor can obtain the written representation from the Related Party's auditor regarding the accuracy and completeness of the related party transactions disclosed in Firm's Financial Statement. This should only be carried where the applicable financial reporting framework establishes minimal or no related party requirements. (MTP 1 Mark Nov 21)

Ans: (a)

Question 1

Coccyx Ltd. supplies navy uniforms across the country. The company has 3 warehouses at different locations throughout the India and 5 warehouses at the borders. The major stocks are generally supplied from the borders. Coccyx Ltd. appointed M/s OPAQE & Co. to conduct its audit for the financial year 2022-23 Mr. P, partner of M/s OPAQE & Co., attended all the physical inventory counting conducted throughout the India but could not attend the same at borders due to some unavoidable reason.

You are required to advise M/s OPAQE & Co.,

I. How sufficient appropriate audit evidence regarding the existence and condition of inventory may be obtained?

II. How is an auditor supposed to deal when attendance at physical inventory counting is impracticable?

Answer 1

(I) Special Consideration with Regard to Inventory: per SA 501 "Audit Evidence- Specific Considerations for Selected Items", when inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

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

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

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

(iii) Inspect the inventory; and

(iv) Perform test counts; and

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

Attendance at Physical Inventory Counting Not Practicable: In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

Further, where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the

AUDIT EVIDENCE

physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

In some cases, though, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, SA 705 on Modifications to the Opinion in the Independent Auditor's Report, requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.

Question 2

GHK Associates, Chartered Accountants, conducting the audit of PBS Ltd., a listed company for the year ended 31.03.2023 is concerned with the presentation and disclosure of segment information included in Company's Annual Report. GHK Associates want to ensure that methods adopted by management for determining segment information have resulted in disclosure in accordance with the applicable financial reporting framework. Guide GHK Associates with 'Examples of Matters' that may be relevant when obtaining an understanding of the methods used by the management with reference to the relevant Standards on Auditing.

Answer 2

The auditors, GHK Associates wanted to ensure and obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by obtaining an understanding of the methods used by management in determining segment information. SA 501 guides in this regard. As per SA 501- "Audit Evidence—Specific Considerations for Selected Items", example of matters that may be relevant when obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework include:

(i) Sales, transfers and charges between segments, and elimination of inter-segment amounts.

(ii) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.

(iii) The allocation of assets and costs among segments.

(iv) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

Question 3

Chintamani Ltd appoints Chintan & Mani as statutory auditors for the financial 2022- 2023. Chintan & Mani seem to have different opinions on Audit approach to be adopted for audit of Chintamani Ltd. Mani is of the opinion that 100% checking is not required and they can rely on Audit Sampling techniques in order to provide them a reasonable basis on which they can draw conclusions about the entire population.

Chintan is concerned that whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

You are required to guide Chintan about his role if audit sampling has not provided a reasonable basis for conclusions about the population that has been tested in accordance with SA 530.

Answer 3

As per SA 530, "Audit Sampling", the auditor shall evaluate:

(a) The results of the sample; and

(b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

If the auditor concludes that audit sampling has not provided a reasonable basis for conclusions about the population that has been tested, the auditor may:

(I) Request management to investigate misstatements that have been identified and the potential for further misstatements and to make any necessary adjustments; or

(II) Tailor the nature, timing and extent of those further audit procedures to best achieve the required assurance. For example, in the case of tests of controls, the auditor might extend the sample size, test an alternative control or modify related substantive procedures.

Question 4

During the audit of Star Ltd. a company engaged in the production of paper the auditor received certain confirmation for the balances of trade payables outstanding in the balance sheet through external confirmation by "Negative Confirmation Request". In the list of trade payables, there are number of small balances except one which is an old outstanding of` 20 lakhs for which no confirmation was received.

Comment with respect to Standards of Auditing relating to the confirmation process and how to deal the non receipt of confirmation.

Answer 4

External Confirmation: As per SA 505, "External Confirmation", negative confirmation is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations.

The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request.

Accordingly, a failure of a confirming party to respond to a negative confirmation request provides significantly less persuasive audit evidence than does a response to a positive confirmation request.

AUDIT EVIDENCE

Confirming parties also may be more likely to respond indicating their disagreement with a confirmation request when the information in the request is not in their favor, and less likely to respond otherwise.

In the instant case, the auditor sent the negative confirmation requesting the trade payables having outstanding balances in the balance sheet while doing audit of Star Limited. One of the old outstanding of ` 20 lakh has not sent the confirmation on the credit balance. In case of non-response, the auditor may examine subsequent cash disbursements or correspondence from third parties, and other records, such as goods received notes. Further non-response for negative confirmation request does not means that there is some misstatement as negative confirmation request itself is to respond to the auditor only if the confirming party disagrees with the information provided in the request.

Question 5

During the course of the audit of TK Home Private Limited, a recognized export house engaged in manufacturing of T-shirts under brand name of "TK". CA Tripti is verifying export revenues of the company for the year 2022-23. She has verified transactions entered in "Export Sales" account maintained in accounting software from relevant export invoices. The export sales are being made on payment of IGST, for which a refund is automatically credited in the account of the company after the goods are shipped.

On enquiring from internal audit staff regarding the recognition of export revenues, she is told that export sales are recognized for the year on the basis of "Bills of Lading". However, she is not convinced with such a response and feels that the same does not appear to be proper.

She finds that three export invoices bearing dates in the month of March 2023 having a value of ` 75.00 lacs have not been recognized in export revenue on the ground that bills of lading for these invoices were issued in the month of April 2023.

Discuss from what sources she can obtain reliable audit evidence in this regard. How can she challenge management's assertion regarding the completeness of export revenues for the year 2022-23?

Answer 5

She can obtain reliable audit evidence by going through GST returns filed by the company on GST portal and correlating the same with e-way bills. She can obtain audit evidence about how company has reflected its export sales in its GST returns and whether export sales pertaining to three invoices having value of ` 75.00 lacs are reflected in such returns.

Further, e-way bills generated on the portal would provide evidence that goods have moved out of the company's premises. The export revenue should have been booked at the time the goods moved out of the company's premises. The company is claiming an IGST refund. The refund is linked to the monthly sales return. This aspect can also be verified.

"Bill of Lading" is only a document issued by the carrier to the shipper of goods that goods have been taken on board. She should challenge and counter management's assertion on the above grounds and point out violations of relevant accounting standards and principles. In this way, she can obtain reliable audit evidence.

Highlighting such digital and other evidence, she can challenge management's assertion regarding the completeness of export revenues and point out that export revenues are understated.

Question 6

CA Prabhjot has planned observing the physical count of inventories at the plant of a company located in remote area in the state of Uttarakhand as part of a statutory audit exercise as at close of year ending 31st March 2023. He has already informed the management of his intention to reach the plant site by evening of 29th March 2023. He plans to inspect inventories, observe the counting process and perform test counts among other matters.

The management has made all necessary arrangements to facilitate the above exercise. However, an agitation in Himalayan hills has started on 28th March 2023 for the promulgation of a strict law relating to the conversion of agricultural land for commercial use. Many civil society groups are participating in the agitation. NH-7 leading to the plant site is blocked by protestors. The plant is not accessible through any other mode. The blockade is lifted after one month when state government announced the formation of a committee to look into protestors' demands.

Does the above case highlight to a situation of "impracticability of attendance" at inventory counting in terms of requirements of SA 501?

How should the auditor proceed in above situation?

Answer 6

The above situation does not highlight the impracticability of attendance at inventory counting. It only shows that the auditor is unable to attend physical inventory counting due to unforeseen circumstances arising out of agitation by protestors. It has led to the inaccessibility of the plant site for a month. The blockade is lifted after a month.

SA 501 states that if the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date and perform audit procedures on intervening transactions. Therefore, the audit should attend to the physical inventory count after the blockade is lifted and perform audit procedures on intervening transactions.

Question 7

On reviewing legal expenses account of Zed Ltd., CA. Sunitha, auditor of company, finds that legal fees amounting to ` 10 lac was paid to B. George, a reputed lawyer, during the year 2022-23. On inquiry with management regarding the purpose of such expenditure, evasive reply was received from management stating that a lot of work is performed by the said lawyer on behalf of the company. However, no specific details were provided.

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She finds it proper to correspond directly with the lawyer. She obtains the address and mail id of the lawyer from his professional services bill. She shoots off an inquiry letter asking for the nature and status of litigation claims against the company on her letterhead.

Is her approach proper? Irrespective of the merits of the approach followed by her, what she is trying to achieve by corresponding with lawyer of the company?

Answer 7

SA 501 states that when audit procedures performed indicate that material litigation or claims may exist, the auditor shall seek direct communication with the entity's external legal counsel. The auditor shall do so through a letter of inquiry prepared by management and sent by the auditor, requesting the entity's external legal counsel to communicate directly with the auditor.

Therefore, her approach in communicating with an external lawyer is wrong. She has to make management aware of her intention to communicate directly with the lawyer. The letter of enquiry has to be prepared by management and sent by her.

Her purpose in corresponding with the lawyer of the company is to identify litigation and claims involving the entity which may give rise to a risk of material misstatement. It is due to the reason that litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

Question 8

On going through financial statements and records of "TS Ltd.," during the course of statutory audit, CA Tanmaya finds that substantial inventories of the company consisting of mast lighting poles remain with "Super Industries" for certain finishing works. While planning audit procedures, he had planned about seeking confirmation from "Super Industries" regarding existence and condition of such mast lighting poles belonging to TS Ltd. lying with them as on 31st March, 2023.

However, the premises of "Super Industries" were raided by DGGI officials (Director General of GST Intelligence) in connection with the busting of a fake billing scam. The proprietor of the firm was arrested in November 2022 and came out on bail in the month of March 2023. The details of proprietor and his firm were flashed prominently in local newspapers of the city where company is located. CA.

Tanmaya also belongs to the same place. Discuss how he should proceed in the above matter as auditor of TS Ltd.

Answer 8

SA 501 states that when inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

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

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

It further states that where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party.

Examples of other audit procedures include:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.
- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties
- In the given case, the integrity of the third party appears to be doubtful in view of DGGI raids and his possible involvement in a fake billing scam. He has already been behind bars.
- Keeping in view above, besides obtaining confirmation from such party, he may attend a third party's physical counting or ask some other auditor to attend physical counting as on reporting date, depending upon practical considerations. He can also inspect the record of goods sent and received back from such party by tracing it to challans, e-ways bills etc. and correlate the above information.

Question 9

As auditor of Groom Limited, you have sent positive confirmation requests to 30 creditors of the company in March 2023. All of the creditors in informal sector are small concerns. You choose to send positive confirmation requests to all the above parties at their business addresses stated on respective bills after discussing the matter with CFO of the company. The CFO is cooperative and does not raise any hassles in the matter.

Responses to confirmation requests are received within a week's time. Your articled clerk informs you that out of above 30 creditors, GST registrations of 25 concerns have been cancelled during financial year 2022-23 itself by collating information from GST portal. He further informs you that there are no fresh registrations pertaining to PANs of these parties.

How you would proceed to deal with the situation as auditor of the company?

Answer 9

SA 505 states that if the auditor determines that a response to a confirmation request is not reliable, the auditor shall evaluate the implications on the assessment of the relevant risks of material misstatement, including the risk of fraud, and on the related nature, timing and extent of other audit procedures.

In the instant case, GST registrations of 25 concerns have been cancelled in the year 2022-23. It indicates that businesses on those addresses were closed. Further, there are no fresh registrations pertaining to the PANs of these parties. However, the auditor sent external confirmation requests in March 2023, which were duly responded. It raises questions on the reliability of responses received.

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

• Was received by the auditor indirectly or

• Appeared not to come from the originally intended confirming party.

Keeping in view the circumstances described in the case situation, there is a risk that the response has not come from the originally intended confirming party.

Unreliable responses may indicate a fraud risk factor that requires evaluation.

Question 10

CA M. Hussain is appointed auditor of a firm for year 2022-23 on 31st July, 2022. The accounts of firm were unaudited in year 2021-22. The firm had material inventories reflected in its financial statements even as on close of 31st March, 2022.

He is performing audit procedures, including attending physical inventory count as on 31st March, 2023.

However, there is a lingering doubt in his mind regarding opening inventories reflected in financial statements.

Does there exist any responsibility on his part in such a situation?

Answer 10

SA 510 states that in conducting an initial audit engagement, one of the objectives of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether opening balances contain misstatements that materially affect the current period's financial statements. The auditor has to evaluate whether audit procedures performed in the current period provide evidence relevant to the opening balances or specific audit procedures are required to be performed to obtain evidence regarding the opening balances.

In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

• Observing a current physical inventory count and reconciling it to the opening inventory quantities.

• Performing audit procedures on the valuation of the opening inventory items.

• Performing audit procedures on gross profit and cut-off.

Question 11

CA. Ritesh Deshpande has drawn some samples during the course of audit of a manufacturing company for testing controls as well as for tests of details. On the basis of the samples selected, he reaches an erroneous conclusion that access controls on applications are less effective.

Further, on the basis of samples selected, he concludes erroneously that work-in progress inventories amounting to ` 5 crore in financial statements are materially misstated.

Outlining the above risk involved, discuss how it is going to affect his audit of the company.

Answer 11

The described risk is sampling risk. It is a risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. In the given case, the auditor has arrived at erroneous conclusions on the basis of the samples selected. In the case of a test of controls, he has concluded that access controls are less effective than they actually are.

In the case of a test of details, he has concluded erroneously that a material misstatement exists when in fact, it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Question 12

"Living Well Private Limited" is engaged in the manufacturing and export of floor coverings. Such products are labor-intensive and do not require much of capital investment in machinery. The company has no plans to diversify in other product lines. Its directors are also holding significant interest in another company "My Living Private Limited" engaged in manufacturing of blankets using capital intensive machinery.

During the course of the audit of "My Living Private Limited", it was noticed by you that the company has sold machinery of ` 1 crore to "Living Well Private Limited" during the year. The transaction has been done at normal market rates applicable to such used machinery.

How do you view the above transaction as auditor of "My Living Private Limited"?

Answer 12

In respect of significantly related party transactions outside the normal course of business of an entity, it is the responsibility of the auditor, in accordance with SA 550, to evaluate the business rationale or lack thereof of transactions that may have been entered to indulge in fraudulent financial reporting or conceal misappropriation of assets.

The auditor has to seek to understand the business rationale of such a transaction from a related party's perspective. It would help him understand the economic reality of such a transaction and why it was carried out.

In the given situation, there is no primary rationale for such a transaction. Living Well Private

Limited does not manufacture blankets, and the purchase of part of old machinery pertaining to blanket manufacturing has no rationale for it primarily. A business rationale from the related party's perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

Integrated Case Scenario

Black & White Ltd. is into the business of manufacturing readymade garments in Amritsar. It procures all the raw material required for its production from Punjab, Himachal Pradesh & J&K. Its sales market, however, covers almost all the northern parts of the country. CA Anu is the engagement partner of Maheshwari & Co appointed as the statutory auditor of the company. She calls for a meeting of the engagement team to delegate work and responsibilities. During the audit, the engagement team comes across the following facts: -

Woolen Private Limited is one of the vendors of the company from which the company has been purchasing wool for many years on a current account basis, but no single purchase has been made in the last nine months, and the outstanding balance stands as it is in the books of accounts. CA Anu wants to confirm the balance and requests the CFO of the company for sending a balance confirmation request to Woolen Private Ltd., to which he refuses and is not willing.

The Fashion Jingo Ltd. is one of the customers of the company and hasn't replied to CA Anu's positive balance confirmation request sent.

Mr. X, one of the fashion designers, had sold his designs to the company but owing to a dispute, the contract got cancelled, and now both the parties are under litigation in the local court of law. The engagement team is guided as to the procedures to be designed and performed to identify this matter.

CA Anu simultaneously seeks direct communication with the company's external legal counsel sensing the risk of material misstatement. However, it ends up in vain as the external legal counsel, Mr. Chadha, refuses to comment. She is unable to obtain sufficient appropriate audit evidence in this regard through alternative audit procedures either.

The team documents all the relevant information w.r.t. the above facts, and CA Anu issues the audit report accordingly.

1. Fashion Jingo Ltd. has not responded to CA Anu's request. What should be proper course of action for her in such a situation?

(a) Perform alternative audit procedures

(b) Consider it as a negative confirmation

(c) Give a Qualified opinion

(d) Should visit the customer company premises herself and confirm the balance on the spot.

Ans: (a)

2. With respect to advocate Chadha's cold shoulder to CA Anu's request, what she should do?

(a) Modify her audit opinion

(b) Give an unqualified opinion

(c) Give a disclaimer of opinion

(d) Withdraw from this engagement

Ans: (a)

3. What should be CA Anu's first and foremost response in the case of request made relating to balance confirmation from Woolen Pvt. Ltd.?

(a) Perform alternate audit procedures.

(b) Withdraw from the engagement.

(c) Communicate with Those charged with Governance telling the effects on his audit opinion.

(d) Inquire as to the reasons behind the management's response and seek audit evidence as to its validity and reasonableness

Ans: (d)

4. Which of the following procedures will not be performed by the engagement team as audit procedures while dealing with the case of Mr. X?

(a) Inquiry of Management.

(b) Inquiry of Mr. X

(c) Reviewing Minutes of Meetings

(d) Reviewing Legal expenses account

Ans: (b)

Case Study 1

Honest Specialty Chemicals Private Limited is a ` 1,000 crore turnover company having plants in Khopoli, Mahad, and Ankles war for manufacturing various products for fertilizer units, cosmetics and paint industry,etc. The company has built up a good reputation, and apart from the domestic market, it exports to the European market and the Middle East. The company is a closely held company owned by three friends and their family members. The types of materials handled and produced are hazardous.

Following further latest information relating to the company is as under: -

- **The company needs to import the key raw materials and is exposed to high risk of price fluctuations and currency risks.**
- **The company carries high inventory due to the long import cycle and seasonal sales pattern.**
- **The working capital is almost 60% blocked in inventory and rest in receivables.**
- **The company has huge investments in plant and machinery financed through term loans from financial institutions.**
- **Since the company has large imports, it buys import licenses from the open market.**
- **The company has received customs notices about using fake licenses for importing materials without paying duty. The company has filed an appeal against the said notice and the same is pending with the Appellate Tribunal. The amount involved is material and, along with interest and penalty, could be more than 10% of turnover.**
- **The company has liquid chemicals stored in huge tanks.**
- **The powdered form of chemicals is stored in standard-sized drums**
- **Few items of stocks like coal, Sulphur are lying in the open area.**
- **The company has huge domestic sales on a consignment basis, and vast quantities of finished inventories are lying with the consignees across India.**
- **The company has received an order from NGT to pay a fine of INR 1.5 crores for the emission of toxic chemicals in the air and water. The company has filed an appeal against the said order.**
- **The type of plant is such that it has to be a continuous process, and at any time, huge quantities of materials are in process.**
- **Raw Materials are stored in huge tanks located 2 kilometers from the plant, and to transport the chemicals (liquid), there is a network of pipes connecting them, and at any point in time, there are huge quantities of materials lying in the pipeline.**
- **The company has prepared its inventory details by involving a management expert.**
- **During the year, the previous auditor resigned, and a new auditor got appointed.**

Based on the case study, please advise the auditor on the important aspects of carrying out the audit procedures to obtain sufficient appropriate audit evidence in respect of the following: -

Question 1

Which audit procedures are required for verifying existence and condition of company's inventories with specific reference to its nature operations?

Answer 1

The auditor needs to obtain sufficient appropriate audit evidence regarding existence and condition of inventory.

For the above, the auditor needs to do all the following: -

(a) Attendance at physical inventory counting to:

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

- The existence of appropriate control activities: collection of used physical inventory count records, accounting for unused physical inventory count records, count and recount procedures.
- The accurate identification of the stage of completion of work-in- progress, of slow moving, obsolete, or damaged items and of inventory lying in tanks, in pipes and in open areas.
- The procedures used to estimate physical quantities, for liquid chemicals lying in process, tanks, pipelines, in open areas like coal pile, sulphur pile, etc.
- Control over the moment of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.

(b) Observe the performance of Management's count procedure by observing the control over the movement of inventory before, during and after the count to determine adequacy and effectiveness of count procedure.

(c) Inspect the inventory to assist in identifying obsolete, damaged or ageing of inventory.

(d) Perform the test counts to obtain the sufficient appropriate audit evidence

(i) By tracing items selected from the physical inventory to management's count records,

(ii) By obtaining copies of Management's completed physical inventory count records

(e) Cross matching the final inventory records with the actual inventory count results.

Question 2

The company has prepared inventory details by involving a management's expert. Elaborating upon its rationale, discuss responsibilities of auditor in regard to information prepared by company involving such an expert.

Answer 2

The company deals with specialty chemicals which are in liquid condition, powdered condition, lying in the huge tanks or in plants under process, lying in pipelines or lying in open areas like coal and

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sulphur. The unit of measurement for each of the above categories may be different and could involve technical and mathematical principles involving technical and scientific expertise. Keeping these matters in view, inventory details have been prepared by involving management's expert.

When information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, having regard to the significance of that expert's work for the auditor's purposes:

a. Evaluate the competence, capabilities and objectivity of that expert

b. Obtain an understanding of the work of that expert and

c. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

Question 3

What additional procedures does the auditor need to carry out in respect of stocks lying with consignees all over the country?

Answer 3

Apart from obtaining the confirmation from the third party as to the quantities and condition of the inventory held on behalf of the entity, the auditor may perform the following other audit procedures:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory,
- Obtaining another auditor's report or a service auditor's report on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties

Question 4

What procedures should the auditor need to undertake for litigation matters?

Answer 4

The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity by: -

- Inquiry of management and, where applicable, others within the entity including in- house legal counsel.
- Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel.
- Reviewing legal expense account.

The legal claims involving customs and fine of NGT are material. In such circumstances if auditor assesses risk of material misstatements regarding litigation, he can seek letter of specific inquiry from the external legal counsel including: -

- A list of litigation and claims
- Where applicable, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including cost involved and
- A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered incomplete or incorrect.
- The auditor may seek meeting with the external legal counsel if the matter is having significant risk, it is complex or there is disagreement between management assertion and legal counsel's views.
- Obtaining written representation from the management and where appropriate those charged with governance that all the known actual or possible litigation and claims whose effects should be considered when preparing the financial statement have been disclosed to the auditor and appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

(MCQS)

1) The objectivity of the management's expert is likely to be lesser if:

a) The expert is competent

b) The expert is capable

c) The expert has relevant experience

d) The expert is employed by the entity

Ans: (d)

2) Which of the following matters is irrelevant for auditor in planning attendance at physical inventory counts?

(a) Nature of inventory

(b) The timing of physical inventory counting

(c) The nature of the internal control related to inventory

(d) Whether 100% of inventory is covered in the count

Ans: (d)

3) External confirmations receivables are not reliable in which of the following situations:

(a) The response directly received by the auditor

(b) The confirmation has come from the address of the confirming party

(c) The confirmation is signed by the plant manager

(d) The confirmation is positive confirmation

Ans: (c)

4) The new auditor planned certain procedures with respect to opening balances. Which of the following procedures is not in accordance with SA 510?

(a) Reading the most recent financial statements and audit report

(b) Where the prior period report is modified, the impact on the current period

(c) Correctly bringing forward of prior period closing balances

(d) Ascertaining whether predecessor auditor had attended physical inventory count

Ans: (d)

Case Study 2

"Trustworthy Real Estate Private Limited" Mr. Bharose Lal as MD along with his wife, Maya, owned the company.

The company had floated one SPV "Real Trust Developers Private Limited" which a foreign entity became a Joint Venture partner with a 50% stake.

The venture was formed with its Head Office in Mumbai to invest in SRA projects (Slum rehabilitation authority) and develop them into commercial units for sale.

Mr. Bharose Lal was going through a rough patch in his life. He was in financial difficulty and had mounting dues and huge outstanding exposure to banks and suppliers in his companies. Mrs. Maya was from a very wealthy family and had fallen in love with Mr. Bharose Lal, who was from a middle-class family. Mrs. Maya had an expensive lifestyle and was always short of funds to maintain her lifestyle. Mr. Bharose Lal sensed a golden opportunity in the new venture because the foreign partner had no knowledge of Indian regulations and how the SRA projects worked and was solely dependent on the local partner to get all the permissions, scouting for the projects, getting consents from the slum dwellers for the project, giving contracts for the construction of projects and such matters.

M/S ABC and Company, Chartered Accountants were appointed as the auditor of the joint venture, and the engagement team was headed by CA Sceptic, who had, in his stint with the firm, was instrumental in unearthing two major frauds and had the ability to sniff out any such scenarios.

Mr. Bharose Lal has a dominant personality and a powerful influence on functioning, and everybody looks to him for guidance. The governance structure was very poor in the organization, and Mr. Bharose Lal used to dictate the decisions. Even though as part of the Joint Venture, there was a detailed governance structure and policies and procedures in place for the decision-making process at the joint venture. However, the representative on the board of the Joint Venture of the foreign partner who had shifted to India to supervise the SRA project had grown friendly with Mr. Bharose Lal, and Mr. Bharose Lal had even gone out of the way to help him get good accommodation and second- hand Mercedes. Often, they both go to a club in the evening for a drink.

The dealings in the SRA project are not very transparent and above board but are very opaque. Given the above situation, CA Sceptic wants to discuss with the audit team areas and situations where risk of material misstatement is possible and there are chances of having an undisclosed related party relationship to misappropriate the funds.

Question 1

Please guide the engagement team on the further course of action as per SA 550.

Answer 1

The engagement team shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions. - The nature and extent of the entity's relationships and transactions with related parties as identified independently by the Auditor by verification of MBP-1 data and data available on MCA website relating to directors and companies, etc.

- An emphasis on the importance of maintaining Professional Skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.
- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor (e.g., a complex organizational structure, use of special purpose entities off-balance sheet transactions, or an inadequate information system).
- The records or documents that may indicate the existence of related party relationships or transactions.
- The importance of management and those charged with governance attached to the identification, appropriate accounting for, and disclosure of related party relationships and transactions (if the applicable financial reporting framework establishes related party requirement), and the related risk of Management override of relevant controls.
- In addition, the discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example:

(a) How special-purpose entities controlled by management might be used to facilitate earnings management

(b) How transaction between the entity and known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind through out the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

Question 2

What are fraud risk factors in given case?

Answer 2

The fraud risk factors are the events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

The fraud risk factors are classified based on the three conditions that are generally present when fraud exists:

(i) An incentive or pressure to commit fraud

(ii) A perceived opportunity to commit fraud

(iii) An ability to rationalize the fraudulent action.

In the given case scenario following fraud risk factors can be segregated in the 2 conditions of incentive or pressure to commit fraud in a perceived opportunity to commit fraud.

1) An incentive or pressure to commit fraud:

- Financial difficulty with huge outstanding dues towards vendors and Financial Institutions.
- Expensive lifestyle.
- Requirement to fund ` 5 crore as equity contribution in the SPV.

2) A perceived opportunity to commit fraud:

- Dependency of the foreign partner and no knowledge of the foreign partner of local laws and the SRA business model in India
- The risk is due to the way the real estate industry functions and particularly risk due to the SRA business model.
- Dominant personality of MD, which can lead to management override of controls for undisclosed business relationships with M/s. Useless and Sons (P) Ltd.

Question 3

Given the situation that each partner in the joint venture has to bring into the entity a contribution of 5 crores each and given the situation that Mr. Bharose Lal had appointed one agency, the name Useless & Sons Private Limited to get consent from the slum dwellers, for which the agency was paid 20 crores as Kitty to get the job done.

CA Sceptic inclines that there is some connection between the 20 crores paid and, simultaneously, within a short span, the infusion of INR 5 crores as equity contribution by Mr. Bharose Lal.

Please guide CA Sceptic in establishing this link based on the guidance available in SA 550 and SA 240.

What additional audit procedures does his team need to undertake for the conclusion?

Answer 3

If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditors, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.

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In such situations, the auditor shall:

- Promptly communicate the relevant information to the other members of the engagement team in order to assist them in determining whether this information affects the results of and conclusions drawn from risk assessment procedures already performed, including whether the risk of material misstatement needs to be reassessed.
- Where the applicable financial reporting framework establishes related party requirements:

i. Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and

ii. Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of the related party relationships or transactions;

- Perform appropriate substantive audit procedures relating to such newly identified related parties or significant related party transactions.
- Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclose to the auditor, and perform additional audit procedures as necessary; and
- If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit. In such cases, the requirements and guidance in SA-240 regarding the auditor's responsibilities relating to fraud in an audit of financial statements are relevant where management appears to have intentionally failed to disclose related parties or significant related party transactions to the auditor. The auditor may also consider whether it is necessary to re-evaluate the reliability of management's responses to the auditor's inquiries and management's representations to the auditor.
- The Auditor needs to carry out verification and inspection of the ownership structure and the review of the financial statements of the M/s. Useless and Sons (P) Ltd through the MCA website and establish the nexus between the two.
- The Auditor needs to carry out an inspection of the data filed by Mr. Bharose Lal for his group companies to establish any past transactions/relationships between the two entities.
- The Auditor needs to ask for all the documents for the utilization of INR 20 crore and can investigate by visiting the parties involved and asking for confirmation directly.

Question 4

If, based on additional audit procedures undertaken by CA Sceptic, it is established that there is a likelihood of misappropriation of funds and the financial statements as a whole may be materially misstated, how CA Sceptic needs to plan the future course of action?

Answer 4

The Auditor needs to reassess the reliability of evidence previously obtained as there are doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation.

(a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is the requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(c) If the auditor withdraws:

(i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

(MCQs)

1) Which of the following best describes the method that Mr. Bharose Lal can indulge to commit fraud?

(a) Concealing and not disclosing facts that could affect the amounts recorded in financial statements.

(b) Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.

(c) Causing an entity to pay for goods or services not received.

(d) Using undisclosed business partners to misappropriate funds in the garb of Making a business transaction and thus siphoning off the funds.

Ans: (d)

2) In the given case scenario, the main factor giving rise to risk of material misstatement is:

(a) The expensive lifestyle of owners.

(b) Appointment of an auditor having experience in earthing of frauds

(c) The deteriorating financial condition of the owner's business.

(d) The vulnerability and dependence of the foreign partner on the local partner.

Ans: (d)

3) In the given case scenario, which is the most important red flag for auditor:

(a) Expensive lifestyle

(b) Undisclosed related party relationships to siphon off the funds.

(c) Financial crunch

(d) The dominant influence of the owners

Ans: (b)

4) Which of the following is not a fraud risk factor?

(a) Dominant influence of the owners

(b) Expensive lifestyle

(c) Fraud risk due to the nature of the industry

(d) Floating of a new SPV itself

Ans: (d)

6 CHAPTER COMPLETION AND REVIEW

SA 560 – Subsequent Events

Question 1

A Co. Ltd. has not included in the Balance Sheet as on 31-03-2017 a sum of ` 1.50 crores being amount in the arrears of salaries and wages payable to the staff for the last 2 years as a result of successful negotiations which were going on during the last 18 months and concluded on 30-04-2017. The auditor wants to sign the said Balance Sheet and give the audit report on 31-05-2017. The auditor came to know the result of the negotiations on 15-05-2017. Advise. (MTP 5 Marks, March 18)

Answer 1

Subsequent Events: This case requires attention to SA 560 "Subsequent Events", AS 4 "Contingencies and Events occurring after the Balance Sheet Date" and AS 29 "Provisions, Contingent liabilities and Contingent Assets".

As per AS 4 "Contingencies and Events occurring after the Balance Sheet Date", adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. Similarly as per AS 29 "Provisions, Contingent liabilities and Contingent Assets", future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that the will occur.

In the instant case, the amount of `1.50 crores is a material amount and it is the result of an event, which has occurred after the Balance Sheet date. The facts have become known to the auditor before the date of issue of the Audit Report and Financial Statements.

The auditor has to perform the procedure to obtain sufficient, appropriate evidence covering the period from the date of the financial statements i.e. 31 -3-2017 to the date of Auditors Report i.e. 31-05-2017.

It will be observed that as a result of long pending negotiations a sum of ` 1.50 cores representing arrears of salaries of the year 2015-16 and 2016-17 have not been included in the financial statements. It is quite clear that the obligation requires provision for outstanding expenses as per AS 4 and AS 29.

As per SA 560 "Subsequent Events", the auditor should assure that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

So the auditor should request the management to adjust the sum of ` 1.50 crores by making provision for expenses. If the management does not accept the request the auditor should qualify the audit report.

Question 2

M/s Krishna Associates, Chartered Accountants, while conducting the audit of Love Kush Ltd want to conduct an inquiry of management and those charged with governance as to whether any subsequent events have occurred which might affect the financial statements. Guide M/s Krishna Associates with the matters where specific inquiries may be conducted to evaluate subsequent events. (MTP 4 Marks April 22)

Answer 2

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

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

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

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

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

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

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

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

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

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

Question 3

The audit report of Kolsi (P) Ltd. for F.Y. 2020-21 was issued by Bishnoi & Co. on 25th July, 2021. However, a case was filed against Kolsi (P) Ltd. on 4th August, 2021, with the Civil Court, with respect to an incident caused in its factory on 17th January, 2021, the outcome of which may result in paying heavy penalty by Kolsi (P) Ltd.

Mr. Raj Bishnoi, the partner of Bishnoi & Co., discussed the said matter with the management and it was determined to amend the financial statements for F.Y. 2020 -21. Further, Mr. Raj inquired how the management intended to address the said matter in the financial statements to

which he was told that the said matter was going to be disclosed as a "Contingent Liability for a Court case" to the foot note in the balance sheet with no additional disclosures.

The management told Mr. Raj that such disclosure was enough as he would further going a description of the said court case and its outcome in the 'Emphasis of Matter' paragraph in his amended audit report.

In the context of aforesaid case scenario, please answer the following questions:-

(a) Whether Mr. Raj on behalf of Bishnoi & Co., has properly adhered to his responsibilities in accordance with SA 560, on becoming aware of the court case filed against Kolsi (P) Ltd.? (RTP Nov'21)

Answer 3

(a) As per SA 560, 'Subsequent Events', the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

(1) Discuss the matter with management and, where appropriate, those charged with governance.

(2) Determine whether the financial statements need amendment and, if so,

(3) Inquire how management intends to address the matter in the financial statements.

In the given case, on becoming aware of the court case filed against Kolsi (P) Ltd., Mr. Raj discussed the said matter with the management and it was determined to amend the financial statements. Also, he inquired how the management intended to address the said matter in the financial statements.

However, If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where Mr. Raj (hereinafter referred as 'the auditor') believes they need to be amended, the auditor shall notify management and, those charged with governance (unless all of those charged with governance are involved in managing the entity), that the auditor will seek to prevent future reliance on the auditor's report. If despite such notification the management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report in accordance with SA 560.

Question 4

Ramadhan & Co., are the Auditors of XYZ Company Ltd., for the year ended on 31/03/2023. The Audit Report for that year was signed by the Auditors on 04/05/2023. The Annual General Meeting was decided to be held during the month of August 2023. On 06/05/2023, the Company had received a communication from the Central Government that an amount of₹ 5800 crores kept pending on account of incentives pertaining to Financial Year 2022-23 had been approved

and the amount would be paid to the Company before the end of May 2023. To a query to Chief Financial officer of the Company by the Board, it was informed that this amount had not been recognized in the Audited Financial Statements in view of the same not being released before the close of the Financial Year and due to uncertain ty of receipt. Now, having received the amount, the Board of Directors wished to include this amount in the Financial Statements of the Company for the Financial Year ended on 31/03/2023. On 08/05/2023, the Board amended the accounts, approved the same and requested the Auditor to consider this event and issue a fresh Audit Report on the Financial Statements for the year ended on 31/03/2023. Analyze the issues involved and give your views as to whether or not the Auditors could accede to the request of the Board of Directors. (PYP 5 Marks, Nov'18, New SM)

Answer 4

Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issue Ads: per SA 560, "Subsequent Events", the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report.

However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall

(i) Discuss the matter with management and, where appropriate, those charged with governance.

(ii) Determine whether the financial statements need amendment and, if so,

(iii) Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment. Further, the auditor shall extend the audit procedures and provide a new auditor's report on the amended financial statements. However, the new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

In the instant case, XYZ Company Ltd. received an amount of rupees 5800 crore on account of incentives pertaining to year 2022-23 in the month of May 2023 i.e., after finalization of financial statements and signing of audit report. Board of Directors of XYZ Ltd. amended the accounts, approved the same and requested the Ramadhan & Co. (auditor) to consider this event and issue a fresh audit report on the financial statements for the year ended on 31.03.2023.

After applying the conditions given in SA 560, Ramadhan & Co. can issue new audit report subject to date of audit report which should not be earlier than the date of approval of the amended financial statements.

COMPLETION AND REVIEW

Question 5

You are the auditor of PQR Ltd. which is in the business of supplying food products to various airline companies operating aircrafts in domestic circle only. As per terms of agreement with airlines, the company needs to stock various non-perishable food items for coming one month (average holding of inventory to the tune of INR 75 Crores). Also the payment terms have been settled and the company receives payment in 45days after the supply of goods. Everything was going-on well till the end of March 2020 when pandemic Covid hit the world and everything came to a stand still. Aviation sector was hit hard and there were no flights from April 2020 onwards. Consequently, the business of PQR Ltd. also got severely affected and the scheduled supplies of goods to airlines also were not made. Also, the liquidity position of airline companies got hit and the scheduled payments were also not received on due dates.

As the auditor of PQR Ltd. what audit procedures would you perform to ensure that all subsequent events are considered, so that financial statements for the year ended 31.03.2020 represent true and fair view? (PYP 5 Marks, Nov-20)

Answer 5

As per SA 560"Subsequent Events", the auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

- The auditor shall perform the procedures required in above paragraph so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto.

Being the auditor of PQR Ltd, to ensure that all subsequent events are considered so that financial statements for the year ending31.03.2020 represent true and fair view, the auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following:

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

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

(c) Reading minutes, if any, of the meetings, of the entity's owners, management and those charged with governance, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.

(d) Reading the entity's latest subsequent interim financial statements, if any.

- When, as a result of the procedures performed as required above, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements.

SA 570 – Going Concern

Question 1

(Includes concepts of SA 701- Key Audit Matters)

Rathi Limited had definite plan of its business being closed within a short period from the close of the accounting year ended on 31st March, 2018. The Financial Statements for the year ended 31/03/2018 had been prepared on the same basis as it had been in earlier periods with an additional note that the business of the Company shall cease in near future and the assets shall be disposed off in accordance with a plan of disposal as decided by the Management. The Statutory Auditors of the Company indicated this aspect in Key Audit Matters only by a reference as to a possible cessation of business and making of adjustments, if any, thereto to be made at the time of cessation only. Comment on the reporting by the Statutory Auditor as above. (MTP 5 Marks, Mar 19 & May 20, PYP 5 Marks, May 18)

Answer 1

Closure of Business: As per SA 570 "Going Concern", management intentions to liquidate the entity or to cease operations is one of the event or condition that may cast significant doubt on the entity's ability to continue as going concern.

As per SA 570, if events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions.

Even when no material uncertainty exists, it requires the auditor to evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosure about events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

Further, as per SA 701 "Communicating Key Audit Matters in the Independent Auditor's Report", when matters relating to going concern may be determined to be key audit matters, and explains that a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern is, by its nature, a key audit matter. SA 701 also emphasis on auditor's responsibility to communicate key audit matters in the auditor's report.

As per the facts given in the case, intention of the Mishti Limited had definite plan of its business being closed down within short period from 31st March, 2018. However, financial statements for the year ended 31.03.2018 had been prepared on the same basis as it had been in earlier periods with an additional note.

Thus, management intentions to liquidate the entity or to cease operations is one of the event or condition that may cast significant doubt on the entity's ability to continue as going concern is a key audit matter.

COMPLETION AND REVIEW

Therefore, the auditor is required to Communicate the Key Audit Matters in accordance with SA 570 in above stated manner. Simple reference as to a possible cessation of business and making of adjustments, if any, he made at the time of cessation only by the auditor in his report is not sufficient.

Question 2

AQP Limited is one of the prominent players in the chemicals industry. The company is a public company domiciled in India and listed on BSE and NSE. The Company was facing extreme liquidity constraints and there were multiple indicators that casted doubt over the company's ability to continue as a going concern.

The Company was led into insolvency proceedings by consortium of banks led by PNB and the NCLT ordered the commencement of corporate insolvency process against the Company on 31 August 2017. The company invited prospective lenders, investors and others to submit their resolution plans to the Resolution Professional (RP) latest by 1 January 2018. The RP reviewed the resolution plans and ensured conformity with Insolvency and Bankruptcy Code 2016. The compliant plans were presented to Committee on Creditors (CoC) on 2 February 2018 and the resolution plan submitted by PQR Ltd. was evaluated as highest evaluated Compliant Resolution Plan. CoC of AQP Ltd approved the Resolution Plan submitted by PQR Ltd. on 2 March 2018. The approval of NCLT was finally obtained on 4 May 2018.

PQR Ltd submitted detailed plans and commitments as part of the resolution plan including clearance of all outstanding debts which were leading to negative cash flows.

Please suggest how would you deal with this situation as the auditors of AQP Ltd. (MTP 5 Marks ,Mar 19, RTP Nov'19)

Answer 2

As per SA 570 Going Concern, if events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern (hereinafter referred to as "material uncertainty") through performing additional audit procedures, including consideration of mitigating factors. These procedures shall inc lude:

a. Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.

b. Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.

c. Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the

i. Evaluating the reliability of the underlying data generated to prepare the forecast; and

ii. Determining whether there is adequate support for the assumptions underlying the forecast.

d. Considering whether any additional facts or information have become available since the date on which management made its assessment.

e. Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

The auditor shall evaluate whether sufficient appropriate audit evidence has been obtained regarding, and shall conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions.

In the instant case, the approval of the resolution plan is a significant mitigating factor to counter the going concern issues of AQP Ltd. PQR Ltd has submitted a detailed plan and commitments that has been given as part of the resolution plan which includes clearance of all outstanding debts which were leading to negative cash flows. Therefore, it can be said that the company that the events and conditions are mitigated effectively and there is no material uncertainty in relation to the ability of the company to continue as a going concern.

Question 3

OM Ltd. is a company engaged in the business of manufacture of spare parts. Shanti & Associates are the statutory auditors of the company for the FY 2020-21. During the course of audit, CA Shanti noticed that the company had a major customer, namely, Korean Mart from South Korea. Owing to an outbreak of war and subsequent destruction leading to government ban on import and export in South Korea, the demand from Korean Mart for the products of OM Ltd. ended for an unforeseeable time period. When discussed with the management, CA Shanti was told that the company is in the process of identifying new customers for their products. CA Shanti understands that though the use of going concern assumption is appropriate but a material uncertainty exists with respect to the identification of new customers. This fact is duly reflected in the financial statements of OM Ltd. for the FY 2020-21. How should CA Shanti deal with this matter in the auditor's report for the FY 2020-21 in accordance with relevant Standard on Auditing? (MTP 5 Marks Nov 21 & April '23)

Answer 3

As per SA 570, "Going Concern", loss of a major market or a key customer is one of the operating indicators that may cast significant doubt on the company's ability to continue as a going concern.

In the present case, OM Ltd. has a key customer in South Korea from which the demand for its products has ended on account of outbreak of war, subsequent destruction and government ban on import and export in South Korea. Further, the company has not yet i dentified new customers and is in the process of doing the same. As such, the identification of new customer is a material uncertainty that cast a significant doubt on the company's ability to continue as a going concern.

However, this matter is duly disclosed by the management of OM Ltd. in the financial statements for the year ended 31.03.2021.

As such, considering that the going concern assumption is appropriate but a material uncertainty exists with respect to identification of new customer, CA Shanti should:

(1) Express an unmodified opinion and

(2) Include in his audit report, a separate section under the heading "Material Uncertainty Related to Going Concern" to:

(i) Draw attention to the note in the financial statements that discloses the matters and

(ii) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

(iii) Thus, CA Shanti should deal with this matter in his auditor's report in the above mentioned manner.

Question 4

(Includes concepts of SA 705- Modification of Opinion)

CA.K is appointed statutory auditor of SEEK INDIA LTD under Companies Act, 2013 for the first time.

The company is preparing its accounts keeping in view applicable requirements of Division II of Schedule III of Companies Act, 2013. On scrutiny of financial statements of company put up for audit, it was noticed that notes to accounts show ageing of trade payables as per amended requirements of Schedule III of the Companies Act, 2013. The ageing schedule forming part of notes is as under: - Outstanding for following periods from due date of payment (` In crore)

Particulars	Less than 1 year	1-2 years	2-3 years	More than 3 years	Total
MSME	NIL	NIL	NIL	NIL	NIL
Others	2	4	3	1	10
Disputed dues-MSME	NIL	NIL	NIL	NIL	NIL
Disputed dues-others	NIL	NIL	NIL	NIL	NIL

Besides above, current ratio, debt-equity ratio, trade payables turnover ratio and net profit ratio disclosed in notes to accounts have slipped drastically as compared to last year and from standard norms.

Most of the key financial ratios are in red. There is no other relevant information concerning above in notes to accounts.

Further, on reviewing bank statement of cash credit limit (against hypothecation of paid stocks), it was noticed that there is no debit transaction in the month of March,2022. On inquiry, he came to know that stock audit of company was conducted in the month of January,2022 and stock auditors have commented vide their report dated 25.2.2022 that company had negative drawing power due to high creditors. Accordingly, the bankers have refused further debits in cash credit account from start of March,2022. There is no information in this respect in financial statements and notes to accounts. Discuss how CA K should deal with above for reporting in his audit report under the Companies Act, 2013. (MTP 5 Marks Oct '22)

Answer 4

In the given situation, it is clear from the ageing schedule that company is not able to pay its creditors on time. Outstanding to creditors for a period of 1 year or more account for 80% of total dues to the creditors of the company from due date of payment. Most of key financial ratios are adverse.

Further, bankers have refused further debits in cash credit account due to negative drawing power from March 2022. Cash credit loans are repayable on demand. There is no other information or disclosure available how the company plans to run its business without bank finance.

All the above factors are indicators that a material uncertainty exists that may cast a significant doubt on the company's ability to continue as going concern. There is no express disclosure of this fact in financial statements.

Therefore, it is a situation where material uncertainty exists which has cast a significant doubt on company's ability to continue as going concern in accordance with SA 570, "Going Concern".

Keeping in view above the fact that although a material uncertainty exists casting a significant doubt on the ability of company to continue as going concern, adequate disclosure of material uncertainty is not made in financial statements, CA K shall give qualified or adverse opinion in accordance with SA-705, "Modifications to the Opinion in the Independent Auditor's Report".

Question 5

MZE Limited is engaged in the manufacturing and export of ready-made garments. The company has lost overseas buyers to Asian competitors with lower raw materials and labour costs. As a result, MZE Limited has lost out on a significant chunk of export orders, and the trend has become more pronounced in the year 2022-23. Further, the US economic recession caused delays in the company's overseas payments, leading to the company being unable to keep its loan repayment commitments with bankers. Further, the company has not been able to pay its creditors on time. Even statutory dues payable by the company are either not paid or being paid after a gap of 5 -6 months, leading to extra costs. Due to declining revenue, the company cannot cover its fixed costs and has begun laying off employees.

Considering all these circumstances, CA P doubts the company's ability to continue as a going concern while conducting the statutory audit for the year 2022 -23. He is studying management's assessment of the company's ability to continue as a going concern by studying projected profitability statements for the next two years containing turnover, expenses and profits estimates. Comment on the above situation with specific reference to audit procedures being performed by CA P in context of relevant Standards on Auditing. (MTP 5 Marks Oct '23)

Answer 5

The indicated events or conditions in MZE Limited may cast significant doubt on ability of company to continue as going concern. SA 570 requires that if events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern through performing additional audit procedures, including consideration of mitigating factors.

In the given situation, the auditor is studying management's assessment of the company's ability to continue as going concern, including its future plan of action containing projected profitability statements for the next two years containing estimates of turnover, expenses and profits. However, as required in SA 570, auditor's procedures should focus on cash flow forecast and not on future profit projections. It is quite possible that a company may continue to carry on as a going concern so long as it can meet its liabilities. Therefore, analysing the projected profitability statements alone is insufficient to support the conclusion on the going concern assumption followed by the company.

Therefore, the auditor should require management to prepare a cash flow forecast in the given circumstances. The auditor should then analyse the cash flow forecast in the evaluation of management's future plan of action. It includes: -

(i) Evaluating the reliability of the underlying data generated to prepare the forecast and

(ii) Determining whether there is adequate support for the assumptions underlying the forecast

Further, some major overseas payments of the company are stuck up. It is quite possible that the timing of cash inflows on account of these payments may affect the situation. The auditor would have to evaluate the reliability of data for preparation for such a forecast and its underlying assumptions. He should perform procedures to obtain evidence regarding assumptions and timing of cash inflows and outflows like any restructuring undertaken by bankers providing relief to the company, future sales and consequent cash realization in downturn conditions, willingness of creditors to provide credit in such a situation, incurring of expenditures to keep the company afloat. All these assumptions underlying such cash flow forecasts need to be challenged and examined.

Question 6

M/s Airlift Ltd., carrying on the business of Passenger Transportation by air is running into continuous financial losses as well as reduction in Sales due to stiff competition and frequent break down of its own aircrafts. The Financial Statements for the Year ended on 31/03/2023 are to be now finalized. The Management is quite uncertain as to its ability to continue in near future and has informed the Auditors that having seized of this matter, it had constituted a committee to study this aspect and to give suggestions for recovery, if any, from this bad situation. Till the study is completed, according to the Management, the issue involves uncertainty as to its ability to continue its business and it informs the Auditor that the fact of uncertainty clamping on the "Going Concern" would suitably be disclosed in notes to accounts. State the reporting requirement if any, in the Independent Auditor's Report in respect of this matter. (PYP 5 Marks Nov'18, New SM)

Answer 6

Reporting requirements in case of Uncertainty clamping on the Going ConcAesrpne:r SA 570 "Going Concern", if the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements : (i)adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and (ii) disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:

(i) Draw attention to the note in the financial statements that discloses the matters set out above; and

(ii) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

In the instant case, M/s Aircraft Ltd. is running into continuous financial losses as well as reduction in sales due to stiff competition and frequent break down of its own aircrafts and management of Aircraft Ltd. is uncertain as of its ability to continue in near future. Therefore, a committee has been constituted to study this aspect and till the time study is completed management accordingly decided to suitable disclose this aspect in notes to accounts. Therefore, the auditor should disclose about the material uncertainty and express an unmodified opinion and in his audit report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to draw attention to the note in the financial statements that discloses the matters set out above; and state that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

COMPLETION AND REVIEW

Question 7

(a) Joy Ltd. is an entertainment company which runs a circus and travels around the country to entertain the masses. The circus began losing its popularity over the past few years and attendance has reportedly dropped by as much as 75% in the current financial year. Animal rights activists continuously targeted the circus for its use of animal creatures like elephants in the show. The CEO noted that the audience seemed to be abandoning the circus due to their expanding entertainment options. The high cost of moving the show from city to city eventually made the business model untenable. As a result, many key managerial personnel of the company left the company, there were delays in the payment of wages and salaries, and the bank from whom the company had taken funds also decided not to extend further finance or to fund further working capital requirements of the company.

When discussed with the management, the statutory auditor understood that the company had no action plan to mitigate such circumstances (Use of going concern assumption is inappropriate).

Further, all such circumstances were not reflected in the financial statements of Joy Ltd. What course of action should the statutory auditor of the company take in the auditor's report in such situation? (PYP 5 Marks May '23)

Answer 7

(a) SA 570, "Going Concern", deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's abilit y to continue as a going concern.

When the use of going concern basis of accounting is inappropriate i.e., if the financial statements have been prepared using the going concern basis of accounting but in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.

Also, when adequate disclosure of a material uncertainty is not made in the financial statements the auditor shall express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised); and in the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

In the present case, the following circumstances indicate the inability of Joy Ltd. to continue as a going concern:

- Losing popularity over the past few years.
- Animal Rights activists continuously targeting the circus.
- Audience abandoning the circus due to their expanding entertainment options.

- High Cost of moving the show from city to city making the business model untenable.
- Key Managerial Personnel leaving the Company.
- Banks decided not to extend further finance and not to fund the working capital requirements of the Company.
- Non availability of sound action plan to mitigate such circumstances.

Therefore, considering the above factors it is clear that the going concern basis is inappropriate for the Company. Further, such circumstances are not reflected in the financial statements of the Company.

As such, the statutory auditor of Joy Ltd. should:

(1) Express an adverse opinion in accordance with SA 705 (Revised) and

(2) In the Basis of Adverse Opinion paragraph of the auditor's report, the statutory auditor should state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

The auditor is also required to report as per clause (xix) of CARO 2020 that on the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date.

MULTIPLE CHOICE QUESTIONS (MCQS)

Question 1

The auditor has determined that there is a significant going concern uncertainty at PQR Ltd. due to the requirement to refinance the company's debt. Discussions with the management and the auditor's evaluation of management's plans for future actions in relation to its going concern assessment have revealed that plans to raise new equity finance are realistic and likely to deal with the problem. Is it appropriate for PQR Ltd. to prepare its financial statements on a going concern basis?

(a) No, PQR Ltd. cannot prepare its financial statements on a going concern basis because a significant uncertainty exists.

(b) Yes, PQR Ltd. can prepare its financial statements on a going concern basis. However, the auditor is required to express a qualified opinion.

(c) Yes, PQR Ltd. can prepare its financial statements on a going concern basis. No additional disclosure is necessary in the financial statements or the auditor's report.

(d) Yes, PQR Ltd. can prepare its financial statements on a going concern basis. However, disclosure of both the nature of the uncertainty and management's plan is required. (MTP 2 Marks, April 19)

Ans:(d)

COMPLETION AND REVIEW

Question 2

Which of the following is not an indicator about material uncertainty over the entity's ability to continue as a going concern:

(a) Net liability or net current liability position.

(b) Cancellation of company's production license due to change on government policies.

(c) Non-declaration of dividend to equity shareholders.

(d) Substantial operating losses or significant deterioration in the value of assets used to generate cash flows. (MTP 1 Mark March 22)

Ans: (c)

SA 580 – Written Representation

Question 1

Mokshda & Co is the statutory auditor of Get My Trip Ltd. The company is in the business of tours and travels. Annual turnover of the company is INR 2765 crore and profits are INR 285 crore. During the planning meeting of the management and the auditors, it was discussed that the management needs to provide written representation letter to the auditors for the preparation of the financial statements and for the completeness of the information provided to the auditor. At the time of closure of the audit, there has been some confusion about the requirements of the written representation letter.

Management argued that representation need not be written, it can also be verbal which has been provided to the audit team during the course of their audit. Auditors have completed their documentation and hence in a way, representation based on verbal discussions with the auditors has also got documented. Auditors explained that this is mandatory to obtain written representation in accordance with the requirements of SA 580. However, still some confusion remains regarding the date and period covered by the written representation. You are required to advise about the date of and period covered by written representation in view of SA 580. (MTP 4 Marks, March 21, RTP May'19, New SM)

Answer 1

As per SA 580, "Written Representations", as written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements. In some circumstances it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole.

Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

Question 1

Ramadhan & Co., are the Auditors of XYZ Company Ltd., for the year ended on 31/03/2023. The Audit Report for that year was signed by the Auditors on 04/05/2023. The Annual General Meeting was decided to be held during the month of August 2023. On 06/05/2023, the Company had received a communication from the Central Government that an amount of₹ 5800 crores kept pending on account of incentives pertaining to Financial Year 2022-23 had been approved and the amount would be paid to the Company before the end of May 2023. To a query to Chief Financial officer of the Company by the Board, it was informed that this amount had not been recognized in the Audited Financial Statements in view of the same not being released before the close of the Financial Year and due to uncertain ty of receipt. Now, having received the amount, the Board of Directors wished to include this amount in the Financial Statements of the Company for the Financial Year ended on 31/03/2023. On 08/05/2023, the Board amended the accounts, approved the same and requested the Auditor to consider this event and issue a fresh Audit Report on the Financial Statements for the year ended on 31/03/2023. Analyze the issues involved and give your views as to whether or not the Auditors could accede to the request of the Board of Directors.

Answer 1

Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issue Ads: per SA 560, "Subsequent Events", the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report.

However, when, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall

(i) Discuss the matter with management and, where appropriate, those charged with governance.

(ii) Determine whether the financial statements need amendment and, if so,

(iii) Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall carry out the audit procedures necessary in the circumstances on the amendment. Further, the auditor shall extend the audit procedures and provide a new auditor's report on the amended financial statements. However, the new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

In the instant case, XYZ Company Ltd. received an amount of rupees 5800 crore on account of incentives pertaining to year 2022-23 in the month of May 2023 i.e., after finalization of financial statements and signing of audit report. Board of Directors of XYZ Ltd. amended the accounts, approved the same and requested the Ramadhan & Co. (auditor) to consider this event and issue a fresh audit report on the financial statements for the year ended on 31.03.2023.

After applying the conditions given in SA 560, Ramadhan & Co. can issue new audit report subject to date of audit report which should not be earlier than the date of approval of the amended financial statements.

Question 2

M/s Airlift Ltd., carrying on the business of Passenger Transportation by air is running into continuous financial losses as well as reduction in Sales due to stiff competition and frequent break down of its own aircrafts. The Financial Statements for the Year ended on 31/03/2023 are to be now finalized. The Management is quite uncertain as to its ability to continue in near future and has informed the Auditors that having seized of this matter, it had constituted a committee to study this aspect and to give suggestions for recovery, if any, from this bad situation. Till the study is completed, according to the Management, the issue involves uncertainty as to its ability to continue its business and it informs the Auditor that the fact of uncertainty clamping on the "Going Concern" would suitably be disclosed in notes to accounts. State the reporting requirement if any, in the Independent Auditor's Report in respect of this matter.

Answer 2

Reporting requirements in case of Uncertainty clamping on the Going Concern : As per SA 570 "Going Concern", if the auditor concludes that management's use of the going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements : (i)adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and (ii) disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

If adequate disclosure about the material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:

(i) Draw attention to the note in the financial statements that discloses the matters set out above; and

(ii) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

In the instant case, M/s Aircraft Ltd. is running into continuous financial losses as well as reduction in sales due to stiff competition and frequent break down of its own aircrafts and management of Aircraft Ltd. is uncertain as of its ability to continue in near future. Therefore, a committee has been constituted to study this aspect and till the time study is completed management accordingly decided to suitable disclose this aspect in notes to accounts. Therefore, the auditor should disclose about the material uncertainty and express an unmodified opinion and in his audit report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to draw attention to the note in the financial statements that discloses the matters set out above; and state that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

COMPLETION AND REVIEW

Question 3

PRSH & Co is the statutory auditor of Make My journey Ltd. The company is in the business of tours and travels. Annual turnover of the company is INR 2000 crores and profits are INR 190 crores. During the planning meeting of the management and the auditors, it was discussed that the management needs to provide written representation letter to the auditors for the preparation of the financial statements and for the completeness of the information provided to the auditor. At the time of closure of the audit, there has been some confusion about the requirements of the written representation letter.

Management argued that representation need not be written, it can also be verbal which has been provided to the audit team during the course of their audit. Auditors have completed their documentation and hence in a way, representation based on verbal discussions with the auditors has also got documented. Auditors explained that this is mandatory to obtain written representation in accordance with the requirements of SA 580. However, still some confusion remains regarding the date and period covered by the written representation. You are required to advise about the date of and period covered by written representation in view of SA 580.

Answer 3

As per SA 580, "Written Representations", as written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

In some circumstances it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

Question 4

"Move Fast Limited" is engaged in the manufacturing of shoes and slippers located in Bahadurgarh in Haryana. Due to unprecedented rains in the area in the month of September 2022, many areas of the town got inundated due to the choking of sewer systems. As a result of the above, the company's premises located in town were also affected, resulting in damage of stocks.

The company has lodged a claim with the insurance company for ₹1 crore, and the same is shown as a claim receivable as of 31st March 2023, as the claim was not settled at year end.

The insurance surveyor appointed in the case submitted a report to the insurance company recommending a claim of ₹45 lacs in the month of April 2023. The company has also given its consent for the same, and the settled amount of ₹45 lacs was transferred to the bank account of the company on 15th May 2023.

You have just finished performing substantive procedures of the company by the end of May 2023. Is there any responsibility cast upon you as auditor of the company in the above situation?

Answer 4

The given situation provides evidence of conditions that existed at the date of financial statements. Initially, the company had lodged claim of ₹1 crore and the same is reflected as claim receivable in financial statements as on 31st March, 2023.

However, subsequent events occurring have provided evidence that claim was settled for ₹ 45 lacs only. Such settled amount has already been accepted by the company by providing its consent.

Therefore, such events have provided fresh information about items included in financial statements. Further, performance of substantive procedures has been finished implying that audit report is not yet issued.

Therefore, financial statements as on 31st March, 2023 should be adjusted to reflect fresh information emanating from described events and management should be asked to take appropriate action in this regard so that adjustment pertaining to above is properly reflected in financial statements in accordance with applicable financial reporting framework.

Question 5

CA Anuj is the auditor of a listed company, and he is in the midst of conducting an audit of the said company for the financial year ending 31St March 2023. At a meeting of the Board of Directors held on 17th April 2023, a dividend of ₹1 crore is proposed to equity shareholders @ ₹10/- per share, and such a proposal has a good chance of being approved in the AGM of the company to be held after few months.

His audit procedures are near completion. He is contemplating finalizing the audit report by 31st July 2023. Is there any responsibility thrust upon him as auditor of the company?

COMPLETION AND REVIEW

Answer 5

In the given situation, dividend has been proposed by Board of Directors on 17th April, 2023. It is an example of condition that arose after the reporting period. No liability exists for the company on reporting date because there is no obligation to pay at the reporting date in accordance with Ind AS 1.

Therefore, above situation does not require recognition of above proposed dividend in financial statements. It is an example of events which does not require adjustments. However, it should be disclosed in financial statements in notes to accounts. Therefore, it should be ensured that it is disclosed in notes to accounts in financial statements. He should verify in accordance with SA 560 that it is so disclosed in notes to accounts.

Question 6

CA. Somya is auditor of a company engaged in rearing of poultry birds and obtaining eggs therefrom. The company has performed very well since its incorporation in 2013. Its sales had also grown and the company had expanded its market from the native northern state of promoters to far-flung areas in eastern parts of country.

However, since last two years, company's fortunes have nosedived. First, due to the effects of the pandemic and then due to recurrent outbreaks of bird flu thrice in a span of two years. The company's sales have dipped from around ₹ 50 crores to ₹10 crores. Further, a major part of its livestock was also wiped off during bird flu. She is not optimistic about the going concern assumption followed by management.

The management now wants to start with new batches of birds. The earlier working capital facilities of the company granted by bank have also been restructured to support the business. She was informed that the repayments of restructured working capital term loans are to begin from ensuing year. No fresh credit facilities have been granted by the bank. The company also plans longer credits from animal feed suppliers.

The company plans to take additional measures to prevent the safety of live stocks, including aggressive vaccination, preventive health check-ups, and more frequent visits of veterinary staff.

The villagers in surrounding areas have accused the company of spreading air pollution.

The management has prepared a cash flow forecast for her examination. Discuss the approach to be adopted by her in examining the "going concern" assumption keeping in view above with specific reference to cash flow forecast.

Answer 6

In accordance with SA 570,"Going Concern", if events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern by performing additional audit procedures, including consideration of mitigating factors.

Where the entity has prepared a cash flow forecast, and analysis of forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future actions, it includes

(i) Evaluating the reliability of the underlying data generated to prepare the forecast and

(ii) Determining whether there is adequate support for the assumptions underlying the forecast.

In the above situation, cash flow forecast has been prepared by management. Therefore, she should carefully evaluate assumptions underlying forecast and also reliability of data to prepare the forecast. For example: -

- She should verify assumption regarding fresh batch of livestock. The bankers have not provided fresh credit facilities. How funds from the same would be arranged? The reasonability of assumption in cash flow forecast needs to be looked into.
- She needs to check loan sanction letters/agreement to verify when repayments are beginning to see their accuracy in cash flow forecasts.
- The company plans to avail longer credits from animal feed suppliers. In the downturn situation of the company, how would suppliers extend longer credits? This is going to have effect on the cash flow forecast.
- Whether company has accounted for increased expenditure on preventive health check-up, vaccination and more frequent visits of veterinary staff in cash flow forecast.
- Since villagers have accused the company of spreading air pollution, how does the company plan to deal with the same? Whether any proposed expenditure in this regard is accounted for in the cash flow statement. She may also consider other implications of this issue and possible effect on cash flows.

Question 7

CA Sooraj finds that key financial ratios of a company, like current ratio, debt-service coverage ratio, inventory turnover ratio, and trade receivables turnover ratio, are in red and have deteriorated considerably as compared to last year. The company is also not able to pay to its creditors on time. The company is requesting time and again to its bankers to grant additional credit facilities, but bankers are not listening.

There have been significant losses to the company due to the lack of response of the company's products in the market. As a result of it, many products are sold at below cost price. There have been situations where the company is not able to pay the salaries of staff on time.

All these negative findings have led him to conclude that the use of going concern as the basis of accounting is not appropriate. He brings this matter to the knowledge of CFO of the company. What is reporting duty cast upon him in such a scenario?

The CFO informs him that the management, in turn, is ready to include in the disclosures the inappropriateness of its use of going concern assumption of accounting.

How should it impact the auditor's opinion in case management itself discloses the inappropriateness of its use of going concern assumption of accounting now?

Answer 7

If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the financial statements is inappropriate, the auditor shall express adverse opinion.

The requirement for an auditor to express an adverse opinion applies regardless of whether or not the financial statements include disclosure of the inappropriateness of management's use of the going concern basis of accounting. Therefore, even if management discloses that its use of going concern assumption of accounting is inappropriate, it would have no impact on auditor's opinion. He would need to express adverse opinion.

Question 8

Following is a written representation given by RES Limited to its statutory auditors i.e. M/s CTK & Associates for audit of financial year 2022-23. The audit was completed and report dated 31.7.23 was issued.

Point out, if there is any, anomaly in written representation reproduced below. 15th April, 2023

To

CTK & Associates

Chartered Accountants

Dear Sir,

This representation letter is provided in connection with your audit of the financial statements of RES Limited for the year ended March 31, 2023 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view in accordance with the applicable accounting standards in India.

We confirm that (to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

Financial Statements

We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated 17th August

2022 for the preparation of the financial statements in accordance with financial reporting Standards, in particular, the financial statements give a true and fair view in accordance with the applicable accounting standards in India.

Significant assumptions used by us in making accounting estimates, including those measured

at fair value, are reasonable.

Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of applicable accounting standards in India. (SA 550)

All events subsequent to the date of the financial statements and for which applicable accounting standards in India require adjustment or disclosure have been adjusted or disclosed. (SA 560)

The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (SA 450)

Information provided

We have provided you with: -

Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

Additional information that you have requested from us for the purpose of the audit; and Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.

All transactions have been recorded in the accounting records and are reflected in the financial statements.

We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.

We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves: -

Management;

Employees who have significant roles in internal control; or

Others where the fraud could have a material effect on the financial statements.

We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

We have disclosed to you all known instances of non-compliance or suspected non- compliance with laws and regulations whose effects should be considered when preparing financial statements.

We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (SA 550)

Chief Financial Officer

COMPLETION AND REVIEW

Answer 8

The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. As the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

In the given situation, written representation is dated 15th April 2023. The audit report is dated 31st July 2023. There is a considerable lag between date of written representations and date of audit report.

It could signify that all subsequent events after date of financial statements requiring adjustments or disclosure may not have been adjusted or disclosed in the financial statements by management.

As audit report is dated 31St July, 2023, it reflects that auditor has considered subsequent events occurring between date of financial statements and date of auditor's report. However, written representations pertain to 15th April 2023.

Case Study

Infinity Hospitality Private Limited was established in 1996 and was in the business of running hotels in tourist destinations in state of Kerala. It took leased properties on long-term leases ranging from 10 to 12 years, most with a lock-in of a whole term. The terms did not cover the force majeure clause The company was family-owned business and had created a good reputation as value for a money- budget hotel. Most of the time, hotels clocked 60 to 75% occupancy rate, and during the festive season/ vacations, hotel business clocked 100% Occupancy.

The capital structure of the company was debt oriented and over-leveraged.

Primary working capital was blocked in maintaining and upkeeping the leased properties, running the restaurant, leases, food and beverages, salary, Director's remuneration etc.

The owners looked at the business as a cash cow and did not plough back the funds to expand the business but were content with the decent profits the hotels were generating.

As the properties were leased and not owned, most of the cash flow generated from operations was used in servicing the property and huge loans from financial institutions. What was left was withdrawn as Directors' remuneration and dividend.

Everything was going on smoothly. However, there were flash floods in Kerala due to unprecedented rains. There were landslides and roads were blocked. The entire tourist season was washed away due to infrastructural challenges. Accessibility to resorts and hotels was badly hindered. Logistics support took time to reach in far flung areas. Visit to the "The God's own countryw" as last on the mind of tourists. The company was hardly trying to get back to some semblance of normalcy when pandemic struck. It was double whammy for the company.

The impact on travel, tourism and hospitality business was very severe. The management of

Infinity Hospitality Private Limited believed that bad days would end soon and the business would be back to normal. They also were optimistic about the government coming up with support for the industry and were hopeful of negotiating with lessors and Financial Institutions for relief. They decided on humanitarian grounds not to terminate the employees and continued paying them a regular salary, maybe deferring 25% to be paid after one year. The immediate fallout was on the top line as suddenly, the business stopped.

The auditors, M/s XYZ and Associates, were conducting the audit of the company and were grappling with the situation and are seeking your guidance for the course of action they need to follow.

Based on the case scenario, you are required to provide your answers to the following: -

Question 1

What additional audit procedures must the auditor undertake as per requirements of SA 570 based on the facts given in the case?

Answer 1

In the given case scenario, the events and conditions have been identified which cast significant doubt on the entity's ability to continue as a Going Concern, the auditor needs to obtain sufficient appropriate audit evidence to determine whether or not material uncertainty and gather evidence including of mitigating factors. It can be done by performing following additional procedures: -

- Analyzing and discussing cash flow, profit and other relevant forecast with management.
- Analyzing and discussing the entity's latest available interim financial statement.
- Reading the terms of loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third party and assessing the financial ability of such parties to provide additional funds.
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
- Confirming the existence, terms and adequacy of borrowing facilities.
- Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.
- Evaluating management's plans for further actions in relation to its going concern assessment, whether the outcome of these plan is likely to improve the situation and whether the management's plans are feasible in the circumstances.
- Evaluating management's plans for future actions may include inquiries of management as to its plan for future action, including, for example, its plan to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.
- Considering whether any additional facts or information have become available since the date on which management made it assessment.
- Requesting written representation from management and, where appropriate, those charged with governance, regarding their plans for future actions and the feasibility of these plans.

Question 2

According to your judgment, what risk assessment procedures should the auditor consider for arriving at a conclusion based on the management assertion of the entity being Going Concern?

Answer 2

When performing risk assessment procedures as required by SA-315, the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's ability to continue the going concern. In so doing, the auditor shall consider whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern.

- The auditor shall discuss the assessment with management and determine whether management has identified events and conditions that, individually or collectively, cast significant doubt on the entity's ability to continue as a going concern and if so, management's plan to address them.
- The auditor shall specifically draw attention of Management on following events or condition and get the response on how they plan to address them:

The company is debt heavy and over leveraged. The leased properties are having considerable lock-in period with absence of force majeure clause. There are no contingency reserves available with company.

All these factors shall be taken into account while performing risk assessment procedures.

Question 3

What should be approach of the auditor if the management agrees that the material uncertainly exists, but the entity is a Going Concern? Also discuss reporting requirements

Answer 3

If the auditor concludes that the management's use of going concern basis of accounting is appropriate in the circumstances but a material uncertainty exists, the auditors shall determine whether the financial statements:

(a) Adequately disclose the principal events or conditions that make a significant doubt on the entity's ability to continue as a going concern and management's plan to deal with these events or conditions, and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on entity's ability to continue as a going concern and therefore, that it may be unable to realize its assets, and discharge its liabilities in the normal course of business.

(c) The disclosures may include:

i. Management's evaluation of the significance of the events or conditions relating to the entity's ability to meet its obligations; or

ii. Significant judgements made by management as a part of its assessment of the entity's ability to continue as a going concern

iii. Disclosures about the magnitude of the potential impact of the principal events or conditions, and the likelihood and timing of the occurrence.

iv. The auditor shall express and unmodified opinion and the auditor's reports shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:

- Draw attention to the note in the financial statement that discloses the events or conditions and
- State that these events are conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and the auditor's opinion is not modified in respect of the matter and how the matter was addressed in the audit.

Question 4

What if the auditor believes, on the basis of his additional audit procedures conducted to conclude that the entity is not a Going Concern, but the management is not accepting the same? What course of action the auditor needs to undertake?

Answer 4

If management has prepared financial statements using the Going Concern assertion to which auditor differs as according to his judgement, the Going Concern assertion by the management is not appropriate, then the auditor is required to express an adverse opinion.

Question 5

What kind of written representation does the auditor need to obtain in case of the scenario covered in Q3 above?

Answer 5

The auditor needs to obtain written representation from management and where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

Multiple Choice questions

1. Which of the following is not a financial event/ conditionate may cast significant doubt on companies' ability to continue as a going concern as per SA 570?

(a) Change from credit to cash on delivery model with suppliers

(b) Arrears or discontinuance of dividend

(c) Opening of a new chain of hotels by renowned competitor near the entity's area

(d) Adverse key financial ratios

Ans: (c)

2. Please choose the mitigating measure as the management is unable to pay lease rentals.

(a) Cancel the lease

(b) Restructure the lease agreement and negotiate for deferment and relief

(c) Terminate the employees and pay the lessor

(d) All the above

Ans: (b)

3. Which one of the following is not a responsibility of the auditor relating to communicating events or conditions identified that may cast significant doubt on the entity's Going Concern assertion?

(a) Perform additional audit procedures to identify events/ conditions beyond 12 months from the date of financial statements

(b) Whether the events constitute a material uncertainty

(c) The adequacy of related discloses in the financial statements

(d) The implications for the auditor's report

Ans: (a)

4. Written Representation need to be mandatorily obtained from:

(a) Audit Committee

(b) Client relationship Managers

(c) Company Secretary

(d) CFO

Ans: (d)

5. Which of the following is not main pillar of written representants?

(a) The management responsibility for preparation of financial statement

(b) Assertion related to completeness

(c) Assertion related to access to data and information

(d) Written representation provides sufficient appropriate audit evidence

Ans: (d)

Case Scenario 1

CA Sneha, a partner in M/s J & Associates, is carrying out a statutory audit of M/s ABC Stores Ltd. for the Financial Year 2022-23, and she is ready to sign her audit report on 01.07.2023. There are some written representations which are pending with the management of the company pertaining to such an audit, and she sent Deepak (her articled trainee), who is also a member of the engagement team, to the company's office for collection of the same.

On returning back, Deepak tells CA Sneha that major stocks of the company got destroyed because of a fire in their plant on 27.06.2023, and it has affected the company's operations badly. However, the business operations are likely to be resumed by management at an alternate place.

CA Sneha postponed the issuance of the audit report to consider the impact of such an event on the financial state of affairs of the company. She wants the management to disclose the impact of this unfortunate event in financial statements for the year 2022-23, to which management is disinclined. After the management's refusal, she issued her audit report on 15.07.2023.

The management of the company seeks an appointment from CA Sneha to discuss an important matter on 20.07.2023. They informed her that the company had lost a lawsuit filed against it by one of the creditors on 18.07.2023 in a fast-track court, and now the company has to pay the plaintiff a huge amount of ₹2 crores. The events causing this lawsuit arose after 31.03.2023.

CA Sneha is a bit perplexed, and her first question to the people from management visiting her office was whether audited financial statements have been made available to any third parties or filed with the regulator. The management responded negatively.

Now, CA Sneha wants them to amend the financial statements to include the impact of this lawsuit on the financial affairs of the company. This time, they agreed and amended the financial statements accordingly to cover the impact of both the events – that of the fire in the plant and losing the lawsuit, but they requested CA Sneha to issue a new audit report against the earlier one dated 15.7.2023. The management amends the financial statements, which are finally approved on 25.7.2023. CA Sneha issues a new audit report.

Considering the above situation, answer the following questions: -

1. What should be the appropriate date of signing of thneed audit report?

(a) 20.07.2023

(b) Anytime between 15.07.2023 & 18.07.2023

(c) On or after 25.07.2023

(d) Anytime between 15.07.2023 & 25.07.2023

Ans: (c)

2. CA Sneha would have taken into account a lot of procedures to get knowledge of the events occurring after the balance sheet date up to the date of the audit report relating to the company. Which of the following does not fall under such audit procedures as per SA 560?

(a) Obtaining an understanding of the management's procedures set up to identify subsequent events.

(b) Inquiring of the management w.r.t the occurrence of any such subsequent events.

(c) Reading the minutes of the meetings of the board held after the balance sheet date during this period.

(d) Getting the Interim financial statements prepared till the date of the audit report mandatorily as a condition to issue the audit report

Ans: (d)

3. W.r.t the first audit report dated 15.07.2023, which type of opinion was most likely provided by her?

(a) Modified opinion

(b) Unqualified opinion

(c) Disclaimer of opinion

(d) Including a statement in Emphasis of Matter/Other matters para.

Ans: (a)

4. W.r.t the new audit report issued, which type of opinion is most appropriate?

(a) Disclaimer of opinion

(b) Unqualified opinion

(c) Adverse opinion

(d) Unqualified opinion and a statement in Emphasis of Matter/Other matters para.

Ans: (d)

5. The fire event occurring on 27.6.2023 itnhe company's plant requires the following action on part of management-:

(a) Disclosure in notes to accounts

(b) Adjustment in financial statements

(c) Waiting for the insurance company to settle the claim

(d) Preparing financial statements afresh

Ans: (a)

Case Scenario 2

CA Namit, a partner in M/s J & Associates, is carrying out a statutory audit of M/s XYZ Gears Ltd. for the Financial Year 2022-23 and is in the process of issuing an audit report. His articled trainee, Manpreet, is very curious about knowing the various facts relating to the consideration of Standards on Auditing while carrying out an audit and issuing the audit report.

She asks CA Namit about the relevance of the Going concern assumption in their audit and further reporting to which CA Namit explains to her that both parties have got their own responsibilities w.r.t this accounting assumption. The management of the company has its own set of responsibilities while reporting upon the same is a very strict and sensitive matter for the auditor as per the requirement of the relevant standard on auditing.

He tells Manpreet to prepare a list of procedures as she thinks that an auditor should carry out when he identifies that the company is facing a downfall in business never seen before due to newer technology in the market and other competitors having sprung up swiftly adopting new technology.

He finds that this condition may cast significant doubt on the company's ability to continue as a going concern.

Manpreet thinks and researches and hands over a list of audit procedures to CA Namit for a final discussion.

CA Namit clarifies accordingly. CA Namit concludes that the use of a going concern basis of accounting is appropriate in this company's case, but a material uncertainty exists as to the future prospects of the current business. However, the management has made an appropriate disclosure w.r.t such material uncertainty in the financial statements.

Manpreet's list of audit procedures includes: -

(i) Requesting management to make its assessment relating to the company's ability to continue as a going concern.

(ii) Evaluating management's plan of future actions.

(iii) Make a specific assessment of the company's ability to continue as a going concern.

COMPLETION AND REVIEW

(iv) Analyzing the cashflow forecast of the company.

(v) Considering the additional facts or information available since the date of management's assessment

(vi) Make appropriate disclosures in the financial statements in connection with going concerns.

(vii) Requesting Written Representation from management regarding the plans of future actions and the feasibility of these plans.

(viii) Writing a para addressed to the stakeholders in the audit report citing the results of procedures adhered to relating to the going concern assumption.

Keeping in view above, answer the following questions: -

1. CA Namit tells Manpreet about the auditor's responsibilities in the above case on the matter under discussion. Which of the following doesn't fall under auditor's responsibilities?

(a) Obtaining sufficient and appropriate audit evidence on the matter under discussion.

(b) Conclude on the appropriateness of the management's use of going concern.

(c) Assessing whether a material uncertainty exists about the company's ability to continue as a going concern.

(d) Guarantee the company's ability to continue as a going concern based upon his audit procedures.

Ans: (d)

2. Identify which set of audit procedures are relevant in the above case scenario as per the list prepared by Manpreet.

(a) (I), (II), (IV), (V) & (VII)

(b) (I), (III) & (V)

(c) (II), (IV), (VI), (VII) & (VIII).

(d) (I), (II), (III), (IV) & (V).

Ans: (a)

3. CA Namit's conclusion in the above case will lead him to give which type of audit opinion from the following?

(I) Modified opinion.

(II) Unmodified opinion.

(III) A separate section "Material uncertainty wrt Going concern" in his audit report.

(a) (I) only

(b) (II) only

(c) I) & (III)

(d) (II) & (III)

Ans: (d)

4. Consider the following statements: -

Statement I: - The Management is under a responsibility to make specific assessment of the company's ability to continue as a going concern.

Statement I: I -. The Management is under a responsibility to make appropriate disclosures in connection with going concern in the financial statements.

(a) Statement I is correct only.

(b) Statement II is correct only as Statement I falls under the auditor's responsibilities.

(c) Both statements are correct.

(d) Both statements are incorrect.

Ans: (c)

5. Which of the following is most appropriate regarding "going concern" assumption?

(a) It signifies that company is reflecting net losses in its financial statements.

(b) It signifies that company is not modernizing its plant and machinery.

(c) It signifies that company has no intention of curtailing materially the scale of its operations in foreseeable future.

(d) It signifies that assets are likely to be recorded at the prices they would fetch.

Ans: (c)

7
CHAPTER

REPORTING

Forming an Opinion and Reporting on Financial Statements

Question 1

"What constitutes a 'true and fair view' is the matter of an auditor's judgement in particular circumstances of a case." Do you agree? Enlist the requirements you as an auditor will observe to ensure true and fair view. (MTP 5 Marks Sep 22)

Answer 1

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

In the context of audit of a company, the accounts of a company shall be deemed as not disclosing a true and fair view, if they do not disclose any matters which are required to be disclosed by virtue of provisions of Schedule III to that Act, or by virtue of a notification or an order of the Central Government modifying the disclosure requirements. Therefore, the auditor will have to see that the accounts are drawn up in conformity with the provisions of Schedule III of the Companies Act, 2013 and whether they contain all the matters required to be disclosed therein. In case of companies which are governed by special Acts, the auditor should see whether the disclosure requirements of the governing Act are complied with.

It must be noted that the disclosure requirements laid down by the law are the minimum requirements. If certain information is vital for presenting a true and fair view, the accounts should disclose it even though there may not be a specific legal provision to do so. Thus, what constitutes a 'true and fair' view is the matter of an auditor's judgment in the particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see:

(i) that the assets are neither undervalued or overvalued, according to the applicable accounting principles,

(ii) no material asset is omitted;

(iii) the charge, if any, on assets are disclosed;

(iv) material liabilities should not be omitted;

(v) the statement of profit and loss discloses all the matters required to be disclosed by Part II of Schedule III

(vi) the balance sheet has been prepared in accordance with Part I of Schedule III;

(vii) accounting policies have been followed consistently; and

(viii)all unusual, exceptional or non-recurring items have been disclosed separately.

Question 2

CA S has been appointed as Statutory Auditor of SRT Ltd. for the financial year 2022-2023. 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 the applicable financial reporting framework. Guide him as to how he should deal with this issue while reporting on the financial statements of SRT Ltd. (MTP 5 Marks Sep '23, RTP May '23)

Answer 2

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.

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.

Question 3

KPI Ltd. is a company on which International Standards on Auditing are applicable along with Standard on Auditing issued by the ICAI. The company appointed new auditors for the audit of the financial statements year ended 31 March 2019 after doing all appointment formalities. Therefore, the auditor's report referred the International Standard on Auditing in addition to the Standard on Auditing issued by the ICAI.

As an expert, you are required to advise the auditor regarding auditor's report for audits conducted in accordance with both the Standards. (RTP Nov 19)

Answer 3

Auditor's Report for Audits Conducted in Accordance with Both Standards on Auditing Issued by ICAI and International Standards on Auditing or Auditing Standards of Any Other Jurisdiction: As per SA 700, "Forming an Opinion and Reporting on Financial Statements", an auditor may be required to conduct an audit in accordance with, in addition to the Standards on Auditing issued by ICAI, the International Standards on Auditing or auditing standards of any other jurisdiction. If this is the case, the auditor's report may refer to Standards on Auditing in addition to the International Standards on Auditing or auditing standards of such other jurisdiction, but the auditor shall do so only if:

1) There is no conflict between the requirements in the ISAs or such auditing standards of other jurisdiction and those in SAs that would lead the auditor:

(i) to form a different opinion, or

(ii)not to include an Emphasis of Matter paragraph or Other Matter paragraph that, in the particular circumstances, is required by SAs; and

2) The auditor's report includes, at a minimum, each of the elements set out in Auditor's Report Prescribed by Law or Regulation discussed above when the auditor uses the layout or wording specified by the Standards on Auditing. However, reference to "law or regulation" in above paragraph shall be read as reference to the Standards on Auditing. The auditor's report shall thereby identify such Standards on Auditing.

When the auditor's report refers to both the ISAs or the auditing standards of a specific jurisdiction and the Standards on Auditing issued by ICAI, the auditor's report shall clearly identify the same including the jurisdiction of origin of the other auditing standards

Question 4

How should auditor give description of auditor's responsibilities for the audit of the financial statements when the auditor disclaims an opinion on the financial statements? .(RTP Nov'22)

Answer 4

When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by SA 700, "Forming an Opinion and Reporting on Financial Statements", to include only the following:

(i) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Standards on Auditing and to issue an auditor's report;

(ii) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

(iii) The statement about auditor independence and other ethical responsibilities required in SA 700.

Question 5

XYZ Limited involved in the hospitality business, appointed Charan & Karan Associates as their statutory auditor for FY 2022-23. Management of XYZ Limited, while drawing up the financial statement for the said period, decided to add the following statement after the Statement of Cash Flow as supplementary information to be presented with financial statements. No specific mentions or labels were added to this statement to present that this is supplementary information.

Statement of Average Revenue Per Booking (ARPB) and Comparative (in ` or otherwise stated)

Total Bookings during FY	
- FY 2021-22	**36500**
- FY 2022-23	**39000**
Average Revenue per Booking	
- FY 2021-22 (Refer Note 28 Revenue from Operations)	**3500**
- FY 2022-23 (Refer Note 28 Revenue from Operations)	**4200**
Bookings Ratio (Organic source by Inorganic source)	
- FY 2021-22	**1:2**
- FY 2022-23	**1:1.65**

Kindly guide the audit team regarding the requirement of SA 700 with respect to the Supplementary Information Presented with the Financial Statements. (RTP Nov '23)

Answer 5

As per SA 700 "Forming an Opinion and Reporting on Financial Statements", 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.

The auditor's evaluation of whether unaudited supplementary information is presented in a manner that could be construed as being covered by the auditor's opinion includes, for example, where that information is presented in relation to the financial statements and any audited supplementary information and whether it is clearly labelled as "unaudited."

In the current case, the Statement of Average Revenue Per Booking (ARPB) and Comparative is unaudited supplementary information that could be construed as being covered by the auditor's opinion. Hence, the audit team should evaluate whether such supplementary information is presented in a way that sufficiently and clearly differentiates it from the audited financial statements.

If not, then audit can suggest management to change the presentation of unaudited supplementary information by:

- Removing any cross-references from the financial statements to unaudited supplementary schedules or unaudited notes so that the demarcation between the audited and unaudited information is sufficiently clear.
- Placing the unaudited supplementary information outside of the financial statements or, if that is not possible in the circumstances, at a minimum placing the unaudited notes together at the end of the required notes to the financial statements and clearly labelling them as unaudited.

Unaudited notes that are intermingled with audited notes can be misinterpreted as being audited.

If the management of XYZ Limited refuses to do so, the auditor shall identify the unaudited supplementary information, i.e., Statement of ARPB and Comparative and explain in the auditor's report that such supplementary information has not been audited.

Question 6

The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

(i) Circumstances beyond the control of the entity;

(ii) Circumstances relating to the nature or timing of the auditor's work; or

(iii) Limitations imposed by management.

Explain with the help of examples (RTP May 20)

Answer 6

The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

(i) Circumstances beyond the control of the entity;

(ii) Circumstances relating to the nature or timing of the auditor's work; or

(iii) Limitations imposed by management.

An inability to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures.

Limitations imposed by management may have other implications for the audit, such as for the auditor's assessment of fraud risks and consideration of engagement continuance.

Examples of circumstances beyond the control of the entity include when:

- The entity is required to use the equity method of accounting for an associated entity, and the auditor is unable to obtain sufficient appropriate audit evidence about the latter's financial information to evaluate whether the equity method has been appropriately applied.
- The timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories.
- The auditor determines that performing substantive procedures alone is not sufficient, but the entity's controls are not effective.

Examples of an inability to obtain sufficient appropriate audit evidence arising from a limitation on the scope of the audit imposed by management include when:

- Management prevents the auditor from observing the counting of the physical inventory.
- Management prevents the auditor from requesting external confirmation of specific account balances.

Question 7

MN & Associates, Chartered Accountants have been appointed as statutory Auditors of Cotton Ltd. for the F.Y 2020-2021. The Company is into the business of yarn manufacturing. For this purpose, cotton ginning is also done within the factory premises. Raw cotton is purchased from local market and processed in-house. The Company received a notice from the State Government to deposit market development fee for the last 5 years to the tune of ` 10.00 crores. The Company and all other organizations in the same business have not deposited the market development fee, taking shelter of an old circular issued by the Government. The trade association met with the government officials to resolve the matter and agreed to deposit the same prospectively. However, the matter relating to payment of development fee for the last 5 years is pending before the Government as at the end of the financial year. The Company, however, disclosed the same in notes to accounts, as contingent liability, without quantifying the effect and proper

explanation. If the liability is provided in the books of accounts, entire reserves will be wiped off. Auditor seeks your guidance as to how this disclosure affects them while forming an opinion on financial statements. (PYP 5 Marks July 21)

Answer 7

Forming an opinion and reporting on financial statements –

As per Ind AS 37, "Provisions, Contingent Liabilities and Contingent Assets", an entity should disclose for each class of contingent liability at the end of the reporting period a brief description of the nature of the contingent liability and, where practicable .

(a) an estimate of its financial effect, measured in the standard;

(b) an indication of the uncertainties relating to the amount or timing of any outflow; and

(c) the possibility of any reimbursement.

SA – 700 - Forming an opinion and reporting on financial statements:

The auditor shall evaluate whether in view of the requirements of the applicable financial reporting framework –

(i) The financial statements adequately disclose the significant accounting policies selected and applied;

(ii) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(iii) The accounting estimates made by the management are reasonable;

(iv) The information presented in the financial statements is relevant, reliable, comparable and understandable;

(v) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.

If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with SA 705. In the present case, auditor may consider modifying his opinion considering the financial effect of liability not disclosed properly.

Multiple Choice Questions (MCQ)

Question 1

AHKPL Ltd. is an unlisted company in the business of the real estate following Accounting Standards. The company recognizes revenue on the basis of percentage completion as per AS 7. The company has various residential and commercial projects at different locations for which separate profitability statements are prepared by the management. Profitability statements are based on estimated costs of the projects. While reviewing the profitability statements, statutory auditors observed that the profitability of the projects have been fluctuating significantly year on year and the prime reason for that is the change in the estimated costs. As per the auditors, frequent changes are made by the management in the estimated costs to increase the percentage completion and through which revenue and profit numbers are manipulated. The auditors are not satisfied with the profitability statements of two major projects which account for 50% of the total turnover of the company.

Management tried to explain the auditors saying that the changes would happen because of the dynamics of the industry which have been changing significantly and are unfavorable to the industry as a whole. All of this is leading to changes in the estimated costs. How should the auditors deal with this matter? (MTP 2 Marks, April 19)

(a) Management's view seems reasonable. Estimated costs are only estimates which are subject to changes and hence the auditors should drop this matter.

(b) The auditors view seems reasonable and if the management does not agree, the auditors should issue qualified report.

(c) The auditors should consider the impact of the adjustment on the financial statements and if the impact is pervasive, the auditor should issue adverse opinion.

(d) The auditors should consider the impact of the adjustment on the financial statements and may take the adjustment to unadjusted entry in the management representation letter and basis that issue a clean report.

Ans: (c)

Question 2

OPP & Co LLP is the statutory auditor of ABBA Private Limited. The company has an annual turnover of INR 1000 crores and profits of INR 250 crores. The company is planning to get listed next year. The company appointed OPP & CO LLP as new auditors to have a fresh look on their financial systems so that the financial reporting can be improved wherever required.

During the course of audit, the auditors have been facing lot of challenges to obtain sufficient appropriate audit evidence and have discussed the same with the management. Now the auditors are determining the implications. Please suggest which one of the following should not be the implication in respect of this matter. (MTP 2 Marks, April 19)

(a) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion.

(b) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall withdraw from the audit, where practicable and possible under applicable law or regulation.

(c) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall withdraw from the audit, where practicable and possible under applicable law or regulation. If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

(d) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall withdraw from the audit, where practicable and possible under applicable law or regulation. If withdrawal from the audit before issuing the auditor's report is not practicable or possible, report the matter to the Registrar of Companies.

Ans: (d)

Question 3

BDJ Ltd. is engaged in the business of providing management consultancy services and have been in operation for the last 15 years. The company's financial reporting process is very good and its statutory auditors always issued clean report on the audit of the financial statements of the company.

The auditors were required to be rotated due to mandatory audit rotation requirement of the Companies Act 2013.

RNJ & Associates, a firm of Chartered Accountants, was appointed as the new auditor of the company for a term of 5 years and have to start their first audit for the financial year ended 31 March 2019.

The auditors had a detailed and clear discussion with the management that they will perform their audit procedures in respect of opening balances along with the audit procedures for the financial year ended 31 March 2019.

Management agreed with that and the audit was completed as per the plan.

The auditors did not have any significant observations and hence they communicated to the management that their report will be clean. Management was quite happy with this and also requested the auditors to share draft report before issuing the final report.

In the draft audit report, all the particulars were fine except 'other matters paragraph' wherein the auditors gave a reference that the financial statements for the comparative year ended 31 March 2018 was audited by another auditor. Management asked the audit team to remove this paragraph as the auditors had performed all the audit procedures on opening balances also. But the auditors did not agree with the management.

Please advise the auditor or the management whoever is incorrect with the right guidance.

(a) The contention of the management is valid. After performing all the audit procedures, an auditor should not pass on the responsibility to another auditor by including such references in his audit report.

(b) Any auditor has two options, either to perform audit procedures on opening balances or given such reference of another auditor in his report. An auditor can not mix up the things like this auditor has done. It is completely unprofessional.

(c) In the given situation even if the auditor wants to give such reference, the management and the auditor should have taken approval from the previous auditor at the time of appointment of new auditor. In this case, it cannot be done.

(d) The report of the auditor is absolutely correct and is in line with the auditing standards. An auditor is required to include such reference in his report as per the requirements of the auditing standard. (RTP Nov 19)

Ans: (d).

Question 4

Shripal Ltd is in the business of manufacturing of tiles and sanitaryware. The company has a large inventory every year. Annual turnover of the company is INR 3600 crore. The company has 9 plants across India. The management of the company carries out physical verification of inventory every year at the time of reporting date. During the year ended 31 March 2022, it was found by the management that the inventory sheets of 31 March 2021 did not include five pages containing details of inventory worth INR 29.5 crore. Management has included this inventory in the valuation of inventory as of 31 March 2022. Management has also explained that considering the size of the company this may happen at times as the inventory is huge and lying at various locations. Moreover, the amount of the inventory is insignificant if considered as a percentage of revenue or inventory. State how you will deal with this matter as an auditor in the accounts of the company (towards substantive audit procedures and excluding the impact on auditor's assessment under Internal Financial Control Framework) for the year ended 31 March 2022.

a. Since the matter is not relevant/ material to current period figures, no reporting in respect of this matter would be required in the auditors' report for the year ended 31 March 2022.

b. Management should restate the financials to adjust the error. Otherwise, auditor may modify his opinion on current year's financial statements considering the materiality.

c. Considering the matter is not relevant/ material to current period figures, the management may include a note in the financial statements and basis that no reporting in respect of this matter would be required in the auditors' report for the year ended 31 March 2022.

d. Include an emphasis of matter because of the effects or possible effects of the error in the auditors' report for the year ended 31 March 2022. (MTP 1 Mark March '23)

Ans: (b)

Question 5

While verifying the salary expense of employees, the auditor has been asked to rely on the values as per SAP software and some hard copy reports and documents as the HRMS package (source software) has become corrupt during the year and the management is not having any data backup.

How should the auditor deal with this issue?

(a) The auditor should issue a disclaimer of opinion as records are destroyed and he is unable to obtain sufficient appropriate audit evidence.

(b) The auditor should perform alternative procedures to obtain sufficient and appropriate audit evidence before disclaiming the opinion.

(c) The auditor should issue an adverse opinion stating that it is deficiency in internal controls.

(d) The auditor can rely on the SAP data and there is no need for qualification of report. (MTP 1 Marks, April 21)

Ans: (b)

Question 6

CA Kamal is the statutory auditor of Autocover Ltd. for the FY 2020 -21. The company is engaged in the business of manufacture of car accessories. CA Kamal noticed that the inventories of the company amounting to Rs. 46 crores (equal to 25% of the total assets of the company) at the end of the year do not exist. Also, sales amounting to Rs. 33 crores (equal to 10% of the total sales during the year) have not actually occurred. CA Kamal noticed both the material discrepancies just before the finalisation of the audit report for the year ending 31.03.2021. CA. Kamal considers that the above misstatement would distort the true and fair view to a greater extent.

What is correct course of action that CA Kamal should consider in such a situation?

(a) CA Kamal should consider withdrawing from the audit engagement or issuing a disclaimer of opinion for the FY 2020-21.

(b) CA Kamal should consider issuing an adverse opinion and mentioning both the material discrepancies in the basis for adverse opinion paragraph of the auditor's report.

(c) CA Kamal should ask the management to explain both the discrepancies in the notes to accounts and he himself should highlight the matter in the Key Audit matter paragraph of the auditor's report.

(d) CA Kamal should give a qualified opinion along with the specific mention of the matters in the Emphasis of matter paragraph in the auditor's report along with appropriate disclosure in the notes to accounts to be made by the management of Auto cover Ltd. (MTP 1 Marks, March 21)

Ans: (a).

Question 7

Preparing the financial statements in accordance with the applicable financial reporting framework is the responsibility of the management of ABC Ltd. Which of the following is correct in regard to the disclosure of such management responsibility?

(a) This is implied responsibility of management and is presumed in an audit of financial statements and therefore need not be specifically mentioned anywhere.

(b) The management may undertake to accept such responsibility through an engagement letter itself.

(c) The auditor's report should describe the management responsibility in a section with heading "responsibility of management for financial statements".

(d) The auditor's report should refer to the responsibility of auditors and not that of the management as the same is obvious. (MTP 1 Marks, March 21)

Ans: (c)

Question 8

In case of audits of unlisted corporate entities, other information section is required in auditor's report when at the date of auditor's report:

(a) Auditor has obtained some or all of the other information.

(b) Auditor has obtained all of the other information.

(c) Auditor has obtained or expects to obtain the other information.

(d) Auditor has obtained some of the other information. (MTP 1 Mark April '23)

Ans: (a)

Question 9

KJA Ltd is in the business of manufacturing of tiles and sanitaryware. The company has a large inventory every year. Annual turnover of the company is INR 3000 crores. The company has 7 plants across India.

The management of the company carries out physical verification of inventory every year at the time of reporting date. During the year ended 31 March 2018, it was found by the management that the inventory sheets of 31 March 2017 did not include five pages containing details of inventory worth INR 24.5 crores. Management has included this inventory in the valuation of inventory as of 31 March 2018. Management has also explained that considering the size of the company this may happen at times as the inventory is huge and lying at various locations. Morever, the amount of the inventory is insignificant if considered as a percentage of revenue or inventory. State how you will deal with this matter as an auditor in the accounts of the company (towards substantive audit procedures and excluding the impact on auditor's assessment under Internal Financial Control Framework) for the year ended 31 March 2018.

(a) Since the matter is not relevant/ material to current period figures, no reporting in respect of this matter would be required in the auditors report for the year ended 31 March 2018.

(b) Management should restate the financials to adjust the error. Otherwise auditor may modify his opinion on current year's financial statements considering the materiality.

(c) Considering the matter is not relevant/ material to current period figures, the management may include a note in the financial statements and basis that no reporting in respect of this matter would be required in the auditors report for the year ended 31 March 2018.

(d) Include an emphasis of matter because of the effects or possible effects of the error in the auditors report for the year ended 31 March 2018. (RTP May 19)

Ans: (b).

Question 10

ADI Ltd. is engaged in the business of providing management consultancy services and have been in operation for the last 15 years. The company's financial reporting process is very good and its statutory auditors always issued clean report on the audit of the financial statements of the company. The auditors were required to be rotated due to mandatory audit rotation requirement of the Companies Act 2013.

RNJ & Associates, a firm of Chartered Accountants, was appointed as the new auditor of the company for a term of 5 years and have to start their first audit for the financial year ended 31 March 2022.

The auditors had a detailed and clear discussion with the management that they will perform their audit procedures in respect of opening balances along with the audit procedures for the financial year ended 31 March 2022.

Management agreed with that and the audit was completed as per the plan.

The auditors did not have any significant observations and hence they communicated to the management that their report will be clean. Management was quite happy with this and also requested the auditors to share draft report before issuing the final report.

In the draft audit report, all the particulars were fine except ' other matters paragraph' wherein the auditors gave a reference that the financial statements for the comparative year ended 31 March 2021 was audited by another auditor. Management asked the audit team to remove this paragraph as the auditors had performed all the audit procedures on opening balances also. But the auditors did not agree with the management.

Please advise the auditor or the management whoever is incorrect with the right guidance.

a) The contention of the management is valid. After performing all the audit procedures, an auditor should not pass on the responsibility to another auditor by including such references in his audit report.

b) Any auditor has two options, either to perform audit procedures on opening balances or given such reference of another auditor in his report. An auditor can not mix up the things like this auditor has done. It is completely unprofessional.

c) In the given situation even if the auditor wants to give such reference, the management and the auditor should have taken approval from the previous auditor at the time of appointment of new auditor. In this case, it cannot be done.

d) The report of the auditor is absolutely correct and is in line with the auditing standards. An auditor is required to include such reference in his report as per the requirements of the auditing standard. (MTP 1 Mark Sep '22)

Ans: (d)

SA 701 Communicating Key Audit Matters in the Independent Auditor's Report

Question 1

AKY Ltd. is a listed company engaged in the business of software and is one of the largest company operating in this sector in India. The company's annual turnover is Rs. 40,000 crores with profits of Rs. 5,000 crores. Due to the nature of the business and the size of the company, the operations of the company are spread out in India as well as outside India. The company's contracts with its various customers are quite complicated and different. During the course of the audit, the audit team spends significant time on audit of revenue – be it planning, execution or conclusion. This matter was also discussed with management at various stages of audit. The efforts towards audit of revenue also involve significant involvement of senior members of the audit team including the audit partner. After completion of audit for the year ended 31 March 2019, the audit partner was discussing significant matters with the management wherein they also communicated to the management that he plans to include revenue recognition as key audit matter in his audit report. The management did not agree with revenue recognition to be shown as key audit matter in the audit report. Comment (MTP 4 Marks, Oct 19)

Answer 1

Determining Key Audit Matters: SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report", deals with the auditor's responsibility to communicate key audit matters in the auditor's report. It is intended to address both the auditor's judgment as to what to communicate in the auditor's report and the form and content of such communication.

The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

a. Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.

b. Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.

c. The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined in accordance with above were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters. In the instant case, AKY Ltd., a listed company engaged in the business of software and its contracts with its various customers are also quite complicated and different. Further, the audit team spends significant time on audit of revenue and efforts towards audit of revenue also involve significant involvement of senior members of the audit team including audit partner during audit. This matter was also discussed with management at various stages. After completion of audit, the audit partner communicated the management regarding inclusion of paragraph on revenue recognition as key audit matter in his audit report.

In view of SA 701, the assessment of the auditor is valid as above matter qualifies to be a key audit matter in the opinion of auditor. Hence, it should be reported accordingly by the auditor in his audit report.

Question 2

"The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the key factors". You are required to define key audit matters and briefly discuss the factors determining the key audit matters. (MTP 4 Marks, April 18)

Answer 2

Definition of Key Audit Matters: SA 701 "Communicating Key Audit Matters in the Independent Auditor's Report", define Key audit matters as matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance. Factors determining Key Audit Matters: As per SA 701 the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

(i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.

(ii) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.

(iii) The effect on the audit of significant events or transactions that occurred during the period.

Question 3

While auditing the complete set of consolidated financial statements of Moksh Ltd., a listed company, using a fair presentation framework, XYZ & Co., a Chartered Accountant firm, discovered that the consolidated financial statements are materially misstated due to the non-consolidation of one of the subsidiary. The material misstatement is deemed to be pervasive to the consolidated financial statements. The effects of the misstatement on the consolidated financial statements could not be determined because it was not practicable to do so. Thus, XYZ

& Co. decided to provide an adverse opinion for the same and further determined that, there are no key audit matters other than the matter to be described in the Basis for Adverse Opinion section. Comment whether XYZ & Co. needs to report under SA 701 'Communicating Key Audit Matters in the Independent Auditor's Report'? (MTP 5 Marks Sep 22)

Answer 3

1. SA 700 establishes requirements and provides guidance on forming an opinion on the financial statements. Communicating key audit matters is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation. SA 705, "Modifications to the Opinion in the Independent Auditor's Report", addresses circumstances in which the auditor concludes that there is a material misstatement relating to the appropriateness or adequacy of disclosures in the financial statements.
2. When the auditor expresses a qualified or adverse opinion in accordance with SA 705, presenting the description of a matter giving rise to a modified opinion in the Basis for Qualified (Adverse) Opinion section helps to promote intended users' understanding and to identify such circumstances when they occur. Separating the communication of this matter from other key audit matters described in the Key Audit Matters section, therefore, gives it the appropriate prominence in the auditor's report.
3. Further, when the auditor expresses a qualified or adverse opinion, communicating other key audit matters would still be relevant to enhancing intended users' understanding of the audit, and therefore the requirements to determine key audit matters apply. However, as an adverse opinion is expressed in circumstances when the auditor has concluded that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements depending on the significance of the matter(s) giving rise to an adverse opinion, the auditor may determine that no other matters are key audit matters.
4. In the given situation Moksh Ltd., a listed company, has not consolidated one of its subsidiary. Further, Consolidated Financial Statements of Moksh Ltd. Are materially misstated due to such nonconsolidation.

   The material misstatement is also deemed to be material and pervasive and effect of the failure to consolidate have not been determined. In the given situation it is appropriate to give Adverse Opinion by XYZ & Co., a Chartered Accountant Firm.
5. Since, in the given case, Adverse Opinion is being expressed thus XYZ & Co. can communicate Key Audit Matter in given below manner:
6. Key Audit Matters: Except for the matter described in the Basis for Adverse Opinion section, we have determined that there are no other key audit matters to communicate in our report.

Question 4

Write a short note on: Key Audit Matters and Circumstances in Which a Matter Determined to Be a Key Audit Matter Is Not Communicated in the Auditor's Report. (RTP May 18)

Answer 4

Key Audit Matters— As per SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report (New)", those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

Circumstances in Which a Matter Determined to Be a Key Audit Matter Is Not Communicated in the Auditor's Report: The auditor shall describe each key audit matter in the auditor's report unless:

(i) Law or regulation precludes public disclosure about the matter; or

(ii) In extremely rare circumstances, the auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. This shall not apply if the entity has publicly disclosed information about the matter.

Question 5

Write a short note on: The purpose of communicating key audit matters.(RTP Nov 18)

Answer 5

Purpose of Communicating Key Audit Matters : The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Communicating key audit matters provides additional information to intended users of the financial statements ("intended users") to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements.

Question 6

Mr. Hemant Ramsey was appointed as the engagement partner for conducting the audit of Kshetra Lap Ltd. for F.Y. 2020-21, on behalf of Ramsey & Associates. Mr. Vishay Tyagi was appointed as the engagement quality control reviewer by the firm for the said audit.

During F.Y. 2020-21, there was an implementation of ERP system in a phased manner, in Kshetra Lap Ltd. due to which some of its business processes got automated. As a result of the implementation of such a system, there was a significant effect on the auditor's overall audit strategy. Mr. Hemant discussed the implementation of such a system with Mr. Vishay and also told him that such a matter may be a key audit matter to be reported in the audit report.

Mr. Vishay considered the significance of such matter but however he was of the opinion that such a matter did not appear to link with the matters disclosed in the financial statements and so there was no need to disclose such matter as a key audit matter.

Whether the contention of Mr. Vishay is proper with respect to the matters to be communicated as a key audit matter? (RTP Nov '21)

Answer 6

As per SA 701, 'Communicating Key Audit Matters in the Independent Auditor's Report', the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

(i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.

(ii) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.

(iii) The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the aforesaid matters considered were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

These aforesaid considerations focus on the nature of matters communicated with those charged with governance. Such matters are often linked to matters disclosed in the financial statements and are intended to reflect areas of the audit of the financial statements that may be of particular interest to intended users.

The fact that these considerations are required is not intended to imply that matters related to them are always key audit matters; rather, matters related to such specific considerations are key audit matters only if they are determined to be of most significance in the audit.

In addition to matters that relate to the specific required considerations, there may be other matters communicated with those charged with governance that required significant auditor attention and that therefore may be determined to be key audit matters. Such matters may include, for example, matters relevant to the audit that was performed that may not be required to be disclosed in the financial statements. For example, the implementation of a new IT system (or significant changes to an existing IT system) during the period may be an area of significant auditor attention, in particular if such a change had a significant effect on the auditor's overall audit strategy or related to a significant risk (e.g., changes to a system affecting revenue recognition).

In the given case, there was implementation of ERP system in the company due to which some of its business processes got automated and which had a significant effect on the auditor's overall audit strategy during the period.

Accordingly, such a matter can be considered as a key audit matter if according to Mr. Hemant, such a matter required significant attention that had affected his overall audit strategy.

Thus, the contention of Mr. Vishay is not proper as matters that do not link with the matters disclosed in the financial statements can also be considered as a key audit matter if it required significant attention of the auditor which had an impact on its audit.

Question 7

What is the auditor's responsibility to report a key audit matter for which there are no relevant disclosures in the financial statements? (RTP May 22)

Answer 7

When communicating key audit matters, the fact that there are no disclosures in the financial statements related to a matter determined to be a key audit matter does not relieve the auditor from the requirement to communicate it. An auditor may determine a key audit matter related to the audit for which relevant disclosure requirements do not exist in the applicable financial reporting framework.

For example, the implementation of a new IT system (or significant changes to an existing IT system) during the period may be an area of significant auditor attention, in particular, if such a change had a significant effect on the auditor's overall audit strategy or related to significant risk (e.g., changes to a system affecting revenue recognition.

Also, if an auditor determines that it is necessary to include information about the entity in order to effectively describe a key audit matter that has not been disclosed by management and management does not agree to disclose that information, the auditor should reconsider the adequacy of the disclosures in accordance with applicable financial reporting framework. The auditor should communicate the matter as a key audit matter unless law or regulation precludes public disclosure about the matter or in extremely rare circumstances, the auditor determines that the matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Question 8

How does the inclusion of Emphasis of Matter (EOM) paragraphs in the Auditor's Report differ from the disclosure of Key Audit Matters (KAM)? (RTP Nov '23)

Answer 8

Relationship between Emphasis of Matter Paragraphs and Key Audit Matters in the Auditor's Report

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Key audit matters—	Emphasis of Matter paragraph –
Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance. [SA 701]	A paragraph included in the auditor's report that refers to a matter appropriately 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. [SA 706]
Matters that are determined to be key audit matters in accordance with SA 701 may also be, in the auditor's judgment, fundamental to users' understanding of the financial statements. In such cases, in communicating the matter as a key audit matter in accordance with SA 701, the auditor may wish to highlight or draw further attention to its relative importance. Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit and may also assist them in understanding the entity and areas of significant management judgment in the audited financial statements.	A widespread use of Emphasis of Matter paragraphs may diminish the effectiveness of the auditor's communication about such matters. Use of Emphasis of Matter paragraphs is not a substitute for a description of individual key audit matters where SA 701 is applicable. There may be a matter that is not determined to be a key audit matter in accordance with SA 701 (i.e., because it did not require significant auditor attention), but which, in the auditor's judgment, is fundamental to users' understanding of the financial statements (e.g., a subsequent event). If the auditor considers it necessary to draw users' attention to such a matter, the matter is included in an Emphasis of Matter paragraph in the auditor's report in accordance with this SA.
The communication of key audit matters in the auditor's report may also provide intended users a basis to further engage with management and those charged with governance about certain matters relating to the entity, the audited financial statements, or the audit that was performed.	The auditor may do so by presenting the matter more prominently than other matters in the Key Audit Matters section (e.g., as the first matter) or by including additional information in the description of the key audit matter to indicate the importance of the matter to users' understanding of the financial statements.

Multiple Choice Questions (MCQs)

Question 1

As per SA 701- Communicating Key audit matters in the Independent auditor's Report, which among the following areas should CA & Co. take into account to determine "Key Audit Matter"?

(i) The effect on audit of significant transactions that took place in the financial year.

(ii) Areas of high risk as assessed and reported by management's expert.

(iii) Significant auditor judgement relating to areas in the financials that involved significant management judgement.

(a) (i) & (ii)

(b) (ii) only

(c) (i) & (iii)

(d) (i), (ii) & (iii) (MTP 1 Mark April 22, RTP Nov'20)

Ans: (c)

Question 2

While auditing the complete set of consolidated financial statements of Tulips Ltd., a listed company, using a fair presentation framework, M/s Pintu & Co., a Chartered Accountant firm, discovered that the consolidated financial statements are materially misstated due to the non- consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the consolidated financial statements. The effects of the misstatement on the consolidated financial statements have not been determined because it was not practicable to do so. Thus, M/s Pintu & Co. decided to provide an adverse opinion for the same and further determined that, there are no key audit matters other than the matter to be described in the Basis for Adverse Opinion section. Comment whether M/s Pintu & Co. needs to report under SA 701 'Communicating Key Audit Matters in the Independent Auditor's Report'?

(a) M/s Pintu & Co. have the option to follow SA 701, thus, need not to report any key audit matters.

(b) SA 701 is mandatory in the case of audit of listed entities, however, as there are no key audit matters other than the matter to be described in the Basis for Adverse Opinion section, no 'Key Audit Matters' para needs to be stated under audit report.

(c) SA 701 is mandatory in the case of audit of listed entities, however, as there are no key audit matters other than the matter to be described in the Basis for Adverse Opinion section, M/s Pintu & Co. shall state, under 'Key Audit Matters' para, that 'except for the matter described in the Basis for Adverse Opinion section, we have determined that there are no other key audit matters to communicate in our report.'

(d) M/s Pintu & Co. is under compulsion to follow SA 701 as the audit is of a listed company and shall report under 'Key Audit Matters' para the matter same as stated in 'Adverse Opinion' para regarding non- consolidation of a subsidiary. (MTP 1 Marks, April 19)

Ans: (c)

REPORTING

Question 3

Descripton of each key audit matter in the "key audit matters section" needs to cover except following aspects:

(a) Reference to related disclosures, if any, in the financial statements.

(b) Explanation on the matter given by management.

(c) How the matter was addressed in the audit.

(d) Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter .(MTP 1 Mark Nov 21)

Ans: (b)

Question 4

RBJ Ltd. is a listed company engaged in the business of software and is one of the largest company operating in this sector in India. The company's annual turnover is ₹ 40,000 crores with profits of ₹ 5,000 crores. Due to the nature of the business and the size of the company, the operations of the company are spread out in India as well as outside India.

Outside India, the company is focusing more on US and European markets and the company has been able to establish its good reputation in these markets as well.

During the course of the audit, the audit team spends significant time on audit of revenue– be it planning, execution or conclusion. The audit team for this engagement is generally very big i.e. a team of approx. 70-80 members. The company's contracts with its various customers are quite complicated and different. The efforts towards audit of revenue also involve significant involvement of senior members of the audit team including the audit partner.

After completion of audit for the year ended 31 March 2019, the audit partner was discussing significant matters with the management wherein he also communicated to the management that he plans to include revenue recognition as key audit matter in his audit report. The management was quite surprised to understand this from the auditor and did not agree with revenue recognition to be shown as key audit matter in the audit report. As per the management, the auditors didn't have any modification and such a matter getting reported as key audit matter would not go down well with various stakeholders and would significantly impact the financial positions of the company in the market. The auditors were not able to convince the management in respect of this point and there was a difference of opinion.

You are requested to give your view in respect of this matter.

(a) The concern of the management is valid. For such a large sized company, such type of matter getting reported as key audit matter is not appropriate.

(b) The assessment of the auditor is valid. Such a matter qualifies to be a key audit matter and hence should be reported accordingly by the auditor in his audit report.

(c) Reporting revenue as key audit matter when the auditor does not have observation in that area leading to any modification in his report, would not be appropriate.

(d) This being the first year of reporting of key audit matters, the auditor should take a soft stand and should avoid reporting such controversial matters in his report.(RTP Nov 19)

Ans: (b).

REPORTING

SA 705 Modifications to the Opinion in the Independent Auditor's Report

Question 1

As an auditor of ABC Limited, in view of given circumstances, you are required to draft qualified opinion and basis for qualified opinion due to the departure from the applicable Financial Reporting Framework:

- **Audit of a complete set of financial statements of an company other than a listed company (registered under the Companies Act, 2013) using a fair presentation framework.**
- **The financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.**
- **A departure from the applicable financial reporting framework resulted in a qualified opinion.**
- **The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).**
- **Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event.**

  In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.
- **The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with SA 701.**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013. (MTP 5 Marks, Aug 18)**

Answer 1

Qualified Opinion

We have audited the standalone financial statements of ABC Limited ("the Company"), which comprise the balance sheet as at March 31, 20X1, and the statement of Profit and Loss, (statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information (in which are included the Returns for the year ended on that date audited by the branch auditors of the Company's branches located at (location of branches).

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the aforesaid financial statements present fairly, in all material respects, or give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at March 31st, 2XXX and profit/loss, (changes in equity) and its cash flows for the year ended on that date.

Basis for Qualified Opinion

The Company's short-term marketable securities are carried in the statement of financial position at xxx. Management has not marked these securities to market but has instead stated them at cost, which constitutes a departure from the Accounting Standards prescribed in section 133 of the Companies Act, 2013. The Company's records indicate that had management marked the marketable securities to market, the Company would have recognized an unrealized loss of Rs.xxx in the statement of comprehensive income for the year. The carrying amount of the securities in the statement of financial position would have been reduced by the same amount at March 31, 20X1, and income tax, net income and shareholders' equity would have been reduced by Rs.xxx, Rs.xxx and Rs.xxx, respectively.

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

Question 2

As an auditor of XYZ Limited, in view of given circumstances, you are required to draft Adverse Opinion and basis for adverse opinion due to a Material Misstatement of the Consolidated Financial Statements.

- **Audit of a complete set of consolidated financial statements of a listed company (incorporated under the Companies Act, 2013) using a fair presentation framework. The audit is a group audit of an entity with subsidiaries (i.e., SA 600 applies).**
- **The consolidated financial statements are prepared by management of the entity in accordance with the Accounting Standards prescribed under section 133 of the Companies Act, 2013 (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the consolidated financial statements in SA 210.**

- **The consolidated financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the consolidated financial statements. The effects of the misstatement on the consolidated financial statements have not been determined because it was not practicable to do so (i.e., an adverse opinion is appropriate).**
- **The relevant ethical requirements that apply to the audit are the ICAI's Code of Ethics and the provisions of the Companies Act, 2013.**
- **Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast signif icant doubt on the entity's ability to continue as a going concern in accordance with SA 570 (Revised).**
- **SA 701 applies; however, the auditor has determined that there are no key audit matters other than the matter described in the Basis for Adverse Opinion section.**
- **Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.**
- **In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under the Companies Act, 2013. (MTP 5 Marks, April 18)**

Answer 2

Adverse Opinion : We have audited the accompanying consolidated financial statements of XYZ Company Limited (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group"), its associates and jointly controlled entities, which comprise the consolidated balance sheet as at March 31, 2XXX, the consolidated statement of profit and Loss, (consolidated statement of changes in equity){where applicable} and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "consolidated financial statements").

In our opinion and to the best of our information and according to the explanations given to us, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 20XX, of its consolidated profit/ loss, (consolidated position of changes in equity)){where applicable} and the consolidated cash flows for the year then ended.

Basis for Adverse Opinion

As explained in Note X, the Group has not consolidated subsidiary PQR Company that the Group acquired during 20XX because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under the accounting principles generally accepted in India, the Group should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had PQR Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with Standards on Auditing (SAs) specified under section 143(10) of the Companies Act, 2013. Our responsibilities under those Standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report.

We are independent of the Group, its associates and jointly controlled entities, in accordance with the Code of Ethics and provisions of the Companies Act, 2013 that are relevant to our audit of the consolidated financial statements in India under the Companies Act, 2013, and we have fulfilled our other ethical responsibilities in accordance with the Code of Ethics and the requirements under the Companies act, 2013. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

Question 3

As an auditor of ABC Limited, in view of given circumstances, you are required to draft disclaimer of opinion and basis for disclaimer of opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about Multiple Elements of the Financial Statement.

- **Audit of a complete set of financial statements of an entity other than a company incorporated under the Companies Act, 2013, using a fair presentation framework. The audit is not a group audit (i.e., SA 600, does not apply).**
- **The financial statements are prepared by management of the entity in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India (a general purpose framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in SA 210.**
- **The auditor was unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements, that is, the auditor was also unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.**
- **The relevant ethical requirements that apply to the audit are ICAI's Code of Ethics and applicable law/regulation**
- **Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.**
- **A more limited description of the auditor's responsibilities section is required.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under relevant law/ regulation. (MTP 5 Marks, March 18)**

REPORTING

Answer 3

Disclaimer of Opinion: We were engaged to audit the financial statements of ABC & Associates ("the entity"), which comprise the balance sheet as at March 31, 20XX, the statement of Profit and Loss, (the statement of changes in equity)(where applicable) and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the entity. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We were not appointed as auditors of the Company until after March 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at March 31, 20X0 and 20X1, which are stated in the Balance Sheets at ` xxx and ` xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the Balance Sheet at a total amount of ` xxx as at March 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of Profit and Loss (and statement of cash flows)(Where applicable).

Question 4

BREW Ltd., FMCG Company having its tea gardens in northeastern states of the country is exclusively dealing in blending, processing, packing and selling of various brands of Tea. During the year under audit, the company entered into joint venture for purchasing Tea Gardens in Sri Lanka and Kenya. M/s PM & Associates are the statutory auditors of the company for the financial year 2021-22. During the course of audit, the audit team was unable to obtain sufficient appropriate evidence about a single element of the consolidated financial statement being Joint venture investment in Dharma Ltd. representing over 91% of the group's net assets having both material and pervasive possible effect to the consolidated financial statements. The group's investment in Dharma Ltd. is carried at ₹ 115 crore in the group's consolidated balance sheet.

Draft the opinion paragraph and basis of opinion paragraph to be included in the Independent Auditor's report. (MTP 5 Marks Oct '22)

Answer 4

M/s PM & Associates are unable to obtain sufficient appropriate audit evidence about the financial information of a joint venture investment that represents over 91% of the group's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are both material and pervasive to the consolidated financial statements. Therefore, the statutory auditor should issue a disclaimer of opinion.

The relevant extract of the Disclaimer of Opinion Paragraph and Basis for Disclaimer of Opinion paragraph is as under:

Disclaimer of Opinion

We were engaged to audit the accompanying consolidated financial statements of BREW Ltd., (hereinafter referred to as the "Holding Company") and its subsidiaries (the Holding Company and its subsidiaries together referred to as "the Group), which comprise the consolidated balance sheet as at March 31, 2022, the consolidated statement of Profit and Loss, (consolidated statement of changes in equity) and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies (hereinafter referred to as the "Consolidated Financial Statements").

We do not express an opinion on the accompanying consolidated financial statements of the Group. Because of the significance of the matter described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

Basis for Disclaimer of Opinion

The Group's investment in its joint venture Dharma Ltd. Company is carried at ` 115 crore on the Group's consolidated balance sheet, which represents over 91% of the Group's net assets as at March 31, 2022.

We were not allowed access to the management and the auditors of Dharma Ltd. Company, including Dharma Ltd.'s auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of Dharma Ltd.'s assets that it controls jointly, its proportional share of Dharma Ltd.'s liabilities for which it is jointly responsible, its proportional share of Dharma Ltd.'s income and expenses for the year, (and the elements making up the consolidated statement of changes in equity) and the consolidated cash flow statement.

Question 5

CA Subhadra is the statutory auditor of SATI Ltd. for the financial year 2021-22. In respect of loans and advances of ₹ 95 lakh given to Shripal Pvt. Ltd., the Company has not furnished any agreement to CA Subhadra and in absence of the same, he is unable to verify the terms of repayment, chargeability of interest and other terms.

Justify the type of opinion which CA Subhadra should give in such situation. Also, Draft an appropriate Opinion paragraph and Basis of Opinion paragraph. (MTP 4 Marks March '23 & April '23, PYP 4 Marks Dec '21)

Answer 5

In the present case, with respect to loans and advances of ₹ 95 Lacs given to Shripal Pvt. Limited, the Company has not furnished any agreement to CA Subhadra. In the absence of such an agreement, CA Subhadra is unable to verify the terms of repayment, chargeability of interest and other terms. For an auditor, while verifying any loans and advances, one of the most important audit evidence is the loan agreement. Therefore, the absence of such document in the present case, tantamount to a material misstatement in the financial statements of the company. However, the inability of CA Subhadra to obtain such audit evidence is though material but not pervasive so as to require him to give a disclaimer of opinion.

Thus, in the present case, CA Subhadra should give a qualified opinion

The relevant extract of the Qualified Opinion Paragraph and Basis for Qualified Opinion paragraph is as under:

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the financial statements of SATI Limited give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as on 31.03.2022 and profit/ loss for the year ended on that date.

Basis for Qualified Opinion

The Company is unable to furnish the loan agreement with respect to loans and advances of ₹ 95 Lacs given to Shripal Pvt. Limited. Consequently, in the absence of such an agreement, we are unable to verify the terms of repayment, chargeability of interest and other terms.

Question 6

ADKS & Co LLP are the newly appointed statutory auditors of PKK Ltd. During the course of audit, the statutory auditors have come across certain significant observations which they believe could lead to material misstatement of financial statements. Management has a different view and does not concur with the view of the statutory auditors. Considering this the statutory auditors are determining as to how to address these observations in terms of their reporting requirement. Please advise. (MTP 5 Marks, April 19, Old & New SM)

Answer 6

As per SA 705, if the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in his report.

The auditor in such a case needs to determine the modification as follows:

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

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

(ii) Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements

(iii) Disclaimer of Opinion: The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove the limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.

Question 7

After accepting the statutory audit of M/s All-in-All Ltd., a departmental store, you became aware of the fact that management of the company have imposed certain limitations on the scope of your assurance function which may adversely affect and result in your inability to obtain sufficient appropriate audit evidence to discharge your responsibility required by the statute. Indicate the consequences and your response to the limitations imposed by the management on your scope. (MTP 5 Marks April 22, PYP 4 Marks, May '19)

Answer 7

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement: As per SA 705, Modification

to the Opinion in the Independent Auditor's Report", if, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.

If management refuses to remove the prescribed limitation, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:

(i) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or

(ii) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:

1. Withdraw from the audit, where practicable and possible under applicable law or regulation; or
2. If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.

If the auditor withdraws as discussed above, before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

Question 8

While conducting audit of RAC Limited, CA R has discovered a misstatement in the financial statements of a company due to non-write off of a huge trade receivable with an outstanding amount of ₹ 2 crores.

The party in question has fled from India and is now absconding. After reviewing the audit evidence, it was concluded by the auditor that there is no possibility of recovering the outstanding debt. Despite the matter being brought to the attention of the management, they have refused to correct the misstatement. As a result, the financial statements of the company show a profit before tax of ₹ 1 crore, which is incorrect due to the management's refusal to correct the aforementioned misstatement. Materiality has been determined for financial statements @ 5% of profit before tax.

Comment as regards to type of opinion to be given by CA R in above situation on the basis of provided information. (5 Marks Oct '23)

Answer 8

SA 705 states that the auditor shall modify the opinion in the auditor's report when:

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

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

In the given situation, auditor has obtained evidence in relation to non-recoverability of outstanding trade receivable.

SA 705 further states that the auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

In this scenario, the uncorrected misstatement stands at 200% of the profit before tax, while the materiality has been determined at 5% of the profit before tax. Hence, this misstatement should be considered as material. Additionally, if such a substantial amount is written off, it would significantly impact the financial position of the company. As a result, losses would have to be reported instead of profits. Taking the above factors into consideration, this misstatement should be classified as both material and pervasive. Therefore, adverse opinion needs to be expressed in accordance with the requirements of SA 705.

Question 9

Compare and explain the following: Audit Qualification vs. Emphasis of Matter.(RTP May'18, Old & New SM)

Answer 9

(a)

(i) Audit Qualification vs. Emphasis of Matter:

REPORT	
Audit Qualification	**Emphasis of Matter**
Standard on Auditing 705 "Modifications to the Opinion in the Independent Auditor's Report", deals with the provisions relating to Audit Qualification.	Standard on Auditing 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" deals with the provisions relating to Emphasis of Matter.
Audit Qualifications are also known as "subject to report" or "except that report".	Emphasis of Matter is a paragraph which is included in auditor's report to draw users' attention to important matter(s) which are already disclosed in Financial Statements and are fundamental to users' for understanding of Financial Statements.
Audit Qualifications are given when auditor is having reservations on some of the items out of the financial statements as a whole i.e. Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements relating to if the impact of material misstatements is not pervasive on the financial statements but is present at some levels of the financial statements, qualified report is issued.	Emphasis of Matter is a paragraph which is issued when there is a uncertainty relating to future outcome of exceptional litigation, regulatory action, etc.; or there is early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.

Question 10

You have been appointed as an auditor of Dharmnath & Sons for FY 2020-21, as entity other than a company incorporated under the Companies Act, 2013, using a fair presentation framework.

Appointment had been made in the month of April, 2021. The financial statements have been prepared by the management in accordance with the Accounting Standards. The management had introduced the new computerized accounts receivable system from November 2020 and still in the implementation phase and thus management is in the process of rectifying system deficiencies and correcting the errors. At the time of implementation of a new system, the earlier system of accounting of receivables had been discarded. The auditor was unable to obtain sufficient appropriate audit evidence about the entity's accounts receivable and inventories. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements. Write the opinion paragraph and basis of opinion paragraph to be included in the Independent Auditor's Report. (RTP May 22)

Answer 10

Opinion Paragraph Disclaimer of Opinion

We were engaged to audit the financial statements of Dharmnath & Sons ("the entity"), which comprise the balance sheet as at March 31, 2021, the statement of Profit and Loss, (the statement of changes in equity) and the statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the entity. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We were not appointed as auditors of the Company until after March 31, 2021 , and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at March 31, 2020, and 2021, which are stated in the Balance Sheets at ₹ xxx and ₹ xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in November 2020 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the Balance Sheet at a total amount of ₹ xxx as at March 31, 2021. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of Profit and Loss (and statement of cash flows)

Question 11

CA Bahubali is the statutory auditor of Bharat Ltd. for the FY 2021-22. During the course of audit CA Bahubali noticed the following:

(i) With respect to the debtors amounting to ₹ 240 crore, no balance confirmation was received by the audit team. Further, there have been defaults on the payment obligations by debtors on the due dates during the year under audit. The Company has created a provision for doubtful debts to the tune of ₹40 crore during the year under audit. The Company has stated that the provision is based on receivables which are older than 39 months, which according to the audit team is inadequate and as such the audit team is unable to ascertain the carrying value of trade receivables.

(ii) In respect of Inventories (which constitutes 38% of the total assets of the company), during the reporting period, the management has not undertaken physical verification of inventories at periodic intervals. Also, the Company has not maintained adequate inventory records at the factory. The audit team was unable to undertake the physical inventory count as such the value of inventory could not be verified.

Under the above circumstances what kind of opinion should CA Bahubali give? Write the opinion paragraph and basis of opinion paragraph to be included in the Independent Auditor's Report. (RTP Nov'22)

Answer 11

In the present case, CA Bahubali is unable to obtain sufficient and appropriate audit evidence with respect to the following:

(i) The balance confirmation with respect to debtors amounting to ₹ 240 crore is not available.

Further there has been default in payment by the debtors and the provision so made is not adequate. The audit team is also unable ascertain the carrying value of trade receivables.

(ii) With respect to 38% of the company's inventory, neither the physical verification has been done by the management nor are adequate inventory records maintained. The audit team is also unable to undertake the physical inventory count as such the value of inventory could not be verified.

In the above two circumstances the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Thus, CA Bahubali should give a Disclaimer of Opinion.

The relevant extract of the Disclaimer of Opinion Paragraph and Basis for Disclaimer of Opinion paragraph is as under:

Disclaimer of Opinion

We do not express an opinion on the accompanying financial statements of Bharat Ltd. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We are unable to obtain balance confirmation with respect to the debtors amounting to ` 240 crore.

Further, there have been defaults on the payment obligations by debtors on the due dates during the year under audit. The Company has created a provision for doubtful debts to the tune of ` 40 crore during the year under audit which is inadequate in the circumstances of the company. The carrying value of trade receivables could not be ascertained.

Further, in respect of Inventories (which constitutes 38% of the total assets of the company), during the reporting period, the management has not undertaken physical verification of inventories at periodic intervals. Also, the Company has not maintained adequate inventory records at the factory. We were unable to undertake the physical inventory count and as such the value of inventory could not be verified.

Question 12

CA. K is appointed statutory auditor of SEEK INDIA PVT LTD under the Companies Act 2013 for the first time. The company is preparing its accounts, considering the applicable requirements of Division I of Schedule III of the Companies Act, 2013. On scrutinizing, the company's financial statements for an audit, it was noticed that notes to accounts show the ageing of trade payables as per amended requirements of the Schedule III of the Companies Act, 2013.

The ageing schedule forming part of the notes is as under: -

Outstanding for following periods from the due date of payment (In ₹ crore)

Particulars	Less than 1 year	1-2 years	2-3 years	More than 3 years	Total
MSME	NIL	NIL	NIL	NIL	NIL
Others	2	4	3	1	10
Disputed dues- MSME	NIL	NIL	NIL	NIL	NIL
Disputed dues others	NIL	NIL	NIL	NIL	NIL

Besides above, current ratio, debt-equity ratio, trade payables turnover ratio and net profit ratio disclosed in notes to accounts have slipped drastically as compared to last year and from standard norms. Most of the key financial ratios are in red.

There is no other relevant information concerning above in notes to accounts.

Further, on reviewing bank statement of cash credit limit (against hypothecation of paid stocks), it was noticed that there is no debit transaction in month of March 2022. On inquiry, he came to know that the company's stock audit was conducted in January, 2022 and stock auditors have commented vide their report dated 25.2.2022 that the company had negative drawing power due to high creditors. Accordingly, the bankers have refused further debits in the cash credit account since March 2022.

Further, upon inquiry with the management, it was identified that management did not have any major future contracts to boost their revenue and financial position.

There is no information in this respect in financial statements and notes to accounts.

Discuss how CA K should deal with above for reporting in his audit report under Companies Act, 2013. (RTP May '23)

Answer 12

It is clear from the ageing schedule that company is not able to pay its creditors on time. Outstanding to creditors for a period of 1 year or more account for 80% of total creditors of the company. Most of key financial ratios are adverse.

Further, bankers have refused further debits in cash credit account due to negative drawing power from March 2022. Cash credit loans are repayable on demand. There is no other information available how the company plans to run its business without bank finance.

Also, Further, upon inquiry with the management, it was identified that management did not have any major future contracts to boost their revenue and financial position.

All the above factors are indicators that a material uncertainty exists that may cast significant doubt on the company's ability to continue as a going concern. There is no express disclosure of this fact in financial statements.

Therefore, it is a situation where material uncertainty exists, which has cast significant doubt on company's ability to continue as going concern in accordance with SA 570 , Going Concern.

Considering above the fact that although a material uncertainty exists casting significant doubt on the ability of the company to continue as going concern, adequate disclosure of material uncertainty is not made in financial statements. Thus, CA K shall give qualified or adverse opinion in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report.

Question 13

In the financial year 2022-23, MOKSH Ltd. faced an extraordinary event (earthquake), which destroyed a lot of business activity of the company. These circumstances indicate material uncertainty on the company's ability to continue as going concern. Due to such event, it may not be possible for the company to realize its assets or pay off the liabilities during the regular course of its business. The financial statement and notes to the financial statements of the company do not disclose this fact. What kind of opinion should the statutory auditor of MOKSH Ltd. issue in such circumstances? (RTP Nov '23, MTP 5 Marks Mar'22, Old & New SM)

Answer 13

In the present case, there exists a material uncertainty that cast a significant doubt on the company's ability to continue as going concern and the same is not disclosed in the financial statements of MOKSH Ltd.

As such, the financial statements of MOKSH Ltd. for the FY 2022 -23 are materially misstated and the effect of the misstatement is so material and pervasive on the financial statements that giving only a qualified opinion will be insufficient and therefore the statutory auditor of MOKSH Ltd. should issue an adverse opinion.

The relevant extract of the Adverse Opinion Paragraph and Basis for Adverse Opinion paragraph is as under:

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly, the financial position of MOKSH Ltd. as at March 31, 2023, and of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

Basis for Adverse Opinion

MOKSH Ltd. has faced an extraordinary event (earthquake), which destroyed a lot of business activity of the company. Due to such event, it may not be possible for the company to realize its assets or pay off the liabilities during the regular course of its business. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statement and notes to the financial statements of the company do not disclose this fact.

Question 14

CA. Uma is the Statutory Auditor of RJ Ltd. for the financial year 2021-22. The company is engaged in the production of electronic products. During the course of audit, CA. Uma obtained certain audit evidence of incorrect disclosure of related party transactions and structured finance deals which was not considered with the affirmation leading to misstatement in the financial statements.

REPORTING

Discuss how CA Uma should deal with the situation in the auditor's report and the different options which can be considered? (PYP 5 Marks Nov 22)

Answer 14

Auditor's duties in case of inconsistency in Audit evidence: SA 705 "Modifications to the Opinion in the Independent Auditor's Report", deals with auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(b) The auditor's judgement about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Further, the auditor shall modify the opinion in the auditor's report when the auditor concludes that based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement:

In the present case, during the course of the audit, CA Uma obtained certain audit evidence which was not consistent with the affirmation made in financial statements. Therefore CA Uma should modify his report in accordance with SA 705.

Conclusion:

Since CA Uma has obtained audit evidence which is inconsistent with the affirmations made in the financial statements. CA Uma should modify his opinion as per the circumstances of the case.

- CA Uma shall express Qualified opinion when, having obtained sufficient appropriate audit evidence, he concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements.
- CA Uma shall express an Adverse opinion, where the auditor, having obtained sufficient appropriate evidence, concludes that misstatements, individually, or in the aggregate, are both material and pervasive to the financial statements.

Question 15

ALM Associates has been appointed as auditor of M/s Hary Ltd. which acquired 55% shares-in M/s Sam Ltd. on 15th October, 2018. During audit of Harry Ltd., the auditors found that the company has not prepared consolidated financial statements because on the date of acquisition the fair value of certain assets & liabilities has not been ascertained which is significant and are accounted for on estimated basis only. Help ALM Associates in framing opinion paragraph of audit report. (PYP 4 Marks, May '19)

Answer 15

Opinion Paragraph of Audit Report: In the instant case, M/s Hary Ltd. acquired 55% shares in M/s Sam Ltd. and the company did not prepare the consolidated financial statements because on the date of acquisition the fair value of certain assets and liabilities has not been ascertained. Therefore, accounting is done on estimate basis only which is not correct as the financial statements are materially misstated due to non-consolidation of subsidiary. The material misstatement is deemed to be pervasive to the consolidated financial statements. Thus, the auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidences, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Adverse Opinion

In our opinion and to the best of our information and according to the explanations given to us, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not give a true and fair view in conformity with the accounting principles generally accepted in India, of their consolidated state of affairs of the Group, its associates and jointly controlled entities, as at March 31, 2019, of its consolidated profit/loss, (consolidated position of changes in equity) and the consolidated cash flows for the year then ended.

Basis for Adverse Opinion is given below:

As explained in Note X, the M/s Hary Ltd. has not consolidated subsidiary M/s Sam Ltd. that the M/s Hary Ltd acquired during 2018 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on an estimate basis. Under the accounting principles generally accepted in India, the Group should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had M/s Sam Ltd. been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

Question 16

ABC Ltd. has been dealing in tyres since 1995. The Company envisaged to expand its business and wanted to manufacture the tyres besides trading. Accordingly, the machinery was imported, installed and manufacturing operations commenced. The Government also gave certain incentives like power subsidy, land acquisition subsidy, etc. After 2 years of operations, Company received a notice from the Income Tax authorities to pay tax on incentive received in the form of power subsidy. The demand notice was served for ` 150.00 Lakhs.

The Company, however, filed an appeal with higher tax authorities against the demand and the matter is undecided as on 31.03 .2021. Legal team of the Company anticipated that tax liability might mature. The Company has not made a provision of anticipated ta x liability. Considering the provisions of Companies Act, 2013, how an auditor of ABC Ltd. should see this matter and report in audit report, if required?(PYP 5 Marks July 21)

Answer 16

Audit report - Legal team anticipated tax liability but the company did not make any provision for that-

The Council of the Institute of Chartered Accountants of India has taken note of the fact that there is a practice prevalent whereby companies do not make provision for tax even when such a liability is anticipated. It has expressed the view that on an overall consideration of the relevant provisions of law, non-provision for tax (where a liability is anticipated) would amount to contravention of the provisions of Sections 128 and 129 of the Companies Act, 2013.

Accordingly, it is necessary for the auditor to qualify his report and such qualification should bring out the manner in which the accounts do not disclose a "true and fair" view of the state of affairs of the company and the profit or loss of the company.

Applying the above to the facts given in the question, auditor should qualify his report.

An example of the manner in which the report on the balance sheet and the Statement of Profit and Loss may be qualified in this respect is given below: "The company has not provided for taxation in respect of its profits and the estimated aggregate amount of taxation not so provided for is ` .... including............for the Year ended on ....To the extent of such non-provision for the year, the profits of the Company for the financial year under report have been overstated and to the extent of such aggregate non-provision, the reserves of the company appearing in the said balance sheet have been over-stated and the current liabilities and provisions appearing in the said balance sheet have been understated".

Question 17

"When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion,"

"Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section." As an expert you are required to brief the special considerations required for expressing:

(a) Qualified Opinion;

(b) Adverse Opinion and

(c) Disclaimer of Opinion. (RTP Nov'18, RTP May'20, Old & New SM)

Answer 17

(a) When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion section:

- When reporting in accordance with a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) […] in accordance with [the applicable financial reporting framework]; or

- When reporting in accordance with a compliance framework, the accompanying financial statements have been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

  When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion.

(b) When the auditor expresses an adverse opinion, the auditor shall state that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion section:

- When reporting in accordance with a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) […] in accordance with [the applicable financial reporting framework]; or
- When reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

(c) When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:

- State that the auditor does not express an opinion on the accompanying financial statements;
- State that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
- Amend the statement required in SA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

Multiple Choice Questions (MCQs)

Question 1

While conducting the current year audit of Finco Ltd, the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements. This misstatement was related to recognition of research and development expenditure. The provisions of Ind AS 38 Intangible Assets relating to capitalization of development expenditure was not applied properly. On this, unmodified opinion had been previously issued. The current auditor verified that the misstatement had not been dealt with as required under Ind AS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Accordingly, the current auditor will:

(a) Express a qualified or an adverse opinion in the auditor's report on the current period financial statements modified with respect to the corresponding figures included therein.

(b) Express an unmodified opinion in the auditor's report on the current period financial statements since it was related to the prior year.

(c) Express a qualified opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein.

(d) Express an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein. (MTP 2 Marks, Oct 19 & April '23)

Ans: (a)

Question 2

The auditor shall express opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements

(a) Adverse

(b) Qualified

(c) Disclaimer of opinion

(d) Clean (MTP 1 Marks, May 20)

Ans: (a).

Question 3

During the conduct of audit, it was found that the management has intentionally made material misstatements in the several items of the financial statements to deceive the users of the financial

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statements, to reduce the pressures of meeting market expectations and to increase the reputation of the company. What would be the implications on the auditor's report if no adjustments are made to the financial statements regarding the misstatements made by the management?

(a) The auditor would issue a qualified audit opinion stating that 'except for' these matters the financial statements are fairly presented. The auditor should also include a 'Basis for Qualified Opinion' paragraph below the opinion paragraph.

(b) The auditor would issue an adverse audit opinion stating that 'except for' these matters the financial statements are fairly presented. The auditor should also include a 'Basis for Qualified Opinion' paragraph below the opinion paragraph.

(c) The auditor would issue an adverse audit opinion stating that financial statements 'do not give a true and fair view'. The auditor should also include a 'Basis for Adverse Opinion' paragraph below the opinion paragraph.

(d) The auditor would issue an adverse audit opinion stating that financial statements 'do not give a true and fair view'. The auditor should also include a 'Basis for Qualified Opinion' paragraph below the opinion paragraph. (MTP 1 Marks, April 21, Sep'23)

Ans: (c)

Question 4

M/s Brahmi and Associates have been appointed as the statutory auditor of Prompton Leaves Limited, a manufacturer of gas geysers for the FY 2021-22. During the course of audit, the auditor found that two customer complaints have been filed against the company in the FY 2021-22, for the use of sub standard pipes and wires in manufacture of gas geysers. The gas geyser blasted at high temperature leading to severe injuries to the family of complainant along with damage to their property. They have sought a demand of rupees 10 crore. However, the lawyer of Prompton Leaves Limited believes that such claim is unsustainable as the incident occurred due to short circuit at both the complainants place. The management of Prompton Leaves Limited accordingly did not include any reference to the litigation in the financial statements. The auditor obtained legal advice from some independent lawyer according to whom the outcome of the case is not ascertainable as of now.

(a) The statutory auditor should give an unqualified opinion.

(b) The statutory auditor should give an unqualified opinion with Emphasis of Matter paragraph.

(c) The statutory auditor should withdraw from the audit engagement.

(d) The statutory auditor should give a qualified opinion. (MTP 1 Mark March 22)

Ans: (d)

Question 5

While verifying the salary expense of employees, the auditor has been asked to rely on the values as per SAP software and some hard copy reports and documents as the HRMS package (source software) has become corrupt during the year and the management is not having any data backup.

How should the auditor deal with the same?

(a) The auditor should issue a qualified opinion as records are destroyed and he is unable to obtain sufficient appropriate audit evidence.

(b) The auditor should perform alternative procedures to obtain sufficient and appropriate audit evidence before disclaiming the opinion.

(c) The auditor should issue an adverse opinion stating that it is deficiency in internal controls.

(d) The auditor can rely on the SAP data and there is no need for qualification of report. (MTP 1 Mark April 22)

Ans: (b)

Question 6

Chandra Ltd. is a company engaged in the manufacture of iron and steel bars. VP & Associates are the statutory auditors of Chandra Ltd. for the FY 2022-23. During the course of audit, CA Vikash, the engagement partner, found that the Company's financing arrangements have expired, and the amount outstanding was payable on March 31, 2023. The Company has been unable to re - negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

What opinion should CA Vikash express in the case of Chandra Ltd.?

(a) Unmodified opinion.

(b) Qualified opinion.

(c) Adverse opinion.

(d) Disclaimer of opinion. (MTP 1 Mark April '23, RTP May'22)

Ans: (c)

SA 706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

Question 1

Difficult Books Limited is engaged in manufacturing of active pharmaceutical ingredients. Due to change in laws and regulations, every company engaged in manufacturing in active pharmaceutical ingredients would now require production capacity license which will restrict the production of companies. Management of the company 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 company 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 in Other Matter Paragraph.

You as an Engagement Partner are required to guide the Audit Team with respect to reporting of the said matter in Audit Report. (MTP 4 Marks Oct '22)

Answer 1

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 t hat 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.

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. 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.

Question 2

The audit report of Kolsi (P) Ltd. for F.Y. 2020-21 was issued by Bishnoi & Co. on 25th July, 2021.

However, a case was filed against Kolsi (P) Ltd. on 4th August, 2021, with the Civil Court, with respect to an incident caused in its factory on 17th January, 2021, the outcome of which may result in paying heavy penalty by Kolsi (P) Ltd.

Mr. Raj Bishnoi, the partner of Bishnoi & Co., discussed the said matter with the management and it was determined to amend the financial statements for F.Y. 2020 -21. Further, Mr. Raj inquired how the management intended to address the said matter in the financial statements to which he was told that the said matter was going to be disclosed as a "Contingent Liability for a Court case" to the foot note in the balance sheet with no additional disclosures.

The management told Mr. Raj that such disclosure was enough as he would further going a description of the said court case and its outcome in the 'Emphasis of Matter' paragraph in his amended audit report.

In the context of aforesaid case scenario, please answer the following questions:-

Whether the contention of management of Kolsi (P) Ltd. is valid with respect to the disclosure of the court case in the financial statements? (RTP Nov '21)

Answer 2

As per SA 706, 'Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report', an Emphasis of Matter paragraph is not a substitute for:

(a) A modified opinion in accordance with SA 705 (Revised) when required by the circumstances of a specific audit engagement;

(b) Disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation; or

(c) Reporting in accordance with SA 570 (Revised) when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

In the given case, the management of Kolsi (P) Ltd. has presumed that as the auditor was going to provide a description of the said court case and its outcome in the 'Emphasis of Matter' paragraph in his amended audit report, there was no further need for it to provide additional disclosures about the court case in the financial statements.

The said contention of management of Kolsi (P) Ltd. is not valid as 'Emphasis of Matter' paragraph cannot be used as a substitute for disclosures required to be made in the financial statements as per the applicable financial reporting framework or that is otherwise necessary to achieve fair presentation, which is the responsibility of the management.

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Question 3

(Includes concepts of SA 800- Special Considerations- Audits of Financial Statements prepared in accordance with Special Purpose Framework)

There are certain circumstances in which Emphasis of Matter in Auditor's Report is mandated to be included. Explain this statement in the light of mandatory requirements of matters that are to be emphasized in Auditor's Report when the Audit Report is on Financial Statements prepared in accordance with Special Purpose Framework. (PYP 5 Marks, Nov '18)

Answer 3

Circumstances in which Emphasis of Matter Paragraph in Auditor's Repo rt is mandated in case of Financial Statements prepared in accordance with a Special Purpose Framework: As per SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" and/or SA 800, "Special Considerations— Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks", the auditor's report on special purpose financial statements shall include an Emphasis of Matter paragraph alerting users of the auditor's report that the financial statements are prepared in accordance with a special purpose frame work and that, as a result, the financial statements may not be suitable for another purpose. The auditor shall include this paragraph under an appropriate heading.

The special purpose financial statements may be used for purposes other than those for which they were intended. For example, a regulator may require certain entities to place the special purpose financial statements on public record. To avoid misunderstandings, the auditor alerts users of the auditor's report that the financial statements are prepared in accordance with a special purpose frame work and, therefore, may not be suitable for another purpose.

Restriction on Distribution or Use: In addition to the alert required above, the auditor may consider it appropriate to indicate that he auditor's report is intended solely for the specific users. Depending on the law or regulation of the particular jurisdiction, this may be achieved by restricting the distribution or use of the auditor's report. In these circumstances, the emphasis of matter paragraph given above maybe expanded to include these other

Question 4

Relevant Notes given by the management in the financial statements of India Branch Office of ABC Limited are:

Income tax authorities have raised demands (including interest up to the date of demand) aggregating to Rs.100 crores and Rs.40 crores respectively for assessment year 2013-14 based on report by auditors consequent to conduct of special audit as directed under section 142(2A) of the Income tax Act, 1961 and in addition, have also initiated penalty proceedings against the Company. The Company has contested these demands before the Commissioner of Income tax (Appeals) and has also filed applications for stay of penalty proceedings and the same are currently pending disposal.

Based on review of underlying documents and legal inputs, the management has assessed that there is probability of likely outflow to the extent of Rs.50 crores (including interest liability till date of stay of payment of Rs.15 crores) in relation to the above demands and has accounted for the same in these financial statements. With respect to further liability of Rs.50 crores, the management believes that it has the necessary documents to furnish to the tax authorities and basis the expert's inputs believes that Company has good chances of success of receiving the judgments in its favour. Further, the management believes that the likelihood of penalties being imposed against the Company is not probable and accordingly, no adjustments are considered necessary in these financial statements.

As at March 31, 2017, the Company has accumulated losses of Rs.150 crores against equity of Rs.100 crores and also net current liabilities of Rs.35 crores. The management is of the view that the current year losses are primarily attributable to income tax liabilities devolving on the Company, as discussed under paragraph XX. As per the management assessment, it is likely to generate Rs.___ and Rs. from the operations during the financial years ending March 31, 2018 and March 31, 2019 respectively. Further, the Company's key shareholders have confirmed that they shall provide continuing financial support to the Company's day to day operations so as to enable the Company to pay off its debts, as and when they fall due. Accordingly, these financial statements have been prepared on a going concern basis.

As an auditor of ABC Limited, you are required to draft emphasis of matter para in the given situation on the basis of analysis of above notes (when there is material tax litigation that casts significant doubt on the entity being regarded as going concern) (RTP May 18)

Answer 4

Emphasis of Matters Para:

- We draw attention to Note XX, regarding certain income-tax demands of Rs.100 crores pending in various stages of assessments/ appeals. The management based upon expert's advice believes that no demand or liability including interest and penalty on account of settlement of assessment/ appeals of the pending matters by the Income tax authorities is likely to devolve on the Company, in addition to those already provided for in these financial statements. Pending the final outcome of the aforesaid matters, no further adjustments have been made in these financial statements in this regard.
- Note XX of the financial statements that as at March 31, 2017, the Company has accumulated losses of Rs.150 crores against equity of Rs.100 crores and also net current liabilities of Rs.35 crores. These conditions indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern, which is dependent on establishing profitable operations and obtaining continuing financial support from its key shareholders. These mitigating factors have been more fully discussed in Note XX of the accompanying financial statements, in view of which the accompanying financial statements have been prepared under the going concern assumption, and consequently, no further adjustments have been made in these financial statements. Our opinion is not modified in respect of the above matters.

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Question 5

(Includes concepts of SA 705)

AKB Associates, a renowned audit firm in the field of CA practice for past two decades. The firm was appointed to conduct statutory audit of Rica Ltd. an unlisted company, which is engaged in the business of paper manufacturing. It decided to commence the audit for the recently concluded financial year. Once after making significant progress in the audit, the auditors made the following observations:

Observation 1: The management had disclosed in the financials that, during the year, one of the warehouses of the Company was affected due to a major flood. As a result of the same, the Company had incurred some losses. But the management was of the view that it was not material.

Observation 2: Due to flood, few records maintained by the Company with respect to a particular transaction was completely destroyed and there was no duplicate record maintained by the Company. However, those details were not pervasive, but material.

You are required to advise, whether AKB Associates should report Observation 1 and 2 in its audit report? If so, under which heading should it be reported? (RTP Nov 20)

Answer 5

Observation 1 - The management had disclosed in the financials that, during the year, one of the warehouses of the Company was affected due to a major flood. As a result of the same, the Company had incurred some losses. But the management was of the view that it was not material: As per SA 706, "Emphasis of Matter Paragraph & Other Matter Paragraph in the Independent Auditor's Report", an Emphasis of Matter Paragraph refers to matter appropriately disclosed in the financials, that in the auditor's judgement is of such importance that it is fundamental to users' understanding of the financials. Hence, in this case, the auditor shall report about the consequences of the flood which affected the Company's warehouse under Emphasis of Matter Paragraph.

Observation 2 - Due to flood, few records maintained by the Company with respect to a particular transaction was completely destroyed and there was no duplicate record maintained by the Company. However, those details were not pervasive, but material: As per SA 705, "Modification to Opinion in the Independent Auditor's Report", where the auditor is unable to obtain sufficient and appropriate audit evidence and where such mater is material but not pervasive, the auditor shall issue a qualified opinion.

Thus, in the given situation, on account of flood few records pertaining to particular transactions was completely destroyed and in the absence of duplicate records, the auditor was unable to obtain sufficient and appropriate audit evidence and those details were material but not pervasive. Therefore, in accordance with SA 705, the auditor is required to issue qualified opinion.

Question 6

Where should the placement of the key audit matters section be in the auditor's report? (RTP May 22)

Answer 6

Generally, the Key Audit Matters section is required to be placed after the Basis for Opinion paragraph and before the Management's Responsibility paragraph.

In case, 'Material uncertainty relating to going concern' section is required as per SA 570(Revised), then KAM section is placed after that section.

Further, regarding placement of KAM section, SA 706 (Revised), "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" provides as under:

When a Key Audit Matters section is presented in the auditor's report, an Emphasis of Matter (EOM) paragraph may be presented either directly before or after the Key Audit Matters section, based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph. The auditor may also add further context to the heading "Emphasis of Matter", such as "Emphasis of Matter – Subsequent Event", to differentiate the Emphasis of Matter paragraph from the individual matters described in the Key Audit Matters section.

Multiple Choice Questions (MCQs)

Question 1

APP Ltd. is listed on National Stock Exchange in India. Post audit rotation, KYP & Co LLP have been appointed as the statutory auditors of APP Ltd. The company has a pending litigation in respect of service tax matter which has been going on for long time now and exposure of the company towards that litigation is very significant.

The new auditors got the exposure of this case evaluated by involving their in-house tax experts who have shared a view that the exposure of the company would be medium. As per the requirements of accounting standards, medium exposure would be considered as a possible impact for which probability is 50%. The company has been disclosing this as a contingent liability in the previous years.

However, the new auditors are of the view that this is a significant matter that requires user's attention by disclosing this in the financial statements and it is of such importance that it is fundamental to user's understanding of financial statements. Further there is a material uncertainty in respect of this matter (i.e. demand raised by service tax department).

Basis this, auditors want to include Emphasis of matter (EOM) in their report. Management is of the view that since this was not reported by previous auditors as EOM, hence it should not be included by new auditors also and also being a listed company, it is not appropriate to include EOM in the first year of audit by a new firm. (MTP 2 Marks, April 19)

Please suggest which of the following is correct.

(a) EOM should be included by new auditors.

(b) EOM should not be included by new auditors if the previous auditors have not given that.

(c) EOM should not be given, however, there should be a disclosure of this matter in the financial statements and also the fact that auditors are in the first year of audit and this matter would require detailed evaluation.

(d) Auditors should quality the report instead of EOM.

Ans: (a)

SA 710 Comparative Information—Corresponding Figures and Comparative Financial Statements

Question 1

It was observed from the modified audit report of the financial statements of Shravasti Ltd. for the year ended 31st March, 2021 that depreciation of ₹ 3.95 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 5 Marks March '23, MTP 5 Marks Oct'20)

Answer 1

Auditor's responsibility 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.

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. 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.

In the instant case, if Shravasti Ltd. does not correct the treatment of depreciation to the extent of rupees 3.95 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 consider to the earlier year's modification.

Question 2

The audit report of P Ltd. for the year 2016-17 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2017-18, decide how would you report, if :

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(i) The company does not make provision for doubtful debts in 2017-18?

(ii) The company makes adequate provision for doubtful debts in 2017-18? (MTP 5 Marks, March 18)

Answer 2

Auditor's responsibilities 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.

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. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

(i) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

(ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

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.

Question 3

Write a short note on the following: Auditor's responsibilities regarding comparatives. (RTP Nov 18)

Answer 3

Auditor's responsibilities regarding comparatives: SA 710, "Comparative Information – Corresponding Figures and Comparative Financial Statements", 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. For this purpose, the auditor shall evaluate whether:

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

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

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

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.

Multiple Choice Questions (MCQs)

Question 1

CA Ram identified that there was a misstatement last year and the same is still not corrected. Although unmodified audit report was issued last year by CA Ram. Guide CA Ram on the audit opinion considering the fact that the last year's misstatement has been identified in the current year and unmodified opinion was issued in the last year?

(a) In accordance with SA 710, CA Ram should give unmodified opinion, but include Other matters paragraph in the audit report as last year's profit is being reflected in reserve and surplus.

(b) In accordance with SA 710, CA Ram should seek legal opinion.

(c) In accordance with SA 710, CA Ram should qualify current period audit report with respect to corresponding figures only.

(d) In accordance with SA 710, CA Ram should give unmodified opinion, but last period's modified opinion should be highlighted in Emphasis of matter paragraph. (MTP 1 Marks, March 21)

Answer 1 : (c).

SA 720 The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements

Question 1

ING Associates, Chartered Accountants, conducting the audit of XYZ Ltd., a listed Company for the year ended 31st March 2020 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 5 Marks, Oct 20)

Answer 1

Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists: 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:

(i) Agrees to make the correction, the auditor shall determine that the correction has been made; or

(ii) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made.

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 those charged with governance, the auditor shall take appropriate action, including:

(i) Considering the implications for the auditor's report and communicating with those charged with governance about how the auditor plans to address the material misstatement in the auditor's report;

(ii) Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

If the auditor concludes that a material misstatement exists in other information obtained after the date of the auditor's report, the auditor shall:

(i) If the other information is corrected, perform the procedures necessary in the circumstances; or

(ii) 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.

Question 2

ANUSHA Associates, Chartered Accountants, conducting the audit of Rishabh Ltd., a listed company for the year ended 31st March 2021 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, ANUSHA 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 ANUSHA Associates with examples of "Amounts" or "other items" that may be included in the "other information" with reference to SA 720. (MTP 5 Marks, April 21, PYP 5 Marks, Nov '19, Old SM)

Answer 2

Examples of Amounts or Other Items that May Be Included in the Other Information: 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.

Amounts

(i) 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.

(ii) Selected operating data, such as income from continuing operations by major operating area, or sales by geographical segment or product line.

(iii) Special items, such as asset dispositions, litigation provisions, asset impairments, tax adjustments, environmental remediation provisions, and restructuring and reorganization expenses.

(iv) Liquidity and capital resource information, such as cash, cash equivalents and marketable securities; dividends; and debt, capital lease and minority interest obligations.

(v) Capital expenditures by segment or division.

(vi) Amounts involved in, and related financial effects of, off-balance sheet arrangements.

(vii) Amounts involved in guarantees, contractual obligations, legal or environmental claims, and other contingencies.

(viii) Financial measures or ratios, such as gross margin, return on average capital employed, return on average shareholders' equity, current ratio, interest coverage ratio and debt ratio. Some of these may be directly reconcilable to the financial statements.

Other Items

(i) Explanations of critical accounting estimates and related assumptions.

(ii) Identification of related parties and descriptions of transactions with them.

(iii) Articulation of the entity's policies or approach to manage commodity, foreign exchange or

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interest rate risks, such as through the use of forward contracts, interest rate swaps, or other financial instruments.

(iv) Descriptions of the nature of off-balance sheet arrangements.

(v) 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.

(vi) Descriptions of changes in legal or regulatory requirements, such as new tax or environmental regulations, that have materially impacted the entity's operations or fiscal position, or will have a material impact on the entity's future financial prospects.

(vii) Management's qualitative assessments of the impacts of new financial reporting standards that have come into effect during the period, or will come into effect in the following period, on the entity's financial results, financial position and cash flows.

(viii) General descriptions of the business environment and outlook.

(ix) Overview of strategy.

(x) Descriptions of trends in market prices of key commodities or raw materials.

(xi) Contrasts of supply, demand and regulatory circumstances between geographic regions.

(xii) Explanations of specific factors influencing the entity 's profitability in specific segments.

Question 3

Jinchandra & Co., Chartered Accountants, have been appointed Statutory Auditors of Gurudeva Ltd. for the F.Y. 2020-21. 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. (MTP 4 Marks Oct 21)

Answer 3

Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists: 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.

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:

(i) Agrees to make the correction, the auditor shall determine that the correction has been made; or

(ii) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance 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.

Question 4

Sujit & Co., Chartered Accountants, have been appointed as Statutory Auditors of Anand Mills Ltd. for FY 2022-23. The audit team has completed the audit and is in the process of preparing the audit report. The Management of the company has also prepared a draft annual report. While reviewing the company's draft annual report, the auditor observed a section that stated a decline in market prices for essential products compared to the previous year. Surprisingly, the financial statements indicated that the company's profit margin had actually increased. The audit Man ager discussed this issue with the firm's partner, who replied that the auditors are not responsible for disclosures made by management in the annual report. Do you think that the partner is correct in his approach to this issue? Discuss with reference to the relevant Standards on Auditing the Auditor's duties with regard to reporting. (MTP 5 Marks Sep '23)

Answer 4

Auditor's responsibilities as to Other Information included in Annual Report : SA 720, "The Auditor's Responsibilities Relating to Other Information", delineates the responsibilities of auditors in regard to other information, which can pertain to financial or non-financial matters and is encompassed within an organization's annual report. This encompasses documentation of market trends pertaining to significant products and quantities 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.

Auditor's duties with regard to reporting: 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:

(i) Agrees to make the correction, the auditor shall determine that the correction has been made; or

(ii) Refuses to make the correction, the auditor shall communicate the matter with those charged with governance and request that the correction be made.

In the given situation, Sujit & Co., Chartered Accountants, have been appointed as Statutory Auditors of Anand Mills Ltd. The auditor, while reviewing the company's draft annual report, has observed a section mentioning about a decline in market prices for essential products compared to previous year and financial statements indicated that company's profit margin has increased. Considering the requirements of SA 720 as stated above, it can be concluded that contention of firm's partner, that auditors are not responsible for disclosures made by management, is not correct. Accordingly, partner is not correct in his approach to this issue.

Duties of Auditors

Question 1

Mr. Raj, the engagement partner of R.O.K. & Co., in connection with statutory audit of Waria Ltd., had assigned the responsibility of enquiring into propriety matters of the Company as required by section 143(1) of the Companies Act, 2013, to Mr. Samay, an engagement team member. Mr. Samay while making such enquiries, was having following queries, as tabulated below, which he ought to get resolved from Mr. Raj, as follows: -

Sr. No.	Query of Mr. Samay
1.	What documents to be seen in case of loan given by the company in lieu of hypothecation of goods from lender as a security for the purpose of reporting as per clause (a) of section 143(1) of the Companies Act, 2013?
2.	What shall be the cost of Debentures and Bonus Shares sold by the company for which the cost is not ascertainable for the purpose of reporting as per clause (c) of section 143(1) of the Companies Act, 2013?
3.	Whether the shares allotted by Waria Ltd. against a loan taken by it from a NBFC can be considered to be allotted for cash for the purpose of reporting as per clause (f) of section 143(1) of the Companies Act, 2013?

Assuming that you are Mr. Raj the engagement partner, please provide answer to the queries of Mr. Samay? (MTP 6 Marks, March 21)

S.N.	Query of Mr. Samay	Response to Query
1.	What documents to be seen in case of loan given by the company in lieu of hypothecation of goods from lender as a security for the purpose of reporting as per clause (a) of section 143(1) of the Companies Act, 2013?	Mr. Samay should see deed of Hypothecation or other document creating the charge, together with a statement of stocks held at the balance sheet date in order.
2.	What shall be the cost of Debentures and Bonus Shares sold by the company for which the cost is not ascertainable for the purpose of reporting as per clause (c) of section 143(1) of the Companies Act, 2013?	For Debentures sold: Where the cost of debentures sold is not ascertainable, the book value thereof at the date of sale may be treated as the cost for the purposes of this clause. For Bonus Shares sold: When bonus shares are received, the number of shares in the portfolio would be increased by the bonus shares while the cost of the total portfolio would remain the same as before. The result would be that the average cost per unit of the total holding would come down proportionately. The usual accounting practice for apportioning the cost of a part of the total holding on the sale thereof is to take it at its average cost.

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		The law on the subject has hitherto been that, where the consideration for the issue of shares is an adjustment against a bona fide debt payable in money on demand by the company, **the shares are deemed to have been subscribed in cash** (vide the decision in Spargo's Case – 1873, 8, Ch. A. 407). According to the legal opinion obtained by the ICAI, the expression "shares allotted for cash" may also include shares allotted against a debt. Therefore, in cases which are covered by the decision in Spargo's case, no comment is required by the auditor, even though the company may have in the Return of Allotment under Section 75, shown such shares as allotted against adjustment of a debt. Thus, the shares allotted by Waria Ltd. against a loan taken by it from a NBFC can be considered to be allotted for cash.
3.	Whether the shares allotted by Waria Ltd. against a loan taken by it from a NBFC can be considered to be allotted for cash for the purpose of reporting as per clause (f) of section 143(1) of the Companies Act, 2013?	

Question 2

Areas of propriety audit under Section 143(1) of the Companies Act, 2013. (RTP Nov 19)

Answer 2

Areas of propriety audit under Section 143(1): Section 143(1) of the Companies Act, 2013 requires the auditor to make an enquiry into certain specific areas. In some of the areas, the auditor has to examine the same from propriety angle as to -

(i) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(ii) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company; Again, considering the propriety element, rationalizing the proper disclosure of loans and advance given by company is made;

(iii) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

(iv) whether loans and advances made by the company have been shown as deposits;

(v) whether personal expenses have been charged to revenue account;

(vi) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

A control has been set up to verify the receipt of cash in case of allotment of shares for cash. Further, if cash is not received, the books of accounts and statement of affairs shows the true picture.

Question 3

CA. G, was appointed by DP Ltd., as Statutory Auditor. While doing the audit of DP Ltd., CA. G observed that certain loans and advances were made without proper securities; certain trade receivables and trade payables were adjusted inter se; and personal expenses were charged to revenue. As a company auditor comment on the, reporting responsibilities of CA. G.(PYP 5 Marks, Nov '19)

Answer 3

Duty of Auditor to Inquire on certain matters: Section 143(1) of the Companies Act, 2013 requires the auditor to make an enquiry in respect of specified matters during the course of his audit. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. It is to be noted that the auditor is required to make only enquiries and not investigate into the matters referred to therein.

The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 143(1) of the Companies Act, 2013 is worth considering and reproduced below:

"The auditor is not required to report on the matters specified in sub-section (1) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor's Report will remain exactly the same as the auditor has to inquire and apply his mind to the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our opinion, it is in this light that the auditor has to consider his duties under section 143(1)." Clause (a) of Section 143(1) requires the auditor to inquire: "Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members".

If the auditor finds that the loans and advances have not been properly secured, he may enter an adverse comment in the report but cannot probably doubt the true view of the accounts by reference to this fact so long the loans and advances are properly described and presented in terms of Part I of Schedule III to the Companies Act. Further the auditor to inquire whether or not the terms on which

the loans or advances have been made are prejudicial to the interests of the company or its members. If it is, he should qualify his report.

If trade receivables and trade payables are adjusted inter se, this amounts to merely book entries. The auditor, as per clause (b) of section 143(1), should enquire "whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company". This proposition has got to be inquired into by reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards".

Regarding Personal Expenses, Clause (e) of section 143(1) requires the auditor to inquire: "Whether personal expenses have been charged to revenue account". The charging to revenue of such personal expenses, either on the basis of the company's contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate or does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon. It suffices to say that if the auditor finds that personal expenses have been charged to revenue and if the amounts are material, he should qualify his report also.

Multiple Choice Questions (MCQs)

Question 1

SBC Private Limited appointed Mr. Vijay, Chartered Accountant as auditor of the company for the year 2017-18. While verifying the accounts Mr. Vijay noticed that the company has neither made any provision for accrued gratuity liability nor obtained the actuarial valuation thereon. Mr. Vijay obtained the actuarial valuation and includes the matter in his Audit Report to the Company's Board of Directors mentioning the amount of accrued liability not provided for. The Board agreed with the auditor's observation and the amount of liability quantified by him. But the auditor didn't disclose the same in his audit report to Member's. One of the members raised an objection on the audit report stating that it does not represent a true and fair view as even though the company has not maintained proper books of accounts as per accounting standards, the auditor has not qualified his report. Whether the auditor is require to give a qualified opinion in his report to members on non-provision of gratuity in company's accounts when the same has already been included in the report to Company's Board of Directors? (MTP 2 Marks, April 19)

(a) As the auditor has already disclosed the matter of non-provisioning in his report to Company's Board of Directors, there is no need to disclose the same in report to Member's u/s 143 of the Companies Act, 2013.

(b) Non-provisioning for accruing gratuity is in contravention to applicable Accounting Standard (AS- 15), therefore the auditor should qualify his report to members through a paragraph on failure of management to quantify the amount of liability.

(c) The auditor should revise the accounts as per the actuarial valuation obtained by him and the revised accounts only should be presented before the Board of Directors and Members. The auditor is not required to qualify his report.

(d) U/s 143 of the Companies Act, 2013, the auditor should qualify his report to members only when the matter reported by the auditor is answered in the negative or with a qualification by the Board.

In the above case the board agreed with the auditor's observation so he need not qualify his report.

Ans: (d)

Question 2

NIC Chartered Accountants was appointed as statutory auditors by PNG Ltd. for the audit of their financial statements. During the course of audit the auditors noticed a fraud of ₹ 101 lac committed by an officer of the Company. The officer sanctioned and made the payment to fake vendors for purchase of fixed assets, however, the assets were not entered in the Fixed Assets Register. The auditor reported the fraud in his audit report to the shareholders of the Company presented in the Annual General Meeting, but did not mention the name of the parties involved. The Board of Directors of the Company asked ICAI to take necessary action against the auditor as he did not comply with his duty to report fraud as per Section 143(12) of the Companies Act, 2013. What is the duty of the auditor as per the Companies Act, 2013 in reporting the fraud committed by officers / employees of the Company?

(a) As per the Companies Act, 2013, since the amount of fraud is more than ₹ 100 lac; the auditor should have reported the matter within 2 days of his knowledge to the Board of Directors/ Audit committee of the Company seeking their reply or observations within 45 days. After completion of 45 days, the auditor should forward his report to the Central Government along with the reply, if any, received from Board/ Audit Committee.

(b) As per the Companies Act, 2013, during the course of audit if the auditor has reason to believe that a fraud has been committed by the officers or employees of the Company, the auditor shall report the matter to the Central Government immediately.

(c) The auditor's duty is restricted to reporting the fraud to shareholders and he is not required to report the matter to the Board of Directors/ Audit Committee/ Central Government.

(d) The auditor can submit his report on fraud to shareholders but is required to mention the name of the parties involved in fraud, as per Section 143(12) of the Companies Act, 2013. (RTP Nov 20, MTP 1 Mark Apr'19)

Ans: (a)

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CARO

Question 1

Whilst the Audit team has identified various matters, they need your advice to include the same in your audit report in view of CARO 2016 (CARO 2020):-

Physical verification of only 40% of items of inventory has been conducted bythe company. The balance 60% will be conducted in next year due to lack of time and resources. (MTP 2 Marks Oct'19, Old SM)

Answer 1

Physical Verification of Inventory: Clause (ii) of Para 3 of CARO, 2016(CARO 2020) requires the auditor to report on whether physical verification of inventory has been conducted at reasonable intervals by the management and (whether the opinion of the Auditor, the coverage and the procedure of such verification by the management is appropriate, whether any discrepancies of 10% or more in the aggregate for each class of inventory was noticed and if so, whether it has been properly dealt with in books of accounts.) Added in CARO 2020. Physical verification of inventory is the responsibility of the management which should normally verify all material items at least once in a year and more often in appropriate cases. The auditor in order to satisfy himself about verification at reasonable intervals should examine the adequacy of evidence and record of verification. In the given case, the above requirement of CARO, 2016 (CARO 2020) has not been fulfilled as such and the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable. He may consider the impact on financial statement and report accordingly.

Question 2

Rishabh Finance Ltd. is a Non-Banking Finance Company and was in the business of accepting public deposits and giving loans since 2015. The company was having net owned funds of ₹ 1,50,00,000/- (one crore fifty lakh) and was not having registration certificate from RBI and applied for it on 30th March 2020. The company appointed Mr. Gautam as its statutory auditors for the year 2019-20.

Advise the auditor with reference to auditor procedures to be taken and reporting requirements on the same in view of CARO 2016 (CARO 2020)? (MTP 6 Marks Oct 21, Mar'19)

Answer 2

As per Clause (xvi) of Paragraph 3 of CARO 2016(CARO 2020) , the auditor is required to report that

(a) "whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

(b) "whether any non-banking financial or housing finance activities without a valid certificate of registration from RBI has been made.

(c) Whether the company is a Core Investment Company (CIC) if yes, whether it fulfills the criteria of CIC.

(d) Whether the group has more than 1 CIC as part of the group, if yes, then indicate the numbers of CIC's (As per CARO 2020)

The auditor is required to examine whether the company is engaged in the business which attract the requirements of the registration. The registration is required where the financing activity is a principal business of the company. The RBI restrict companies from carrying on the business of a non banking financial institution without obtaining the certificate of registration.

Audit Procedures and Reporting:

(i) The auditor should examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.

(ii) The financial statements should be examined to ascertain whether company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.

(iii) Whether the company has net owned funds as required for the registration as NBFC.

(iv) Whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.

(v) The auditor should report incorporating the following:-

(1) Whether the registration is required under section 45-IA of the RBI Act, 1934.

(2) If so, whether it has obtained the registration.

(3) If the registration not obtained, reasons thereof.

In the instant case Rishabh Finance Ltd. is a Non Banking Finance Company and was in the business of accepting public deposits and giving loans since 2015. The company was having net owned funds of ₹ 1,50,00,000/-(one crore fifty lakhs) which is less in comparison to the prescribed limit i.e. 2 crore rupees and was also not having registration certificate from RBI (though applied for it on 30th March 2020). The auditor is required to report on the same as per Clause (xvi) of Paragraph 3 of CARO 2016 (CARO 2020).

Question 3

Whilst the Audit team has identified various matters, they need your advice to include the same in your audit report in view of CARO 2016 (CARO 2020):-

(i) The long term borrowings from the parent has no agreed terms and neither the interest nor the principal has been repaid so far. (MTP 2 Marks Nov'21, Mar'19, RTP May'19)

(ii) An amount of ₹ 2.35 Lakh per month is paid to M/s. RARE Associates, a partnership firm, which is a 'related party' in accordance with the provisions of the Companies Act, 2013 for the marketing services rendered by them. Based on an independent assessment, the consideration paid is higher than the arm's length pricing by ₹ 0.35 Lakh per month. Whilst the transaction was accounted in the financial statements based on the amounts' paid, no separate disclosure has been made in the notes forming part of the accounts highlighting the same as a 'related party' transaction. (MTP 2 Marks Nov 21, MTP 3 Marks, Oct 19, RTP May'19)

Answer 3

(i) As per clause (xiii) of para 3 of CARO 2016 (CARO 2020) the auditor is required to report, "whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards".

In the present case, the auditor is required to report as per clause xiii of para 3 of CARO 2016 (CARO 2020) regarding receipt of long term borrowing from Parent Company which qualifies as a transaction with the related party.

(ii) As per clause (xiii) of para 3 of CARO 2016 (CARO 2020), the auditor is required to report, "whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards;"

Therefore, the duty of the auditor, under this clause is to report (i) Whether all transactions with the related parties are in compliance with section 177 and 188 of the Companies Act, 2013 ("Act"); (ii) Whether related party disclosures as required by relevant Accounting Standards (AS 18, as may be applicable) are disclosed in the financial statements. In the present case, the auditor is required to report as per clause xiii of para 3 of CARO 2016 (CARO 2020), as one of related party transaction amounting ₹ 2.35 lakhs per month i.e. in lieu of marketing services has been noticed of which amount ₹ 0.35 lakh per month is exceeding the arm's length price has not been disclosed highlighting the same as related party transactions as per AS 18. Thus, the auditor is required to report accordingly.

Question 4

Whilst the Audit team has identified various matters, they need your advice to include the same in your audit report in view of CARO 2016 (CARO 2020): -

(i) The Company is in the process of selling its office along with the freehold land available at Pune and is actively on the lookout for potential buyers. Whilst the same was purchased at ₹ 20 Lakh in 2006, the current market value is ₹ 200 Lakh. This property is pending to be registered in the name of the Company, due to certain procedural issues associated with the Registration though the Company is having a valid possession and has paid its purchase cost in full. The Company has disclosed this amount under Fixed Assets though no disclosure of non-registration is made in the notes forming part of the accounts. (MTP 2 Marks Oct'21, RTP May'19)

(ii) The Internal Auditor of the Company has identified a fraud in the recruitment of employees by the HR department wherein certain sums were alleged to have been taken as kick -back from the employees for taking them on board with the Company. After due investigation, the concerned HR Manager was sacked. The amount of such kickbacks is expected to be in the range of ₹13.50 Lakh. (MTP 2 Marks Oct 21, MTP 2.5 Marks Mar'19, RTP May'19)

Answer 4

(i) As per clause (i) (c) of para 3 of CARO 2016 (CARO 2020) the auditor is required to report, "whether the title deeds of immovable properties are held in the name of the company (other than properties where the company is the lessee and the lease agreements are duly executed in the favor of the lessee). If not, provide the details thereof in the following format below."

In the present case, the Company has office along with freehold land in Pune. Though company has paid its purchase cost in full however, this property is pending to be registered in the name of the company i.e. title deed is not in the name of Company since 2006. Therefore, the auditor is required to report the same in accordance with clause (i)(c) of para 3 of CARO 2016 (CARO 2020).

The reporting under this clause, where the title deeds of the immovable property are not held in the name of the Company, may be made incorporating following details, in the form of a table or otherwise in case of land:-

• total number of cases,

• whether leasehold / freehold,

• gross block and net block, (as at Balance Sheet date), and

• remarks, if any.

The reporting under this clause, in the form of a table-

• Description of Property

• Gross Carrying Value

• Held in Name of

• Whether promoter, director, relative or employee

• Period held-indicate range where appropriate

• Reason for not being held in name of company (Also indicate if in dispute)

(AS per CARO 2020)

(ii) As per clause Clause (x)(xi)(As per CARO 2020) of para 3 of CARO 2016 (CARO 2020) the auditor is required to report,

(a) "whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated."

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

(c) Whether the auditor has considered whistle blower complaints if any received during the year In the instant case, a fraud has been identified in recruitment of employees by the HR Department wherein certain sums were alleged to have been taken as kickback from the company of amounting

rupees approx. 13.50 lakh. The auditor is required to report on the same in accordance with clause (x)(xi) of para 3 of CARO 2016 (CARO 2020).

Question 5

Stone Private Limited was engaged in business of manufacture of Cycles. CA. Chandra was appointed as a Statutory Auditor of the Company for the financial year 2021 -22. Outing the year under audit, Stone Private Limited obtained working capital facilities from Royal Bank Limited for ₹ 10 crore hypothecating the Stock of goods as primary security. On inquiry CA. Chandra was informed by management that stock statements are furnished periodically to Royal Bank Limited and the details of submission of quarterly stock statement are as follows:

Period of Stock	Stock Value as per Books of Account as at the end of the quarter (₹ in crore)	Stock Value as per quarterly statement submitted to Royal Bank Limited as at the end of quarter (₹ in crore)
Q1-2021-22	21.50	24.00
Q2-2021-22	24.75	27.00
Q3-2021-22	21.50	24.00
Q4-2021-22	25.25	25.25

The management of Stone Private Limited did not disclose the above variations in Notes to accounts forming part financial Statements of the Company for the year 2021 -22. The management replied that there are no variations as on the Balance sheet date and further they are of the view that stock statement furnished to bank is only a formality and computed arbitrarily only for the purpose of securing higher drawing power and hence statutory auditors need not be bothered.

Is the contention of the management valid? As a statutory auditor how CA. Chandra should deal with the same and discuss the disclosure/reporting requirements if any, as per the Companies Act, 2013 and CARO, 2020. (MTP 5 Marks March '23, PYP 5 Marks May '22)

Answer 5

As per clause (vii) of point Y of Schedule III to the Companies Act, 2013 - Division I - Financial Statements for a company whose financial statements are required to comply with the Companies (Accounting Standard) Rules, 2006, "where the company has borrowings from banks or financial institutions on the basis of security of current assets, it shall disclose the following :

(a) whether quarterly returns or statements of current assets filed by the company with banks or financial institutions are in agreement with the books of accounts.

(b) if not, summary of reconciliation and reasons of material discrepancies, if any to be adequately disclosed.

Further, as per para 3(ii) (b) of CARO 2020, the auditor is required to report whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details.

The above clause requires CA Chandra to comment on whether during any point of time of the year, the company has been sanctioned working capital limits in excess of ₹ 5 crores in aggregate. Stone (P) Ltd. has been sanctioned working capital facilities/limit of ₹ 10 crores which is apparently in excess of ₹ 5 crores.

Secondly, whether the quarterly returns filed by the Stone (P) Ltd. company with Royal Bank Ltd. are in agreement with the book of accounts of the company.

According to the data given in the instant situation, it is clear that there are variations in Quarter 1, Quarter 2 & Quarter 3 requiring reporting under this clause because of difference in stock value as per Book of Accounts & Stock Value as per Quarterly returns submitted to Royal Bank Ltd.

Therefore, Contention of the management is not valid.

CA. Chandra should report the differences as per the Companies Act, 2013 and CARO 2020 as follows:

	Stock value as per Book Accounts (₹ in Crore)	Stock value as per quarterly statement Submitted to Royal Bank Ltd. (₹ in Crore)	Variation
Q - 1	21.50	24.00	Excess reporting of stock to Bank by 2.50 crore
Q - 2	24.75	27.00	Excess reporting of stock to Bank by 2.25 Crore
Q - 3	21.50	24.00	Excess reporting of stock to bank by 2.50 crore

Question 6

Mr. Arjun was appointed as the engagement partner on behalf of Bhism & Co., a Chartered Accountant Firm, for conducting statutory audit assignment of Sinwar Ltd., unlisted public company. Mr. Brijesh, one of the senior engagement team members, was given the responsibility to audit the matters as per the requirements of CARO, 2020 and in that connection, he made the following observations, that may be relevant for reporting as per the said Order:-

Sr. No.	Observations
a.	One of the Plant and Equipment taken on a lease ('right of use' asset) by Sinwar Ltd. was revalued based on the valuation by a registered valuer and the net carrying value of Plant and Equipment in aggregate was changed from ₹ 4 crore to ₹ 4.45 crore.
b.	During the year under consideration, cash credit limit of ₹ 5.5 crore was sanctioned to Sinwar Ltd. by DMC Bank based on the security of current assets which was reduced to ₹ 4.5 crore after 6 months. In this connection, quarterly returns have been filed by the company with the DMC bank which are in agreement with Books of Accounts.

You are required to examine the contention of Mr. Brijesh regarding reporting of the above observations in accordance with CARO 2020. (RTP May 22)

Answer 6

Matters to be reported by Mr. Brijesh as per CARO, 2020 are as follows:-

(a) According to Clause (i) (d) of Para 3 of CARO 2020, the auditor is required to report whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if the change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets;

In the given situation, Sinwar Ltd. has revalued one of the Plant and Equipment taken on a lease ('right of use' asset) based on the valuation by a registered valuer. The amount of change in the value of such Plant and Equipment is ₹ 45 lakh. As the net carrying value of Plant and Equipment in aggregate was changed from ₹ 4 crore to ₹ 4.45 crore i.e. change was 10% or more.

Thus, the auditor is required to report the amount of change of ₹ 45 lakh in accordance with Clause (i) (d) of Para 3 of CARO 2020.

(b) As per Clause (ii) (b) of Para 3 of CARO 2020, the auditor is required to report whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutio ns on the basis of security of current assets; whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the Company, if not, give details;

In the instant case, Sinwar Ltd. has been sanctioned a cash credit limit of ₹ 5.5 crore by DMC Bank during the year under consideration, which is exceeding the prescribed limit of ₹ 5 crore based on the security of current assets. Further, quarterly returns have also been filed by the company with the DMC bank in this connection which is in agreement with Books of Accounts. In view of the above, the auditor is required to report the same in accordance with Clause (ii) (b) of Para 3 of CARO 2020

Question 7

Gautam Limited had borrowed ₹ 1000 crore from XYZ Bank, the principal of which was repayable after 5 years and interest was payable at the end of each year. For 4 years, Gautam Limited paid the interest amount on time. Gautam Limited defaulted the 5th instalment of interest payment and principal which was due on June 30, 2021. On March 31, 2021, Gautam Limited approached XYZ bank and MNO bank to restructure the existing liability. As a result, the existing principal and outstanding and overdue interest was restructured into a new loan amounting to ₹ 1,100 crore. The management did not provide any disclosure for the default on the loan on the belief that the old loan ceased to exist and the new loan has maturity after 5 years.

During the statutory audit for the financial year 2021-22, KP & Co. identified this transaction and obtained the relevant documents and understanding. Based on the underlying documents, it was identified that the said restructuring agreement was approved and signed on April 8, 2022, by both of the banks. As a result, on March 31, 2022, the restructuring was still not approved.

In the light of the above scenario, kindly guide the statutory auditors in the reporting of this transaction. .(RTP Nov'22)

Answer 7

As per Clause 3(ix) of CARO 2020, the auditor is required to report whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, the period and the amount of default to be reported as per the format below.

Nature of borrowing, including debt securities	Name of lender	Amount not paid on due date	Whether principal or interest	No. of days delay or unpaid	Remarks, if any
	lender wise details to be provided in case of defaults to banks, financial institutions and Government.				

In the given case, the company Gautam Limited defaulted in payment of the principal amount of the loan due of ₹ 1000 crore on 30 June 2021 and the interest instalment of₹ 100 crore. The said default continued till the end of the year and on 8 April 2022, a restructuring agreement was signed by the banks and company for re-structuring the outstanding loan. Moreover, no disclosure was provided by the company with respect to the said matter.

Hence the auditor is required to report the same matter under Clause (ix) of Para 3 of CARO 2020, i.e., whether the company has defaulted in repayment of loans or other borrowings or in the payment of interest thereon to any lender, if yes, then provide the details of the period and the amount of default.

Also, the auditor needs to consider the impact of such non-disclosure and the non-compliance with the financial reporting framework and accordingly the auditor needs to either issue a qualified opinion or an adverse opinion as per SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

Question 8

LIU Private Limited is a company based out of Mumbai. The company had an authorised capital of ₹ 200 lakh and paid-up capital plus reserves of ₹ 95 lakh as of 31st March. During the audit for the year ended 31st March 202X, the auditor M/s Y&S Associates noted the following points:

(i) On 15th December, the company had total bank borrowings of ₹ 75 lakh. On the said date, the company received a new loan of ₹ 30 lakh for a new project that was to be developed. However, the project was shelved on 17th December due to technical reasons, and the whole loan was paid on the same date.

(ii) During the financial year, a new proceeding was initiated against the company for holding a benami property worth ₹ 2.5 crore. However, the company's legal team had advised that the case would not withstand the law and would be dismissed during the hearing in April of next financial year.

(iii) The company had incurred a cash loss of ₹ 39 lakh during the financial year compared to a cash profit of ₹ 15 lakh in the previous financial year. The total turnover of the company for the financial year was ₹ 45 Crore.

During the year, the Y&S Associates had offered to resign from acting as the company's auditors. However, they later decided to postpone their resignation to the following year. At the conclusion of the audit, there was a difference of opinion between two articled assistants (Jack & Jill), who were assigned to the engagement, concerning disclosing the points mentioned above in the Companies (Auditor's Report) Order 2020. Jack was of the opinion that the proceeding initiated under Benami Property Act need not be disclosed since the expert legal team had informed them that the case would not withstand the law. However, he insisted that the cash loss shall be disclosed along with the amount. Jill was of the opinion that CARO is not at all applicable to the company, hence nothing needs to be reported. They both approached the firm's partners (Mr. Y & Mr. S) to resolve their argument.

Mr Y supported Jack's viewpoint & Mr S supported Jill's viewpoint. Now, both partners approached their Senior Partner to get clarification on the same. As a Senior Partner, kindly clarify the correct disclosure requirement. (RTP May '23)

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Answer 8

As per para 1 of Companies (Auditor's Report) Order 2020, CARO 2020 is applicable to every company, including a foreign company, as defined in clause (42) of section 2 of the Companies Act 2013, except,

(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);

(ii) an insurance company as defined under the Insurance Act,1938 (4 of 1938);

(iii) A company licensed to operate under section 8 of the Companies Act;

(iv) a One Person Company as defined under clause (62) of section 2 of the Companies Act and a small company as defined under clause (85) of section 2 of the Companies Act; and

(v) a private limited company, not being a subsidiary or holding company of a public company, having a paid up capital and reserves and surplus not more than rupees one crore as on the balance sheet date and which does not have total borrowings exceeding rupees one crore from any bank or financial institution at any point of time during the financial year and which does not have a total revenue as disclosed in Scheduled III to the Companies Act, 2013 (including revenue from discontinuing operations) exceeding rupees ten crore during the financial year as per the financial statements.

In the given case, though LIU is a private company, and its paid-up capital is less than ₹ 1 crore as on the balance sheet date, it is to be noted that for the period 15 th December to 17th December, the total borrowings of the company had exceeded ₹ 1 crore (75 lakh + 30 lakh). The borrowings are less than ₹ 1 crore as of the balance sheet date and the authorized capital is ₹ 200 lakh, are irrelevant to the current scenario. Also, the turnover of the company was greater than ₹ 40 crore. Hence, CARO 2020 is applicable to LIU Private Limited.

(i) As per clause (i) (e) of para 3 of CARO 2020, the auditor shall include a statement on: whether any proceedings have been initiated or pending against the company for holding any benami property under the Benami Transactions (Prohibition) Act, 1988 (45 of 1988) and rules made thereunder, if so, whether the company has appropriately disclosed the details in its financial statements.

In the given situation, a new proceeding was initiated against the company for holding a benami property worth ₹ 2.5 crores during the financial year. However, the company's legal team had advised that the case would not withstand the law and would be dismissed during the hearing, which would be held in April of the next financial year.

Therefore, the above observation of a new proceeding initiated against the company for holding a benami property worth ₹ 2.5 crores need to be disclosed as per clause (e) of para 3 of CARO 2020.

(ii) As per clause (xvii) of para 3 of CARO 2020, the auditor shall include a statement on whether the company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the amount of cash losses.

In the given situation, the company incurred a cash loss of ₹ 39 lakh during the financial year.

Hence, a cash loss of ₹ 39 lakh during the financial year need to be reported as per clause (xvii) of para 3 of CARO 2020.

(iii) As per clause (xviii) of para 3 of CARO 2020, the auditor shall include a statement on whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors.

In the instant case, there has been no resignation made by the statutory auditors during the financial year. The mere fact that Y&S Associates were thinking of resigning does not matter in the current scenario, and hence this clause shall not be applicable in the given situation.

Question 9

CA. F has been appointed as the Statutory Auditor of XYZ Limited for the financial year 2022-23. XYZ Limited has one subsidiary, namely AT Private Limited, whose statutory auditor is CA. B for the same financial year i.e., 2022-23.

CA. B issued a qualification in CARO 2020 for AT Private Limited, stating that short -term funds raised were utilised for long-term purposes. When consolidating the financial statements, CA. F decided to include the aforementioned qualification in the audit report of the Consolidated Financial Statements for the financial year 2022 -23. The management of XYZ Limited argued that CA. F is not obligated to take into account and report the qualification given by CA. B in the audit report of the subsidiary company in the consolidated financial statements for the financial year 2022 -23.

Discuss the reporting requirement as per CARO, 2020.(RTP Nov '23)

Answer 9

XYZ Limited is the parent company, and it has a subsidiary named AT Private Limited. CA F is the appointed statutory auditor for XYZ Limited for the financial year 2022 -23. Another auditor, CA B, has conducted the statutory audit for AT Private Limited and issued a CARO 2020 report, which includes a qualification regarding the short-term funds raised and utilised for long-term purposes.

Provision of Paragraph 2 of CARO 2020: Paragraph 2 of CARO 2020 specifies that the CARO provisions do not apply to the auditor's report on consolidated financial statements except for clause (xxi) of Paragraph 3.

Clause (xxi) of Paragraph 3 of CARO 2020: Clause (xxi) of Paragraph 3 of CARO 2020 mandates the auditor to comment on whether there are any qualifications or adverse remarks in the CARO reports of companies included in the consolidated financial statements. If such qualifications or adverse remarks exist, the auditor is required to provide details of the companies and the paragraph numbers of the CARO report containing those qualifications or adverse remarks.

CA F's Responsibility: Considering the provisions stated above, CA F, as the auditor of XYZ Limited's consolidated financial statements, is required to follow these steps:

a. **Report under Clause (xxi) of Paragraph 3 of CARO 2020:** CA F must include a comment in the consolidated financial statement's audit report regarding whether there are any qualifications or adverse remarks in the CARO reports of the companies included in the consolidated financial statements.

b. **Incorporate Qualification by CA B:** CA F should incorporate the qualification made by CA B (regarding short-term funds raised and utilized for long-term purposes in AT Private Limited) into the auditor's report for XYZ Limited's consolidated financial statements.

c. **Mention Paragraph Number:** CA F must also provide the paragraph number of CA B's CARO report where the qualification is stated.

Management's Contention: The management of XYZ Limited's contention that CA F is not required to consider and report CA B's qualification in the subsidiary's CARO report for the consolidated financial statements is not valid. As per the provisions, CA F is indeed required to report such qualifications as specified in Clause (xxi) of Paragraph 3 of CARO 2020.

In conclusion, based on the information provided and the provisions of CARO 2020, CA F is obligated to incorporate the qualification from CA B's CARO report for AT Private Limited into the auditor's report for XYZ Limited's consolidated financial statements for the financial year 2022-23, as well as provide the necessary details as per the requirements of Clause (xxi) of Paragraph 3 of CARO 2020.

Question 10

C Limited has defaulted in repayment of dues to a financial institution during the financial year 2016- 17 and the same remained outstanding as at March 31, 2017. However, the Company settled the total outstanding dues including interest in April, 2017 subsequent to the year end and before completion of the audit. Discuss how you would deal with this matter and draft a suitable Auditor's Report. (RTP May 18)

Answer 10

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

Further, as per clause (viii) (ix) (As per CARO 2020) of Para 3 of CARO, 2016 (CARO 2020),

(a) the auditor of a company has to state in his report whether the Company has defaulted in repayment of dues to a financial institution or bank or debentures holders and if yes, the period and amount of default to be reported.

(b) Reporting whether company is declared willful defaulter by any bank or financial institution or other lender.

(c) Reporting whether term loans were applied for the purpose intended.

(d) Reporting whether funds raised for short term have been utilized for long term purpose, if yes, then amount and nature of the same.

(e) Reporting on whether the company has taken any funds from any entity or person on account of or to meet obligations of its subsidiaries, joint ventures or associates, if yes, then amount and nature of the same.

(f) Reporting on whether the company has raised loans on the pledge of securities held in its subsidiaries, joint ventures and associates, if yes, then give details and also report any default in repayment, if any.

In the given case, C Ltd. has defaulted in repayments of dues to a financial institution during the financial year 2016-17 which remain outstanding as at March 31, 2017. However, the company has settled the total outstanding dues including interest in April, 2017 but, the dues were outstanding as at March 31, 2017. Therefore, it needs to be reported in the notes to accounts.

The draft report for above matter is as under:

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

The company has defaulted in repayment of dues including interest to a financial institution during the financial year 2015-16 amounting to Rs.XXXX which remained outstanding as at March 31, 2017. The period of default is XXX days. However, the outstanding sum was settled by the company in April, 2017."

Question 11

Under CARO, 2016 (2020), as a statutory auditor, how would you report?

(i) RPS Ltd. has entered into non-cash transactions with Mr. Rahul, son of director, which is an arrangement by which the RPS Ltd. is in process to acquire assets for consideration other than cash.

(ii) NSP Limited has its factory building, appearing as fixed assets in its financial statements in the name of one of its director who was overlooking the manufacturing activities. (RTP Nov 19)

Answer 11

(a)

(i) Non-cash Transactions with Relative of Director: As per Clause (xv) of paragraph 3 of CARO, 2016 (CARO 2020), the auditor is required to report "whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act, 2013 have been complied with".

Section 192 of the said Act deals with restriction on non-cash transactions involving directors or persons connected with them. The section prohibits the company from entering into such types of arrangements unless it is an arrangement by which the company acquires or is to acquire assets for consideration other than cash, from such director or person so connected.

In the instant case, RPS Ltd. has entered into non-cash transactions with Mr. Rahul, son of director which is an arrangement by which RPS Ltd. is in process to acquire assets for consideration other than cash. In the above situation the provisions of section 192 of Companies Act, 2013 have been complied with.

However, the reporting requirements under this clause are given in two parts. The first part requires the auditor to report on whether the company has entered into any non-cash transactions with the directors or any persons connected with such director/s. The second part of the clause requires the auditor to report whether the provisions of section 192 of the Act have been complied with.

Therefore, the second part of the clause becomes reportable only if the answer to the first part is in affirmative. In the given situation, RPS Ltd. has entered into non-cash transactions with Mr. Rahul, son of director which is affirmative answer to the first part of the Clause (xv) of Paragraph 3 of CARO, 2016 (CARO 2020), thus, reporting is required for the same. Draft report is given below.

According to the information and explanations given to us, the Company has entered into non-cash transactions with Mr. Rahul, son of one of the directors during the year, for the acquisition of assets, which in our opinion is covered under the provisions of Section 192 of the Companies Act, 2013.

(ii) Title deeds of Immovable Property in the name of Director:

As per clause (i) (c) of para 3 of CARO 2016 (CARO 2020) the auditor is required to report, "whether the title deeds of immovable properties are held in the name of the company (other than properties where the company is the lessee and the lease agreements are duly executed in the favor of the lessee). If not, provide the details thereof in the following format below."

In the present case, the Company has office along with freehold land in Pune. Though company has paid its purchase cost in full however, this property is pending to be registered in the name of the company i.e. title deed is not in the name of Company since 2006. Therefore, the auditor is required to report the same in accordance with clause (i)(c) of para 3 of CARO 2016 (CARO 2020).

The reporting under this clause, where the title deeds of the immovable property are not held in the name of the Company, may be made incorporating following details, in the form of a table or otherwise in case of land:-

• total number of cases,

• whether leasehold / freehold,

• gross block and net block, (as at Balance Sheet date), and

• remarks, if any.

The reporting under this clause, in the form of a table-

• Description of Property

• Gross Carrying Value

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• Held in Name of

• Whether promoter, director, relative or employee

• Period held-indicate range where appropriate

• Reason for not being held in name of company (Also indicate if in dispute)

(AS per CARO 2020)

Question 12

ABC & Associates are conducting audit of consolidated financial statements of "Crazy Paints Limited" for year 2022-23. The consolidated financial statements consist of financial statements of parent company and its five subsidiaries (audited by component auditors). While drafting audit report in respect of consolidated financial statements under Companies Act, 2013, how firm should proceed to deal with issue of reporting under CARO, 2020? (MTP 4 Marks Oct '23)

Answer 12

CARO, 2020 specifically provides that it shall not apply to the auditor's report on consolidated financial statements except clause (xxi) of paragraph 3. This means that the auditor will need to give a CARO report on the consolidated financial statements with respect to clause 3(xxi) of the Order only. Thus, the auditor is not required to report on rest of the clauses of paragraph 3.

Clause 3(xxi) of CARO 2020 requires the auditor to state whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies included in the consolidated financial statements. If yes, indicate the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.

Therefore, it requires the auditor to provide details of the companies and the paragraph numbers of the respective CARO report containing the qualifications or adverse remarks only. Reporting under this is only required for those entities included in the consolidated financial statements to whom CARO 2020 is applicable.

Question 13

The Property, Plant and Equipment of ABC Ltd. included ₹ 25.75 crores of earth removing machines of outdated technology which had been retired from active use and had been kept for disposal after knock down. These assets appeared at residual value and had been last inspected ten years back. As an Auditor, what may be your reporting concern as regards matters specified above? (PYP 5 Marks, May '18, MTP 4 Marks, May'20 & April 21)

Answer 13

Disclosure in Audit Report: The auditor is required to specifically include certain matters as per CARO, 2016 (CARO 2020) under section 143 of the Companies Act, 2013.

According to clause (i) (a) of CARO, 2016 (CARO 2020) the auditor has to comment whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets (Property, Plant & Equipment) and whether the company is maintaining proper records showing full particulars of intangible Assets ; and as per clause (i) (b) whether these fixed assets (Property, Plant & Equipment and Intangible Assets) have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

In the given case, ABC Ltd. has intention to sale its earth removing machines of outdated technology which had been retired from active use and had been kept for disposal after knock down and these assets are appearing at residual value. Further, inspection of such machines (though it is a retired machine, however value is ₹ 25.75 crores which is material amount) was done 10 years back, is not in compliance with CARO, 2016 (CARO 2020).

Hence, this fact needs to be disclosed in the Audit Report as per clause (i) (a) and (b) of Paragraph 3 of CARO 2016(CARO 2020).

Question 14

During the financial year ended on 31/03/2018, LM Private Limited had borrowed from a Nationalized Bank, a term loan of ₹ 120 lakhs consisting of ₹ 100 lakhs for purchase of a machinery for the new plant and ₹ 20 lakhs for erection expenses. As on the date of 31st March, 2018, the total of capital and free reserves of the Company was ₹ 50 lakhs and turnover for the year 2017-18 was ₹ 750 lakhs. The Bank paid ₹ 100 lakhs to the vendor of the Company for the supply of machinery on 31/12/2017. The machinery had reached the yard of the Company. On 28/02/2018, the Company had drawn the balance of loan viz. ₹ 20 lakhs to the credit of its current account maintained with the Bank and utilized the full amount for renovating its administrative office building. The machinery had been kept as capital stock under construction. Comment as to reporting issues, if any, that the Auditor should be concerned with for the financial year ended on 31/03/2018, in this respect. (PYP 5 Marks, Nov '18)

Answer 14

Applicability of CARO, 2016 (CARO 2020). and Utilization of Term Loan: CARO, 2016 (CARO 2020). specifically exempts a private limited company, not being a subsidiary company of a public company, having a paid up capital , reserves & surplus not more than rupees one crore as on balance sheet date and which does not have total borrowing exceeding rupees one crore from any bank or financial institution at any point of time during the year and which does not have a total revenue as disclosed in Schedule III to the companies Act 2013 exceeding Rd 10 crore during the financial year as per financial statements.

In the case of LM Pvt. Ltd, it has paid up capital of rupees 50 lacs which is below the specified limit of rupees 1 crore and turnover is rupees 7.5 crore which is also less than specified rupees 10 crore. However, there is total borrowing of rupees 1.20 crore which is more than rupees 1 crore and exceeding the specified limits of rupees 1 crore. Hence CARO, 2016 (CARO 2020). will be applicable to LM Pvt. Ltd.

As per clause (ix) of Para 3 of CARO, 2016 (CARO 2020),

(a) an auditor need to state in his report that whether the term loans were applied for the purpose for which the loans were obtained. If not, the details together with delays or default and subsequent rectification, if any, as may be applicable, be reported.

In a specific format in the form of a table as follows:

- Nature of borrowings including debt securities
- Name of Lender (Lender wise details to be provided in case of defaults to banks, financial institutions and Government)
- Amount not paid on due date
- Whether principal or interest
- No. of days delay or unpaid
- Remarks if any

(b) Reporting whether company is declared willful defaulter by any bank or financial institution or other lender.

(c) Reporting whether term loans were applied for the purpose intended.

(d) Reporting whether funds raised for short term have been utilized for long term purpose, if yes, then amount and nature of the same.

(e) Reporting on whether the company has taken any funds from any entity or person on account of or to meet obligations of its subsidiaries, joint ventures or associates, if yes, then amount and nature of the same.

(f) Reporting on whether the company has raised loans on the pledge of securities held in its subsidiaries, joint ventures and associates, if yes, then give details and also report any default in repayment, if any (As per CARO 2020)

The auditor should examine the terms and conditions subject to which the company has obtained the term loans. The auditor may also examine the proposal for grant of loan made to the bank. As mentioned above, normally, the end use of the funds raised by term loans is mentioned in the sanction letter or documents containing the terms and conditions of the loan. The auditor should ascertain the purpose for which term loans were sanctioned. The auditor should also compare the purpose for which term loans were sanctioned with the actual utilization of the loans. The auditor should obtain sufficient appropriate audit evidence regarding the utilization of the amounts raised. If the auditor finds that the funds have not been utilized for the purpose for which they were obtained, the auditor's report should state the fact.

In the present case, the term loan obtained by LM Private Ltd. amounting rupees 20 lakh have not been utilized for erection expenses instead its utilized for renovating its administrative office building.

Further, assuming that erection work has not been done and machinery is not being installed, disclosure of the same as Capital Stock under construction is in order.

Here, the auditor should report the fact in his report that pending utilization of the term loan for erection expenses, the funds were temporarily used for the purpose other than the purpose for which the loan was sanctioned as per clause (ix) of Para 3 of CARO, 2016 (CARO 2020).

Question 15

You are appointed as the Auditor of XMP Pvt. Ltd. for financial year 2021-22 after the resignation of RS & Co. Chartered Accountants, as statutory auditor of the company. RS & Co., had certain concerns on the accounting matters of the company, leading to change of auditors. All the compliances under Sections 139 and 140 are made by the company with regard to resignation and appointment.

During the course of audit, it came to your notice that a survey has been conducted on December 7, 2021 by the Income Tax Department and department has unearthed unrecorded sales of ₹ 5 lakhs which had been made in cash on different dates during the year 2020-21. XMP Pvt. Ltd. has purchased gold from such collections and these transactions are not recorded. Company surrendered and disclosed these transactions before the assessing officer and paid taxes thereon. However, company has not recorded those transactions in books of account even after surrender before Income Tax authorities.

You want to report the above matters in CARO, but the management requested you not to report them. Comment with respect to auditor's response to the management and his reporting requirements to the shareholders. (PYP 5 Marks Nov 22)

Answer 15

Clause (xviii) of Paragraph 3 of CARO, 2020:

In the given situation of XMP Pvt Ltd, the auditors RS & Co. resigned due to concerns on the accounting matters of the company. However, all the compliances regarding resignation and appointments discussed in section 139 and 140 of the Companies Act, 2013 are also being complied with. The auditor would be required to report the same in CARO, 2020 as per Clause (xviii) of Paragraph 3 of CARO, 2020 given hereunder:

Clause (xviii) of Paragraph 3 of CARO, 2020 requires the auditor to report whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors.

Clause (viii) of Paragraph 3 of CARO, 2020:

Further, the auditors noticed that a survey was conducted by the Income Tax Department and unrecorded sales of Rs 5 Lakhs were unearthed which had been made in cash on different dates during the year. XMP Pvt Ltd. has also purchased gold and the transactions remained unrecorded. Though Company surrendered and disclosed these transactions before the Assessing Officer and paid taxes thereon. The

auditor would be required to report in CARO as per Clause (viii) of Paragraph 3 of CARO, 2020.

Clause (viii) of Paragraph 3 of CARO, 2020 requires the auditor to report -whether any transactions not recorded in the books of account have been surrendered or disclosed as income during the year in the tax assessments under the Income Tax Act, 1961 (43 of 1961), if so, whether the previously unrecorded income has been properly recorded in the books of account during the year.

Since it is a statutory obligation on the part of the auditor to report in terms of CARO, 2020 as given above and consequently management's request to the auditor that not to report the above transactions is not tenable.

Question 16

SPM Ltd., about to complete fifty years of age since its incorporation in the F.Y 2023-2024, decided during the F.Y year 2022-23 to upgrade its registered office at an important location in Mumbai city. As part of planned package, it decided to acquire a land very adjacent to the site of registered office, which had been owned by Mr. Parry, who is a director of the Company. Since he was reluctant to part with the ownership, he had been persuaded to convey the property in favour of the company in exchange of a site owned by the company located at the next street to the street where the registered office is situated, which is 1.50 times larger in area than that of the site owned by the director adjacent to the Registered office. Happier with what he was offered in negotiation, Mr. Parry agreed for transferring the property in favour of the company in a deed of exchange duly executed by authorized persons of the Board, and Mr. Parry. The registration formalities were completed by 31st December, 2022. Assuming that you are the engagement partner for the audit of the accounts of the company for the financial year ended on 31st March, 2023, give a list of additional audit procedures and reporting requirements, if any, that this transaction might trigger in your audit. (PYP 5 Marks May '23)

Answer 16

CARO Audit Procedures and Reporting:

In the given situation, SPM Ltd has entered into non-cash transactions with one of the directors, Mr. Parry during the year, by transferring the property (by Mr. Parry) in favour of the Company in a deed of exchange of a site owned by the company.

Paragraph 3 Clause (xv) of the CARO 2020 & Reporting Requirements:

The auditor is required to report the transaction as per Paragraph 3(xv) of the CARO, 2020 which states that whether the company has entered into any non-cash transactions with directors or persons connected with him and if so, whether the provisions of section 192 of Companies Act have been complied with.

For reporting on the first part of this clause, the starting point of the auditor's procedures could be obtaining a management representation as to whether the company has undertaken any non-cash transactions with the directors or persons connected with the directors, as envisaged in section 192(1) of the Act.

The second part of this clause requires the auditor to report whether the company has complied with the provisions of section 192 in this regard. Section 192(1) and (2) of the Act envisage the following compliances in respect of such transactions:

(i) The company should have obtained a prior approval for such arrangement by a resolution in the general meeting.

(ii) Notice for approval of the resolution should contain details of the arrangement along with the value of assets involved.

The auditor should check compliance with section 192(2) of the Act and verify the notice of the general meeting that it includes particulars of arrangement along with the value of the assets involved in such arrangements.

This transaction was duly executed by the authorised persons of the Board. The auditor has to state the fact whether approval has been obtained in the general meeting of the company.

Related Party Transactions

This is a transaction with a related party. The provisions of section 188 of the Companies Act, 2013 as regards Related Party Transactions are to be checked for compliance. Section 189 of the Companies Act, 2013 requires a register to be maintained wherein the contract with related parties are to be entered.

The compliance with section 177 and section 188 has to be reported under Clause (xiii) of the CARO, 2020.

Documents to be verified:

A scrutiny of the following books of account, records and documents could provide source of such audit evidence to the auditor as to the existence of such non- cash transactions.

- Register of Loans, Guarantee, Security and Acquisition Made by the Company, Register of Contracts with Related Party and Contracts and Bodies etc. in which Directors are Interested.
- Movements in the Fixed Asset Register.
- Minutes book of the General Meeting and Meetings of Directors.
- Report on Annual General Meeting.

Question 17

In the course of audit of MM Ltd. for the financial year ended 31st March, 2019, your audit team has identified the following matter:

All amount of ₹ 4 Lakh per month for the marketing services rendered is paid to M/s. MG Associates, a partnership firm in which Director of MM Ltd. is also a managing partner, with a profit sharing ratio of 30%. Based on an independent assessment, the consideration paid is higher than the arm's length pricing by ₹ 1.50 Lakh per month. Whilst the transaction was accounted in the financial statements based on the amounts paid, no separate disclosure has been made in the notes forming part of the accounts. Give your comments for reporting under CARO 2016 (CARO 2020). (PYP 4 Marks, Nov '20)

Answer 17

According to clause (xiii) of Para 3 of CARO, 2016 (CARO 2020), whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc., as required by the applicable accounting standards.

Therefore, the duty of the auditor, under this clause is to report

i. Whether all transactions with the related parties are in compliance with section 177 and 188 of the Companies Act,2013:

ii. Whether related party disclosures as required by relevant Accounting Standards (AS 18, as may be applicable) are disclosed in the financial statements.

In the Instant case, MG Associates is a related party and also rendering marketing services to MM Ltd. in return of Consideration of ₹ 4 Lakhs which is related party transaction. No separate disclosure has been made in the notes to accounts in this context, which was required to be made.

In view of above, Auditor shall report under the above clause as under:

1. Nature of the related party relationship and the underlying transaction-MG Associates is a partnership firm in which Director of MM Ltd is also a managing partner, with a profit sharing ratio of 30 %. Payment of ₹ 4 Lakhs to MG Associates is a related party transaction.
2. Amount involved is Consideration for the Marketing services rendered by MG Associates (₹ 4 Lakhs p.m.) is higher than the arm's length pricing by ₹ 1.50 Lakh p.m. (₹ 18 Lakhs p.a.)

Multiple Choice Questions (MCQs)

Question 1

One of your team members has recently qualified as a chartered accountant and joined your team to audit a portfolio of audit clients who are private companies. One of the clients Surrey Pvt. Ltd. is a hotel in the small town near Jaipur. The revenue generated for the current year ended is Rs.10.5 crores and the entity is not a holding or subsidiary of any public company. The owner of the business Mr. Hazelwood runs this family business from last 10 years. Your team member is keen to know whether Surrey Pvt . Ltd is required to comment on the matter prescribed under CARO 2016 (CARO 2020). Which of your explanations to him are correct?

(a) The entity's revenue exceeds Rs.10 crores. Hence, no need to comment on the matter prescribed under CARO 2016 (CARO 2020).

(b) The entity is not a holding or subsidiary of any public company, hence no need to comment on the matter prescribed under CARO 2016 (CARO 2020).

(c) The entity's revenue for the year is Rs.10.5 cr which exceed the limit of Rs.10 cr. Hence, the entity has to provide the comment on the matter prescribed under CARO 2016 (CARO 2020).

(d) The entity is not a holding or subsidiary of any public company, hence there is a need to comment on the matter prescribed under CARO 2016 (CARO 2020). (MTP 1 Mark , Mar 19)

Ans: (c)

Question 2

Honeywell Ltd, a listed company pays its key managerial persons the remuneration in excess of the limits which have been prescribed under 197 of the Companies Act, 2013 without obtaining the necessary approvals from the regulatory authority. In this circumstance, the auditor while reporting under CARO 2016 (CARO 2020), is required to state:

(a) Name of the managerial persons to whom the remuneration has been paid in excess of limits and the amount involved.

(b) Name of the managerial persons to whom the remuneration in excess of limits are paid and the steps taken by the company for securing refund of the same.

(c) The maximum remuneration payable and amount paid in excess of the maximum remuneration to the managerial persons.

(d) The amount involved and steps taken by the company for securing the refund of the same. (MTP 2 Marks, Oct 19)

Ans: (d)

Question 3

Kinfin Private Limited had taken overdrafts from three banks (Bank A, Bank B and Bank C) with a limit of ₹ 40 lacs each against the security of fixed deposit it had with those banks and an unsecured overdraft from a financial institution (Financial Institution X) of ₹ 36 lacs.

As on 30th October 2019, the management used the overdraft fully of the A & C bank to the tune of ₹ 40 lacs each. However, the overdraft of second bank (Bank B) was not used until 31 st December, 2020.

On 31st December, 2020, Management took overdraft of B bank and very next day management paid the overdraft of C bank as the rate of interest charged by Bank C on overdraft facility was 15% whereas, the rate of interest charged by Bank B was 12%.

As at 31st March 2021 only overdraft of Bank A and Bank B were used fully , overdrafts of Bank C and Financial Institution X were unused. The paid-up capital and reserves of the company as at that date was ₹ 85 lacs and its revenue for the financial year ended on 31st March 2021 was ₹ 8.95 crores. The management of the company is of the opinion that CARO, 2016 (CARO 2020) is not applicable to it because turnover and paid-up capital were within the limits prescribed.

With respect to the loans, management was of the view that the total outstanding as at 31 March 2021 is less than the prescribed limit. The company further contended that loan limit is to be reckoned per bank or financial institution and not cumulatively. Comment.

(a) The CARO 2016 (CARO 2020) is applicable to the company as the turnover of the company exceeds the prescribed limit.

(b) The CARO 2016 (CARO 2020) is not applicable to the company as the turnover of the company does not exceeds the prescribed limit.

(c) The CARO 2016 (CARO 2020)is not applicable to the company as the borrowing of the company does not exceeds the prescribed limit.

(d) The CARO 2016(CARO 2020) is applicable to the company as the borrowing of the company exceeds the prescribed limit.(MTP 1 Mark Nov 21)

Ans: (d)

Question 4

While reporting under clause (ii) of Paragraph 3 of CARO 2020, which of the following is correct:

(a) The 10% threshold for reporting must be applied on a gross basis before adjusting excesses and shortages within the class of an inventory and must be based on value for each class of Inventory.

(b) The 10% threshold for reporting must be applied on a gross basis before adjusting excesses and shortages within the class of an inventory and must be based on value for all classes of Inventory.

(c) The 10% threshold for reporting must be applied on a net basis after adjusting excesses and shortages within the class of an inventory and must be based on value for each class of Inventory.

(d) The 10% threshold for reporting must be applied on a net basis after adjusting excesses and shortages within the class of an inventory and must be based on value for all classes of Inventory. (MTP 1 Mark April 22)

Ans: (c)

Question 5

KFintech Pvt Ltd was having paid-up share capital and reserves of ₹ 150 lakh including paid-up share capital of ₹ 90 lakh at the end of FY 20-21. During FY 21-22, KFintech borrowed ₹ 80 Lakh from Bank A and ₹ 140 Lakh from Bank B. The amount borrowed from Bank B was repaid during the same FY. For FY 20-21 the turnover of the company was ₹ 1,850 lakh. Select the appropriate option with respect to the applicability of CARO 2020:

a) CARO 2020 will be applicable as the paid-up capital and reserves exceeding the limit specified in the Order i.e., one crore rupees.

b) CARO 2020 will be applicable as the company has paid-up capital and reserves exceeding the limit specified in the Order i.e., one crore rupees and have total borrowings exceeding one crore rupees from any bank or financial institution at any point of time during the financial year.

c) CARO 2020 will not be applicable as the company repaid the amount borrowed from bank B before the end of the financial year and hence, the borrowings do not exceed the limit specified in the Order.

d) CARO 2020 will not be applicable as the company will fall under the exemption provided in the Order for Small Company as per section 2(85) of the Companies Act 2013. (MTP 1 Mark Sep '22)

Ans 5 : (d)

Question 6

CA. A, the auditor of XYZ Limited resigned from the post due to his personal reasons. CA. B was appointed as the subsequent auditor of the company by the Board of Directors. During the conclusion of the audit for the FY, should CA. B mention about CA. A 's resignation in the Companies (Auditor's Report) Order 2020?

(a) Yes. As per clause (xviii) of para 3 of CARO, CA. B should report the resignation of CA. A and state if he has taken into consideration the issues or objections raised by CA. A.

(b) No. Since the resignation of CA. A is due to his own personal reason, the same need not be reported under CARO.

(c) Yes. As per clause (xxi) of para 1 of CARO, CA. B should report the resignation of CA. A and state if he has taken into consideration the issues or objections raised by CA. A.

(d) No. CARO 2020 does not state any requirements to report resignation of auditor. However, the same needs to be mentioned by CA. B in the Audit Report under Other Matter Paragraph, as per SA 706.(MTP 1 Mark Oct 22)

Answer 6 : (a)

Question 7

ASAUS Ltd is in the business of optics and imaging products. It is a wholly owned subsidiary of Japanese company, ASU Ltd. ASAUS Ltd has many expatriates (Expats) working in the company whose tenure range from 2 to 5 years. During the course of audit of financial statements of the company, the statutory auditors observed that the company has not been deducting and depositing the TDS (tax deducted at source) on salaries of expats. The auditors assessed that the impact of this can be significant as the company has many expats and salary amount is significant. Management explained that TDS on salary of expats would lead to unnecessary hassles to the expats and they serve the company only for a short period. How should the auditors of ASAUS Ltd deal with this matter?

a. Considering this as a statutory non-compliance, the auditor should look at the significance of the matter and accordingly should report the same in CARO only.

b. Considering this as a statutory non-compliance, the auditor should look at the significance of the matter and accordingly should consider reporting this in the main report along with CARO.

c. The auditor should agree to the management's view as the expats are temporary workers and this may not be convenient for the management.

d. Since the matter relates to statutory liability only, the reporting requirements do not arise till the time this becomes disputed. (MTP 1 Mark March '23, RTP May'19)

Answer 7 : (b)

Question 8

CA Aarti is in the midst of performing audit procedures in the month of March 2023 for conducting a statutory audit of "Tess Products Private Limited" engaged in manufacturing of footwear products for the year 2022-23. The turnover of the company as per profit and loss account for the immediately preceding financial year is ₹ 35 crores. In the last week of March 2023, she gathered that the turnover of the company during the year 2022-23 would also be just nearing ₹ 35 crores. The company is also registered as a "Small Enterprise" under the Micro, Small and Medium Enterprises Development Act, 2006. Its present paid-up share capital is ₹3.50 crores, which has remained unchanged for the past few years. Besides, it is availing and utilizing a working capital credit facility of ₹ 2 crores from a bank during all these years, including the year 2022-23. The company has acquired all shares of a company based in Hong Kong during the year 2022-23. She wants to be sure about the applicability or otherwise of CARO 2020 for suitably planning and directing her audit procedures for year 2022 -23. Identify likely correct statement in this regard:

(a) Reporting under CARO, 2020 would not be applicable as it is a small company.

(b) Reporting under CARO, 2020 would not be applicable as it is registered as a small enterprise under Micro, Small and Medium Enterprises Act, 2006.

(c) Reporting under CARO, 2020 would be applicable as it is not a small company.

(d) Reporting under CARO, 2020 would not be applicable as it meets certain threshold criteria prescribed for private companies. (MTP 1 Mark Oct '23)

Answer 8 : (c)

Question 9

While auditing with respect to compliance with CARO, 2020, Mr. Omprakash, for additional reporting purpose, observed the following, relevant to Para 3(vii) of CARO, 2020:

Statutory Dues	Undisputed Amount (₹ in lakh)	Date Payable	Date Paid
Provident Fund	1.5	24th September, 2021	27th March, 2022
GST	2.45	23rd October, 2021	24th April, 2022
Customs Duty	0.65	20th September, 2021	10th April, 2022
Income Tax Demand for A.Y. 2019-20	0.55	18th October, 2021	Not Paid till date

Also, a representation was made to GST Department for waiving a penalty of ₹ 1 lakh for late payment of GST demand. What total amount of statutory dues need to be reported by Mr. Omprakash as per Para 3 of CARO?

(a) ₹ 3.10 lakh.

(b) ₹ 0.65 lakh.

(c) ₹ 3.65 lakh.

(d) ₹ 2.70 lakh. (RTP Nov'22)

Answer 9 (b)

Question 1

Under the applicable Standards on Auditing, in what circumstances does the report of the statutory auditor require modifications? What are the types of modifications possible to the said report?

Answer 1

SA 705 deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised), the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

Types of Modified Opinions as per SA 705:

(i) Qualified Opinion

(ii) Adverse Opinion

(iii) Disclaimer of Opinion

The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Qualified Opinion: The auditor shall express a qualified opinion when:

The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive

Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Disclaimer of Opinion: The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

REPORTING

Question 2

Write a short note on Emphasis of matter paragraph in Audit Reports.

Answer 2

Emphasis of Matter paragraph – A paragraph included in the auditor's report that refers to a matter appropriately 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.

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:

(a) The auditor would not be required to modify the opinion in accordance with SA 705 (Revised) as a result of the matter; and

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

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

(a) Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";

(b) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and

(c) Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

Question 3

Write a short note on Certificate for Special Purpose vs. Audit Report.

Answer 3

Certificate for Special Purpose vs. Audit Report: A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. The term 'certificate' is, therefore, used where the auditor verifies the accuracy of facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain figures and is in a position to vouch safe their accuracy as per his examination of documents and books of account. A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill. The 'report' involves expression of opinion which may differ from one professional to another. There is no question of exactitude in case of a report since the information contained therein is based on estimates and involves judgement element.

Question 4

Compare and explain the following:

(i) Reporting to Shareholders vs. Reporting to those Charged with Governance

(ii) Audit Qualification vs. Emphasis of Matter.

Answer 4

(i) Reporting to Shareholders vs. Reporting to those Charged with Governance:

REPORT	
Reporting to Shareholders	**Reporting to those Charged with Governance**
• Section 143 of the Companies Act, 2013 deals with the provisions relating to reporting to Shareholders. Thus, it is a Statutory Audit Report which is addressed to the members.	• Standard on Auditing 260 deals with the provisions relating to reporting to those Charged with Governance.
• Statutory Audit Report is on true and fair view and as per prescribed Format.	• It is a reporting on matters those charged with governance like scope of audit, audit procedures, audit modifications, etc.
Statutory Audit Reports are in public domain.	• Reporting to those Charged with Governance is an internal document i.e., private report.

(ii) Audit Qualification vs. Emphasis of Matter:

REPORT	
Audit Qualification	**Emphasis of Matter**
• Standard on Auditing 705 "Modifications to the Opinion in the Independent Auditor's Report", deals with the provisions relating to Audit Qualification.	• Standard on Auditing 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" deals with the provisions relating to Emphasis of Matter.
• Audit Qualifications are modifications to the opinion of the Auditors opinion where the auditor concludes that there is a material misstatement in the financial statement due to which the modification to the opinion of the auditor is necessary.	• Emphasis of Matter is a paragraph which is included in auditor's report to draw users' attention to important matter(s) which are already disclosed in Financial Statements and are fundamental to users' for understanding of Financial Statements.

	• The Emphasis of matter pre- supposes that there is Sufficient Appropriate audit evidence and the matter has been correctly disclosed.
• Audit Qualifications are given when auditor has concluded that the financial statementsare materially misstated or do not confirm to the financial reporting framework. Depending upon the nature of material misstatement being pervasive or otherwise the appropriate type of modified opinion is issued.	• Emphasis of Matter is a paragraph which is issued when the auditor feels that it is necessary to invite attention to a particular mater which has been appropriately disclosed in the financial statements which in the opinion of the auditor is necessary for better understanding of the financial statement.

Question 5

"When the auditor modifies the audit opinion, the auditor shall use the heading "Qualified Opinion,"

"Adverse Opinion," or "Disclaimer of Opinion," as appropriate, for the Opinion section." As an expert

you are required to brief the special considerations required for expressing:

(a) Qualified Opinion;

(b) Adverse Opinion and

(c) Disclaimer of Opinion.

Answer 5

(i) When the auditor expresses a qualified opinion due to a material misstatement in the financial statements, the auditor shall state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion section:

(a) When reporting in accordance with a fair presentation framework, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of) […] in accordance with [the applicable financial reporting framework]; or

(b) When reporting in accordance with a compliance framework, the accompanying financial statements have been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion.

(ii) When the auditor expresses an adverse opinion, the auditor shall state that, in the auditor's opinion, because of the significance of the matter(s) described in the Basis for Adverse Opinion section:

(a) When reporting in accordance with a fair presentation framework, the accompanying financial statements do not present fairly (or give a true and fair view of) […] in accordance with [the applicable financial reporting framework]; or

(b) When reporting in accordance with a compliance framework, the accompanying financial statements have not been prepared, in all material respects, in accordance with [the applicable financial reporting framework].

(iii) When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor shall:

(a) State that the auditor does not express an opinion on the accompanying financial statements;

(b) State that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

(c) Amend the statement required in SA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.

Question 6

ADKS & Co LLP are the newly appointed statutory auditors of PKK Ltd. During the course of audit, the statutory auditors have come across certain significant observations which they believe could lead to material misstatement of financial statements. Management has a different view and does not concur with the view of the statutory auditors. Considering this the statutory auditors are determining as to how to address these observations in terms of their reporting requirement. Please advise.

Answer 6

As per SA 705 (Revised), if the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement, the auditor shall modify the opinion in his report.

The auditor in such a case needs to determine the modification as follows:

Qualified Opinion: The auditor shall express a qualified opinion when:

(a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or

(b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

(i) Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements

(ii) **Disclaimer of Opinion:** The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Question 7

KPI Ltd is a joint venture of KPI Inc, a company based in US, and OPQ Ltd, a company based in Japan (hereinafter referred to as 'JV partners'). KPI Ltd was registered in India and is operating as a marketing support company for KPI Inc. All the costs of KPI Ltd are incurred in India and entire revenue of KPI Inc is generated in USD. The entire funding requirements of KPI Ltd are taken care of by the JV partners.

Since KPI Ltd is based in India, hence it is also required to get its financial statements audited.

The company appointed new auditors for the audit of the financial statements for the year ended 31 March 2023 after doing all appointment formalities wherein auditors are required to ensure compliance with Standards on Auditing and Internal Standards on Auditing.

As an expert you are required to advise the auditor about the requirements regarding auditor's report for audits conducted in accordance with both Standards on Auditing issued by ICAI and International Standards on Auditing.

Answer 7

An auditor may be required to conduct an audit in accordance with, in addition to the Standards on Auditing issued by ICAI, the International Standards on Auditing or auditing standards of any other jurisdiction. If this is the case, the auditor's report may refer to Standards on Auditing in addition to the International Standards on Auditing or auditing standards of such other jurisdiction, but the auditor shall do so only if:

(a) There is no conflict between the requirements in the ISAs or such auditing standards of other jurisdiction and those in SAs that would lead the auditor:

(i) to form a different opinion, or

(ii) not to include an Emphasis of Matter paragraph or Other Matter paragraph that, in the particular circumstances, is required by SAs; and

(b) The auditor's report includes, at a minimum, each of the elements set out in Auditor's Report Prescribed by Law or Regulation discussed above when the auditor uses the layout or wording specified by the Standards on Auditing. However, reference to "law or regulation" in above paragraph shall be read as reference to the Standards on Auditing. The auditor's report shall thereby identify such Standards on Auditing.

When the auditor's report refers to both the ISAs or the auditing standards of a specific jurisdiction and the Standards on Auditing issued by ICAI, the auditor's report shall clearly identify the same including the jurisdiction of origin of the other auditing standards.

Question 8

TUV Ltd. is a company engaged in the business of manufacture of spare parts. Saroj & Associates are the statutory auditors of the company for the FY 2022-23. During the course of audit, CA Saroj noticed that the company had a major customer, namely, Korean Mart from South Korea. Owing to an outbreak of war and subsequent destruction leading to government ban on import and export in South Korea, the demand from Korean Mart for the products of TUV Ltd. ended for an unforeseeable time period.

When discussed with the management, CA Saroj was told that the company is in the process of identifying new customers for their products. CA Saroj understands that though the use of going concern assumption is appropriate but a material uncertainty exists with respect to the identification of new customers. This fact is duly reflected in the financial statements of TUV Ltd. for the FY 2022-23.

How should CA Saroj deal with this matter in the auditor's report for the FY 2022-23?

Answer 8

As per SA 570, "Going Concern", loss of a major market or a key customer is one of the operating indicators that may cast significant doubt on the company's ability to continue as a going concern.

In the present case, TUV Ltd. has a key customer in South Korea from which the demand for its products has ended on account of outbreak of war, subsequent destruction and government ban on import and export in South Korea. Further, the company has not yet identified new customers and is in the process of doing the same. As such, the identification of new customer is a material uncertainty that cast a significant doubt on the company's ability to continue as a going concern.

However, this matter is duly disclosed by the management of TUV Ltd. in the financial statements for the year ended 31.03.2023.

As such, considering that the going concern assumption is appropriate but a material uncertainty exists with respect to identification of new customer, CA Saroj should:

(1) Express an unmodified opinion and

(2) Include in his audit report, a separate section under the heading "Material Uncertainty Related to Going Concern" to:

(i) Draw attention to the note in the financial statements that discloses the matters and

(ii) State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

(3) Thus, CA Saroj should deal with this matter in his auditor's report in the above-mentioned manner.

Question 9

Sun Moon Ltd. is a power generating company which uses coal as raw material for its power generating plant. The company has been allotted coal blocks in the state of Jharkhand and Odisha. During the FY 2022-23, a scam regarding allotment of coal blocks was unveiled leading to a ban on the allotment of coal blocks to various companies including Sun Moon Ltd. This happened in the month of December 2023 and as such entire power generation process of Sun Moon Ltd, came to a halt in that month. As a result of such ban, and the resultant stoppage of the production process, many key managerial personnel of the company left the company. There were delays in the of payment of wages and salaries and the banks from whom the company had taken funds for project financing also decided not to extend further finance or to fund further working capital requirements of the company.

Further, when discussed with the management, the statutory auditor understood that the company had no action plan to mitigate such circumstances. Further, all such circumstances were not reflected the financial statements of Sun Moon Ltd. What course of action should the statutory auditor of the company consider in such situation?

Answer 9

SA 570 - "Going Concern" deals with the auditor's responsibilities in the audit of financial statements relating to going concern and the implications for the auditor's report.

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern.

When the use of Going Concern Basis of Accounting Is Inappropriate i.e. if the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate, the auditor shall express an adverse opinion.

Also, when adequate Disclosure of a Material Uncertainty Is Not Made in the Financial Statements the auditor shall:

(i) Express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised); and

(ii) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

In the present case, the following circumstances indicate the inability of Sun Moon Ltd. to continue as a going concern:

- Ban on the allotment of coal blocks
- Halt in power generation

- Key Managerial Personnel leaving the company.
- Banks decided not to extend further finance and not to fund the working capital requirements of the company.
- Non availability of sound action plan to mitigate such circumstances.

Question 10

CA Omkar is the statutory auditor of Sabhyata Ltd. for the FY 2022-23. The company is engaged in the business of manufacture of floor tiles. During the course of audit, CA Omkar obtained certain audit evidence which were not consistent with the affirmation made in the financial statements. Discuss as to how CA Omkar should deal with the situation in the auditor's report.

Answer 10

SA 705 (Revised) deals with the auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700, the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary.

The decision regarding which type of modified opinion is appropriate depends upon:

(a) The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

(b) The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

Further, the auditor shall modify the opinion in the auditor's report when the auditor concludes that based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.

In the present case, during the course of audit, CA Omkar obtained certain audit evidence which were not consistent with the affirmation made in the financial statements. Therefore, CA Omkar should modify his report in accordance with SA 705- "Modifications to The Opinion In The Independent Auditor's Report.

CA Omkar should issue either a qualified opinion or an adverse opinion depending upon the circumstances of the case:

(a) CA Omkar shall express a qualified opinion when, having obtained sufficient appropriate audit evidence, he concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements

(b) CA Omkar shall express an adverse opinion, when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.

Thus, since CA Omkar has obtained audit evidence which are inconsistent with the affirmations made in the financial statement, CA Omkar should modify his opinion as per the circumstances of the case.

Question 11

The auditors of a listed company have affirmed in their audit report communication of significant audit findings including significant deficiencies in internal control of the company identified to those charged with governance. Where are such matters included in audit report of a listed company? Also dwell upon importance of such communication.

Answer 11

Such matters are in nature of auditor's responsibilities and are stated in "The Auditor's Responsibilities for the Audit of the Financial Statements" section of the auditor's report in accordance with SA 700.

Communication of significant audit findings and deficiencies identified in internal control to those charged with governance is one of important responsibilities of auditor.

Such communication assists those charged with governance in fulfilling their responsibility to oversee the financial reporting process and in fulfilling their oversight responsibilities.

Question 12

Below is draft extract of audit report of a listed company. Para (A) below reflects certain matter stated in audit report communicated with CFO of company and Para (B) is in nature of auditor's response to said matter.

(A) The Company recognizes revenues when the control of goods is transferred to the customer at the net consideration which the Company expects to receive for those goods from customers in accordance with contracts terms and conditions.

The terms of sales arrangements based on the terms and conditions of relevant contract and nature of discount and rebates create complexities that require judgment in determining revenues.

(B) We read the Company's revenue recognition policy and assessed its compliance in terms of Ind AS 115 "Revenue from contracts with customers".

We assessed design and tested the operating effectiveness of internal controls related to sales and rebates/discounts.

We tested on a sample basis that revenue has been recognized in the proper period with reference to the supporting documents including confirmations from customers.

From description given above, identify what auditors are trying to report and under what heading such matter should be reflected in audit report of the company?

REPORTING

Answer 12

The above matter is in nature of Key audit matter and should be stated under heading "Key audit matters" in audit report. Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.

SA 701 states that the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, significant auditor judgments relating to areas in the financial statements that involved significant management judgment including accounting estimates that have been identified as having high estimation uncertainty be taken into account.

The above-described matter relates to revenue recognition and creation of complexities requiring judgment in revenues. Further, the description also describes how the matter was addressed by auditors by performing various audit procedures in accordance with SA 701.

Question 13

PTD Limited is engaged in business of executing construction contracts for its clients. There are non current receivables outstanding in financial statements of the company as on 31st March, 2023 for ₹500 crore. Such amounts represent claims raised by the company on its clients relating to cost overruns necessitated due to delays caused by clients, change in work specifications and related matters. Besides negotiations, the company has also gone for arbitration in some of the said cases. The management of company has considered above amounts to be fully recoverable as stated in notes to accounts.

CA. Piyush, auditor of the company, has relied only upon management representation in this regard. Besides, he has decided to include the said matter in "Emphasis of Matter" Paragraph in audit report. How do you view decision to include above matter in "Emphasis of Matter" Paragraph by auditor of the company?

Answer 13

In accordance with SA 706, Emphasis of Matter Paragraph is a paragraph included in the auditor's report that refers to a matter appropriately 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.

As per SA 706, the objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to: -

(a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements or

(b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Further, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor would not be required to modify the opinion in accordance with SA 705 as a result of the matter.

In the given situation, auditor has relied upon management representation letter only. He has not performed any other audit procedures like verifying contracts with customers, status of arbitration proceedings etc. Since management representations by themselves do not constitute sufficient appropriate evidence, performing necessary audit procedures may lead auditor to conclude that modification in opinion is necessary. In such circumstances, matter cannot be included in Emphasis of matter Paragraph.

Therefore, auditor should form his opinion by performing necessary audit procedures and obtaining sufficient appropriate evidence. It is only when he concludes that modification of opinion is not required as a result of said matter in terms of SA 705, the said matter may be included in Emphasis of Matter paragraph.

Question ILLUSTRATION 14

CA Sameer is the statutory auditor of Tram Farm Ltd. for the FY 2022-23. While concluding the audit CA Sameer decided to issue an unmodified opinion, though he also concluded that a material uncertainty exists with respect to the company's ability to continue as a going concern on account of a pending litigation related to labour laws. He is of the view that the company has made appropriate disclosures with respect to such pending litigation in the notes to accounts annexed to the financial statements of Tram Farm Ltd. for the FY 2022-23. Explain how CA Sameer will deal with the above situation in his auditor's report (draft the relevant portion of the auditor's report.)

Answer 14

Material Uncertainty Related to Going Concern

We draw attention to Note 10 in the financial statements, which indicates that the outcome of a litigation on account of labour laws is pending in case of the company during the year 31 March, 2023. As stated in Note 11, this event or condition, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Question ILLUSTRATION 15

The following illustrates the presentation in the auditor's report if the auditor has determined there are no key audit matters to communicate:

Key Audit Matters

[Except for the matter described in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section,] We have determined that there are no [other] key audit matters to communicate in our report.]

Question ILLUSTRATION 16

XYZ Ltd. is a company engaged in the manufacture of cranes. CA Sudhir is the statutory auditor of the company for the FY 2022-23. The company has taken long term funding for fixed capital requirements and short-term funding for its working capital requirements. During the course of audit, CA Sudhir found that the company's financing arrangements are about to expire and the company is unable to renegotiate or obtain the replacement financing. As such the company may be unable to realize its assets and discharge its liabilities in the normal course of business. Notes to accounts annexed to the financial statements discuss the magnitude of financing arrangements, the expiration and the total financing arrangements; however, the financial statements do not include discussion on the impact or the availability of refinancing. Thus, the financial statements (and notes thereto) do not fully disclose this fact. What kind of opinion should CA Sudhir issue in case of XYZ Ltd.?

Answer 16

In the present case, XYZ Ltd. is unable to re- negotiate or obtain the replacement financing for its long term and short-term funding requirements. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore, XYZ Ltd. may be unable to realize its assets and discharge its liabilities in the normal course of business.

Further, the financial statements of XYZ Ltd. do not disclose this fact adequately.

Thus, the financial statements of XYZ Ltd. are materially misstated due to the inadequate disclosure of the material uncertainty. CA Sudhir will express a qualified opinion as the effects on the financial statements of this inadequate disclosure are material but not pervasive to the financial statements.

The relevant extract of the Qualified Opinion Paragraph and Basis for Qualified Opinion paragraph is as under:

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion section of our report, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of XYZ Ltd. as at March 31, 2023, and profit/loss, for the year ended on that date.

Basis for Qualified Opinion

As discussed in Note 6, the Company's financing arrangements are about to expire and the Company has been unable to conclude renegotiations or obtain replacement financing. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this matter.

Question ILLUSTRATION 17

ABC Ltd. is a company engaged in the manufacture of iron and steel bars. PP & Associates are the statutory auditors of ABC Ltd. for the FY 2022-23. During the course of audit, CA Prakash, the engagement partner, found that the Company's financing arrangements have expired and the amount outstanding was payable on March 31, 2023. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact. What opinion should CA Prakash express in case of ABC Ltd.?

Answer 17

In the present case based on the audit evidence obtained, CA Prakash has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, and the entity is considering bankruptcy. The financial statements of ABC Ltd. omit the required disclosures relating to the material uncertainty.

In such circumstances, CA Prakash should express an adverse opinion because the effects on the financial statements of such omission are material and pervasive.

The relevant extract of the Adverse Opinion Paragraph and Basis for Adverse Opinion paragraph is as under:

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly, the financial position of the entity as at March 31, 2023, and of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

Basis for Adverse Opinion

The financing arrangements of ABC Ltd. has expired and the amount outstanding was payable on March 31, 2023. The entity has been unable to conclude re-negotiations or obtain replacement financing and is considering filing for bankruptcy. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statements do not adequately disclose this fact.

Question ILLUSTRATION 18

MNO Ltd. is a power generating company having its plants in the north eastern states of the country. For the FY 2022-23, M/s PRT & Associates are the statutory auditors of the company. During the course of audit, the audit team was unable to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements. That is, the auditor

was also unable to obtain audit evidence about the financial information of a joint venture investment (in XYZ Ltd.) that represents over 90% of the entity's net assets. What kind of opinion should the statutory auditors issue in such case?

Answer 18

M/s PRT & Associates are unable to obtain sufficient appropriate audit evidence about the financial information of a joint venture investment that represents over 90% of the entity's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are both material and pervasive to the consolidated financial statements.

Therefore, the statutory auditor should issue a disclaimer of opinion.

The relevant extract of the Disclaimer of Opinion Paragraph and Basis for Disclaimer of Opinion paragraph is as under:

Disclaimer of Opinion

We do not express an opinion on the accompanying financial statements of MNO Ltd. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

The Group's investment in its joint venture XYZ Company is carried at ₹ 95 crores on the Group's consolidated balance sheet, which represents over 90% of the Group's net assets as at March 31, 2023.

We were not allowed access to the management and the auditors of XYZ Company, including XYZ Company's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of XYZ Company's assets that it controls jointly, its proportional share of XYZ Company's liabilities for which it is jointly responsible, its proportional share of XYZ's income and expenses for the year, (and the elements making up the consolidated statement of changes in equity) and the consolidated cash flow statement.

Question ILLUSTRATION 19

CA Yash is the statutory auditor of Laksmi Vardhan Limited for the FY 2022-23. In respect of loans and advances of ₹ 55,00,000/- given to Sarvagya Private Limited, the Company has not furnished any agreement to CA Yash and in absence of the same, he is unable to verify the terms of repayment, chargeability of interest and other terms.

What kind of opinion should CA Yash give in such situation?

Answer 19

In the present case, with respect to loans and advances of ₹ 55,00,000/- given to Sarvagya Private Limited, the Company has not furnished any agreement to CA Yash. In absence of such agreement, CA Yash is unable to verify the terms of repayment, chargeability of interest and other terms. For an auditor, while verifying any loans and advances, one of the most important audit evidences is the loan agreement.

Therefore, the absence of such document in the present case, tantamount to a material misstatement in the financial statements of the company. However, the inability of CA Yash to obtain such audit evidence is though material but not pervasive so as to require him to give a disclaimer of opinion.

Thus, in the present case, CA Yash should give a qualified opinion

The relevant extract of the Qualified Opinion Paragraph and Basis for Qualified Opinion paragraph is as under:

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the financial statements of Laksmi Vardhan Limited give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as on 31.03.2023 and profit/ loss for the year ended on that date. Basis for Qualified Opinion

The Company is unable to furnish the loan agreement with respect to loans and advances of ₹ 55,00,000/- given to Sarvagya Private Limited. Consequently, in absence of such agreement, we are unable to verify the terms of repayment, chargeability of interest and other terms.

Question ILLUSTRATION 20

In the financial year 2022-23, MSD Ltd. faced an extraordinary event (earthquake), which destroyed a lot of business activity of the company. These circumstances indicate material uncertainty on the company's ability to continue as going concern. Due to such event it may not be possible for the company to realize its assets or pay off the liabilities during the regular course of its business. The financial statement and notes to the financial statements of the company do not disclose this fact. What kind of opinion should the statutory auditor of MSD Ltd. issue in such circumstances?

Answer 20

In the present case, there exists a material uncertainty that cast a significant doubt on the company's ability to continue as going concern and the same is not disclosed in the financial statements of MSD Ltd. As such, the financial statements of MSD Ltd. for the FY 2022-23 are materially misstated and the effect of the misstatement is so material and pervasive on the financial statements that giving only a qualified opinion will be insufficient and therefore the statutory auditor of MSD Ltd. should issue an adverse opinion.

The relevant extract of the Adverse Opinion Paragraph and Basis for Adverse Opinion paragraph is as under: Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion section of our report, the accompanying financial statements do not present fairly, the financial position of MSD Ltd. as at March 31, 2023, and of its financial performance and its cash flows for the year then ended in accordance with the Accounting Standards issued by the Institute of Chartered Accountants of India.

Basis for Adverse Opinion

MSD Ltd. has faced an extraordinary event (earthquake), which destroyed a lot of business activity of the company. Due to such event it may not be possible for the company to realize its assets or pay off the liabilities during the regular course of its business. This situation indicates that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. The financial statement and notes to the financial statements of the company do not disclose this fact.

Question illustration 21

CA Abhimanyu is the statutory auditor of PQR Ltd. for the FY 2022-23. During the course of audit CA Abhimanyu noticed the following:

With respect to the debtors amounting to ₹ 150 crores, no balance confirmation was received by the audit team. Further, there have been defaults on the payment obligations by debtors on the due dates during the year under audit. The Company has created a provision for doubtful debts to the tune of ₹25 Cr. during the year under audit. The Company has stated that the provision is based on receivables which are older than 36 months, which according to the audit team is inadequate and as such the audit team is unable to ascertain the carrying value of trade receivables.

Further, in respect of Inventories (which constitutes 40% of the total assets of the company), during the reporting period, the management has not undertaken physical verification of inventories at periodic intervals. Also, the Company has not maintained adequate inventory records at the factory. The audit team was unable to undertake the physical inventory count as such the value of inventory could not be verified.

Under the above circumstances what kind of opinion should CA Abhimanyu give?

Answer 21

In the present case, CA Abhimanyu is unable to obtain sufficient and appropriate audit evidence with respect to the following:

1. The balance confirmation with respect to debtors amounting to ₹ 150 crores is not available.

Further there has been default in payment by the debtors and the provision so made is not adequate. The audit team is also unable ascertain the carrying value of trade receivables.

2. With respect to 40% of the company's inventory, neither the physical verification has been done by the management nor are adequate inventory records maintained. The audit team is also unable to undertake the physical inventory count as such the value of inventory could not be verified.

In the above two circumstances the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

Thus, CA Abhimanyu should give a Disclaimer of Opinion.

The relevant extract of the Disclaimer of Opinion Paragraph and Basis for Disclaimer of Opinion paragraph is as under:

Disclaimer of Opinion

We do not express an opinion on the accompanying financial statements of PQR Ltd. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We are unable to obtain balance confirmation with respect to the debtors amounting to ₹ 150 crores.

Further, there have been defaults on the payment obligations by debtors on the due dates during the year under audit. The Company has created a provision for doubtful debts to the tune of ₹25 Cr. during the year under audit which is inadequate in the circumstances of the company. The carrying value of trade receivables could not be ascertained. Further, in respect of Inventories (which constitutes 40% of the total assets of the company), during the reporting period, the management has not undertaken physical verification of inventories at periodic intervals. Also, the Company has not maintained adequate inventory records at the factory. We were unable to undertake the physical inventory count and as such the value of inventory could not be verified.

Question ILLUSTRATION 22

In respect of the audit of BDS Ltd., the statutory auditor of the company noticed some matters. The statutory auditor wants to draw the user's attention towards such matters, though his opinion is not modified in respect of such matters. Draft the relevant paragraphs of the audit report for the following matters:

i. **The company has a plan to resume its construction activities with respect to one of its thermal power projects, The activity of such power plant was suspended in the F Y 2020-21. The thermal power project comprises of the plant and equipment amounting to ₹ 5.95 crore and capital work in progress of ₹ 147.50 crore.**

ii. **The financial statements of 5 branches are included in the Standalone Financial Statements of BDS Ltd. whose financial statements reflect total assets of ₹ 90 crores as at 31.03.2023 and total revenue from operations of ₹ 40 crores for the year ended on that date. The financial statements of these branches have been audited by the branch auditors.**

Answer 22

Emphasis of Matter

We draw attention to the following note of the standalone financial statements:

Note 27 regarding the plans of the Company to resume construction/developmental activities of a thermal power project. The carrying amounts related to the project as at 31st March, 2023 comprise of plant and equipment of ₹ 5.95 crore and capital work in progress of ₹ 147.50 crore.

Our opinion is not modified in respect of this matter.

Other Matter

We did not audit the financial statements of 5 branches included in the Standalone Financial Statements of the company whose financial statements reflect total assets of ₹ 90 crores as at 31.03.2023 and total revenue from operations of ₹ 40 crores for the year ended on that date. The financial statements of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of these branches, is based solely on the report of the branch auditors.

Our opinion is not modified in respect of this matter.

Integrated Case Scenario

CA. Raghav is in midst of finalizing audit reports of five clients. On reviewing each file, it is noticed as under: -

(a) **In case of a company engaged in business of selling of agricultural products which are outside ambit of GST, engagement team has found that substantial part of revenues of the company (about 80%) is generated through cash sales. However, there is no proper system and internal control to verify accuracy of revenues generated through cash sales. Therefore, team has been unable to verify such revenues generated through cash sales.**

(b) **TS Limited has been dragged to court by BS Limited for stealing its trade secrets using cyber theft and filed a claim for ₹50 crore. On reviewing audit file of TS Limited, CA Raghav finds that legal opinion of company's standing counsel is ambiguous. There are precedent case laws both in favour and against on such issue. The financial statements of TS Limited are silent on this litigation matter.**

(c) **It is noticed on review of audit file of a client that net profit before tax was ₹2 crore on a turnover of ₹100 crore. There is an export receivable from a chain of stores outstanding in financial statements of ₹3 crore for which there is no chance of recovery. The said chain of stores has gone bankrupt. There is also no hope of recovering money through ECGC (Export credit Guarantee Corporation) due to certain technical issues. Debt has not been written off by the client despite being communicated to client.**

(d) On reviewing file of a small finance bank, it was noticed that team has drafted following para proposed to be included under Emphasis of Matter paragraph: -

Concerns are raised regarding "Going Concern" status of the Bank. However, the Bank feels that it continues to remain a "Going Concern" in view of reasons stated in note 10.

Our opinion is not modified in respect of this matter."

(e) On reviewing file of a client, it is noticed that team was not informed about finished goods of ₹1 crore lying at a location taken on rent in February 2023. The said issue was flagged at time of reconciling inventories by the team. Hence, team could not attend physical inventory counting.

The alternative procedures cannot be performed in absence of adequate records pertaining to above location. Total inventories reflected in financial statements is ₹ 8 crores. PBT of client is ₹10 crores.

Based upon above, answer the following questions: -

1. As regards description regarding revenues generated through cash sales of a company, which of the following statements is most appropriate in terms of SA 705?

(a) Qualified opinion will be issued and basis for qualified opinion will also be provided.

(b) Adverse opinion will be issued and basis for adverse opinion will also be provided.

(c) A disclaimer of opinion will be issued and basis for disclaimer of opinion will also be provided.

Besides, statement in audit report will be changed from "financial statements have been audited" to "auditor was engaged to audit financial statements."

(d) A disclaimer of opinion will be issued and basis for disclaimer of opinion will also be provided.

Besides, statement in audit report will be changed from "financial statements have been audited" to "financial statements have not been audited."

Ans: (c)

2. Considering litigation matter of TS Limited, which of the following statements is most appropriate in this regard?

(a) Unmodified opinion needs to be expressed by auditor.

(b) It amounts to non-disclosure of a material contingent liability by the company. Adverse opinion needs to be expressed by auditor.

(c) It amounts to non-disclosure of a material contingent liability by the company. Qualified opinion needs to be expressed by auditor.

(d) The company has not made a material provision resulting in material misstatement. Adverse opinion needs to be expressed by auditor.

Ans: (c)

3. considering description of issue regarding non-recoverability of export receivable of ₹3 crore from a chain of stores, which type of opinion is appropriate to be issued in audit report?

(a) Disclaimer of opinion

(b) Unmodified opinion

(c) Qualified opinion

(d) Adverse opinion

Ans: (d)

4. As regards matter of going concern in respect of a small finance Bank, which of the following statements is most appropriate?

(a) The para drafted by team is proper and in accordance with SA 570 since auditor has decided to give unmodified opinion.

(b) The para drafted by team is proper and in accordance with SA 570 since matter has been disclosed in notes to accounts by bank management.

(c) Instead of giving emphasis of matter paragraph, separate paragraph on 'Material Uncertainty Related to Going Concern' in report should be given in accordance with SA 570.

(d) Separate paragraph on 'Material Uncertainty Related to Going Concern' under the heading "Emphasis of matter" paragraph in report should be given in accordance with SA 570.

Ans: (c)

5. Regarding issue of not informing team regarding inventory of finished goods lying at a location taken on rent in February 2023, which type of opinion is appropriate to be issued in case of this client?

(a) Modified opinion

(b) Qualified opinion

(c) Unmodified opinion

(d) Either Modified or Qualified opinion

Ans: (b)

8 CHAPTER

SPECIALISED AREAS

SA 800- Special Considerations- Audits of Financial Statements prepared in accordance with Special Purpose Framework

Question 1

The financial statements of AKY & Co. have been prepared by management of an entity in accordance with the financial reporting provisions of a contract (that is, a special purpose framework) to comply with provisions of the contract. Based on the contract, management does not have a choice of financial reporting frameworks. As an auditor advise the considerations to be taken care while planning and performing audit? (MTP 4 Marks, Aug 18, MTP 5 Marks March 18)

Answer 1

Considerations for Planning and Performing Audit in case of Special Purpose Framework: As per SA 800 "Special Considerations-Audits of Financial Statements Prepared in accordance with Special Purpose Frameworks", financial statements prepared in accordance with a special purpose framework may be the only financial statements an entity prepares. In such circumstances, those financial statements may be used by users other than those for whom the financial reporting framework is designed.

While planning and performing audit of such special purpose framework based company, the auditor should consider below mentioned factors:

a. To obtain an understanding of the entity's selection and application of accounting policies. In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements.

b. Compliance of all SAs relevant to audit, the auditor may judge it necessary to depart from a relevant requirement in an SA by performing alternative audit procedures to achieve the aim of that requirement.

c. Application of some of the requirements of the SAs in an audit of special purpose financial statements may require special consideration by the auditor. For example, in SA 320, judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. In the case of an audit of special purpose financial statements, however, those judgments are based on a consideration of the financial information needs of the intended users.

d. In the case of special purpose financial statements, such as those prepared in accordance with the requirements of a contract, management may agree with the intended users on a threshold below which misstatements identified during the audit will not be corrected or otherwise adjusted. The existence of such a threshold does not relieve the auditor from the requirement to determine materiality in accordance with SA 320 for purposes of planning and performing the audit of the special purpose financial statements.

e. Communication with those charged with governance in accordance with SAs is based on the relationship between those charged with governance and the financial statements subject to audit, in particular, whether those charged with governance are responsible for overseeing the preparation of those financial statements. In the case of special purpose financial statements, those charged with governance may not have such a responsibility.

SPECIALISED AREAS

SA 810- Engagements to report on Summary Financial Statements

Question 1

The management of CSITA Ltd. has prepared its summary financial statements for the year 2017 - 18 to be provided to its investors. Consequently, the company wants to appoint you for conducting audit of summary financial statements. What are the procedures that you will perform and consider necessary as the basis for forming an opinion on the summary financial statements? (MTP 4 Marks, April 18)

Answer 1

As per SA 810, “Engagement to Report on Summary Financial Statements”, the auditor shall perform the following procedures, and any other procedures that the auditor may consider necessary, as the basis for the auditor’s opinion on the summary financial statements:

(i) Evaluate whether the summary financial statements adequately disclose their summarized nature and identify the audited financial statements.

(ii) When summary financial statements are not accompanied by the audited financial statements, evaluate whether they describe clearly:

(1) From whom or where the audited financial statements are available; or

(2) The law or regulation that specifies that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements.

(iii) Evaluate whether the summary financial statements adequately disclose the applied criteria.

(iv) Compare the summary financial statements with the related information in the audited financial statements to determine whether the summary financial statements agree with or can be recalculated from the related information in the audited financial statements.

(v) Evaluate whether the summary financial statements are prepared in accordance with the applied criteria.

(vi) Evaluate, in view of the purpose of the summary financial statements, whether the summary financial statements contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.

(vii) Evaluate whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty, unless law or regulation provides that they need not be made available and establishes the criteria for the preparation of the summary financial statements.

Question 1

CA P is auditor of a company responsible for auditing complete set of financial statements. He intends to express adverse opinion on complete set of financial statements considering conclusions drawn by him during course of audit. He is also auditing trade receivables of company for the same period in a separate engagement. Can he express unmodified opinion in respect of trade receivables? If so, discuss those circumstances. (SA 805)

Answer 1

If the auditor undertakes an engagement to report on a single financial statement or on a specific element of a financial statement in conjunction with an engagement to audit the entity's complete set of financial statements, the auditor shall express a separate opinion for each engagement.

If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole, RevSisAed 705 does not permit the auditor to include in the same auditor's report an unmodified opinion on a single financial statement that forms part of those financial statements or on a specific element that forms part of those financial statements.

This is because such an unmodified opinion would contradict the adverse opinion or disclaimer of opinion on the entity's complete set of financial statements as a whole If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole but, in the context of a separate audit of a specific element that is included in those financial statements, the auditor nevertheless considers it appropriate to express an unmodified opinion on that element, the auditor shall only do so if

a) The auditor is not prohibited by law or regulation from doing so;

b) That opinion is expressed in an auditor's report that is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion; and

c) The specific element does not constitute a major portion of the entity's complete set of financial statements.

Question 2

List out few factors affecting auditor's determination of the acceptability of the applied criteria before accepting audit of summary financial statements. (SA 810)

Answer 2

Factors affecting the auditor's determination of the acceptability of the applied criteria:

- The nature of the entity
- The purpose of the summary financial statements
- The information needs of the intended users of the summary financial statements and
- Whether the applied criteria will result in summary financial statements that are not misleading in the circumstances.

SPECIALISED AREAS

Question 3

SA 800 deals with special considerations applicable in respect of audit of financial statements prepared in accordance with special purpose framework Explain, by giving examples, meaning of special purpose framework. (SA 800)

Answer 3

SA 800 defines special purpose framework as a financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.

The requirements of the applicable financial reporting framework determine the form and content of the financial statements and what constitutes a complete set of financial statements.

Examples of Special purpose framework: -

- The cash receipts and disbursements basis of accounting for cash flow information that an entity may be requested to prepare for creditors.
- The financial reporting provisions established by a regulator to meet the requirements of that regulator
- The financial reporting provisions of a contract, such as a bond indenture, a loan agreement, or a project grant

Question 4

CA Y is auditor of a company. He has expressed adverse opinion on audited financial statements. What additional points he has to keep in mind while expressing opinion on summary financial statements derived from such audited financial statements? (SA 810)

Answer 4

When the auditor's report on the audited financial statements contains a qualified opinion, an Emphasis of Matter paragraph, or an Other Matter paragraph, but the auditor is satisfied that the summary financial statements are consistent, in all material respects, with or are a fair summary of the audited financial statements, in accordance with the applied criteria, the auditor's report on the summary financial statements shall, also contain followings: -

(a) State that the auditor's report on the audited financial statements contains a qualified opinion, an Emphasis of Matter paragraph, or an Other Matter paragraph; and

(b) Describe

(i) The basis for the qualified opinion on the audited financial statements, and that qualified opinion; or the Emphasis of Matter or the Other Matter paragraph in the auditor's report on the audited financial statements; and

(ii) The effect thereof on the summary financial statements, if any.

When the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion, the auditor's report on the summary financial statements shall, additionally:-

a) State that the auditor's report on the audited financial statements contains an adverse opinion or disclaimer of opinion;

b) Describe the basis for that adverse opinion or disclaimer of opinion; and

c) State that, as a result of the adverse opinion or disclaimer of opinion, it is inappropriate to

d) express an opinion on the summary financial statements

Question 5

CA Lalita is auditor of a company. She is also offered professional work of audit of financial statements prepared specifically for meeting requirements of a loan agreement for the same period. She chooses to accept work and has made up her mind to disclose this fact in "Other matter Paragraph" in audit report to be issued by her for this specific engagement. Is her approach proper? (SA 805)

Answer 5

In the given situation, the approach of CA Lalita is proper. There is no bar upon accepting such an engagement even though she is the auditor of the company. Besides, she has intended to disclose this fact in "Other Matter Paragraph" of the audit report to be issued by her for such specific engagement.

Question 6

CA Lakshmi has prepared a draft audit report for financial statements of X Ltd. prepared in accordance with financial reporting provisions of a contract with Y Ltd. She has drafted an unmodified opinion to be given in audit report. Besides, she has also drawn attention in draft audit report to Note "A "to the financial statements which describes the basis of accounting (under the heading "Basis of accounting").

How she should ensure that report would not be misused? Draft a suitable para to be included in the report for this purpose. (SA 800)

Answer 6

SHE may consider it appropriate to indicate that the auditor's report is intended solely for specific users.

Depending on the law or regulation applicable, this may be achieved by restricting the distribution or use of the auditor's report. In these circumstances, the paragraph alerting the readers may be expanded to include these other matters and the heading modified accordingly. The draft para should read as under: -

Basis of Accounting and Restriction on Distribution and Use

Without modifying our opinion, we draw attention to Note A to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the company to

comply with the financial reporting provisions of the contract referred to above. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for X Ltd. and Y Ltd. and should not be distributed to or used by parties other than X Ltd. and Y Ltd.

Question 7

CA M. Surya is auditor for financial statements of an entity prepared in accordance with financial reporting provisions of a contract. He is also offered audit of trade receivables appearing in above financial statements. Can he accept such engagement? Discuss brief outline of his audit approach in such a situation. (SA 805)

Answer 7

The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, SA 800 also applies to the audit.

In the given case, financial statements of the entity are prepared in accordance with financial reporting provisions of a contract. It is a special purpose framework. The auditor of financial statements prepared in accordance with special purpose framework is also offered audit of trade receivables appearing in above financial statements which relates to audit of element of financial statements prepared in accordance with special purpose framework. Hence, his audit approach should include considering requirements of both SA 800 and SA 805.

Question 8

CA G is offered appointment for audit of trade payables of financial statements of a company. However, financial statements prepared under Companies Act, 2013 are audited by CA Jignesh. Discuss why it would be practically difficult for CA G to perform such an audit. (SA 805)

Answer 8

Compliance with the requirements of SAs relevant to the audit of a single financial statement or of a specific element of a financial statement may not be practicable when the auditor is not also engaged to audit the entity's complete set of financial statements. In such cases, the auditor often does not have the same understanding of the entity and its environment, including its internal control, as an auditor who also audits the entity's complete set of financial statements. Accordingly, the auditor may need further evidence to corroborate audit evidence acquired from the accounting records.

In the case of an audit of a specific element of a financial statement, certain SAs require audit work that may be disproportionate to the element being audited. If the auditor concludes that an audit of a single financial statement or of a specific element of a financial statement in accordance with SAs may not be practicable, the auditor may discuss with management whether another type of engagement might be more practicable.

Question 9

CA Madhur is auditor of a company and has issued audit report dated 15th June of a particular year. The audit report on summary financial statements derived from such audited financial statements is dated 15th July of that particular year. Discuss whether there exists any additional reporting responsibility for auditor in such a situation in respect of audit report on summary financial statements. (SA 810)

Answer 9

The audit report on summary financial statements derived from audited financial statements is dated 15th July of that particular year. However, the audit report on audited financial statements is dated 15th June of that year.

In the above situation, the auditor's report on summary financial statements should state that the summary financial statements and the audited financial statements do not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements.

Question 10

Consider that the audit report on financial statements issued by CA Madhur for above said company contains qualified opinion. Can he issue an unmodified opinion on summary financial statements derived from audited financial statements? Discuss. (SA 810)

Answer 10

If the auditor is satisfied that the summary financial statements are consistent, in all material respects, with or are a fair summary of the audited financial statements, in accordance with the applied criteria, he can issue an unmodified opinion.

However, when auditor's report on audited financial statements contains a qualified opinion, the auditor's report on the summary financial statements shall, also contain following:

(a) State that the auditor's report on the audited financial statements contains a qualified opinion

(b) Describe:

(i) The basis for the qualified opinion on the audited financial statements, and that qualified opinion in the auditor's report on the audited financial statements; and

(ii) The effect thereof on the summary financial statements, if any. Hence, above points should be included by CA Madhur.

INTEGRATED CASE SCENARIO

Liabilities	Smart investment equity and debt fund	Smart investment equity savings fund
Unit Capital	20000.00	15000.00
Reserve and Surplus	160000.00	80000.00
Other current liabilities & provisions	100.00	100.00
Total	180100.00	95100.00
Assets		
Investments	170000.00	90000.00
Deposits	100.00	100.00
Other Current assets	10000.00	5000.00
Total	180100.00	95100.00

Abridged revenue account for year ended 31st March 20XX (In₹ Lacs)

Income	Smart investment equity and debt fund	Smart investment equity savings fund
Income	34000.00	1000.00
Expenses and losses	3400.00	1500.00
Net realized gains	30600.00	(500.00)
Add: Change in unrealized appreciation in value of investments	2000.00	700.00
Net Surplus	32600.00	200.00
Dividend appropriation	3000.00	50.00
Retained Surplus	29600.00	150.00

The abridged financial statements of the Schemes of the Fund have been prepared by Board of Trustees of Fund pursuant to SEBI regulations and in accordance with format prescribed by SEBI. Previous year figures have been ignored for purpose of case. Unmodified opinion has been expressed by auditor in audited financial statements of the schemes of "Smart Investment Mutual Fund" as at 31st March 20XX and for year ended 31st March, 20XX.

Keeping in view above, answer the following questions: -

1. Given the above extract of abridged financial statements and description, which the following statements is most appropriate?

(a) The auditor may presume that criteria applied by the Board of Trustees in the preparation of the abridged financial statements are acceptable.

(b) The auditor cannot presume that criteria applied by the Board of Trustees in preparation of abridged financial statements are acceptable.

(c) The abridged financial statements have been prepared by the Board of Trustees. The auditor cannot ordinarily accept criteria applied by them for the preparation of such abridged financial statements before detailed evaluation.

(d) The auditor is duty bound to accept the criteria applied by the Board of Trustees in the preparation of abridged financial statements.

Ans: (a)

2. Which of the following statements in reference to abridged financial statemen not in accordance with three querulents of SA 810?

(a) The notes to accounts should specifically disclose that these abridged financial statements have been derived from audited financial statements.

(b) The Board of Trustees has disclosed that audited financial statements are available on the website of the company.

(c) It should be stated in the auditor's report that abridged financial statements have been compared with the related information in the audited financial statements to determine whether the abridged financial statements agree with or can be re- calculated from the related information in the audited financial statements.

(d) It should be stated in auditor's report that reading the abridged financial statements is not a substitute for reading the audited financial statements of the Schemes of the Fund.

Ans: (c)

3. Which of the following paras is most appropriate to be included under heading "Auditor's responsibility" in the auditor's report?

(a) Our responsibility is to express an opinion on the Abridged financial statements based on our procedures, which were conducted in accordance with Standards on Auditing issued by the Institute of Chartered Accountants of India.

(b) Our responsibility is to express an opinion on the Abridged financial statements based on our procedures, which were conducted in accordance with Standard on Auditing (SA) 810, "Engagements to Report on Summary Financial Statements" issued by the Institute of Chartered Accountants of India.

(c) Our responsibility is to express an opinion on the Abridged financial statements based on our procedures, which were conducted in accordance with Standards on Auditing adapted in circumstances including (SA) 810, "Engagements to Report on Summary Financial Statements" issued by the Institute of Chartered Accountants of India.

(d) Our responsibility is to express an opinion on the Abridged financial statements based on our procedures, which were conducted in accordance with SEBI regulations and Standards on Auditing adapted in circumstances including (SA) 810, "Engagements to Report on Summary Financial Statements" issued by the Institute of Chartered Accountants of India.

Ans: (b)

4. Which of the following paras is most appropriate to be included under healing "Opinion" in auditor's report?

(a) In our opinion, the abridged financial statements, derived from the audited financial statements of the Schemes of the Fund as at March 31, 20XX and for the year ended March 31, 20XX are a fair summary of those financial statements, and are in accordance with the accounting policies and standards specified in SEBI regulations and generally accepted accounting principles in India to the extent applicable.

(b) In our opinion, the abridged financial statements, as at March 31, 20XX and for the year ended March 31, 20XX are a fair summary of those financial statements.

(c) In our opinion, the abridged financial statements, derived from the audited financial statements of the Schemes of the Fund as at March 31, 20XX and for the year ended March 31, 20XX are consistent with audited financial statements and are in accordance with the accounting policies and standards specified in SEBI regulations and generally accepted accounting principles in India to the extent applicable.

(d) In our opinion, the abridged financial statements, derived from the audited financial statements of the Schemes of the Fund as at March 31, 20XX and for the year ended March 31, 20XX are consistent with audited financial statements

Ans: (a)

5. Which of the following is usually nonelement of audit report on abridged finance statements in accordance with SA 810?

(a) Emphasis of matter paragraph.

(b) Other matter paragraph.

(c) Management's responsibility for abridged financial statements.

(d) Key audit matters.

Ans: (d)

SPECIALISED AREAS

CA HARSHAD JAJU
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SWAPNIL PATNI CLASSES
caharshad

9 CHAPTER RELATED SERVICES

SRS 4400- Engagements to perform agreed upon procedures regarding Financial Information

Question 1

CA P is the auditor of Master Data Ltd. for the year 2021-22. The company requests the auditor to undertake an exercise involving only verification of trade receivables for half year ending 30th September 2021. The company wants to be satisfied that trade receivables are properly confirmed and reconciled.

In this regard, CA P has to verify the arithmetical accuracy of trade receivables, obtain confirmation of trade receivables and ensure verification of proper reconciliations with confirmations.

He is in a dilemma as to whether he can give a report providing assurance to the company in this respect. Guide CA P with reasoning. Assume that above exercise can be undertaken and there is no legal bar. (RTP May '23)

Answer 1

In the given case situation, auditor has to verify trade receivables for half year ending 30th September,2021. Such a process/exercise is only a fact finding and reporting exercise. The auditor has to report the facts as these are. Like, he would have to state whether confirmation from a particular debtor has been received or not.

The auditor can issue an assurance report in case of audit and review engagements. By providing assurance, the auditor provides comfort to users of financial statements. Assurance in the above context refers to the auditor's satisfaction as to the reliability of an assertion made by one party for use by another. To provide such assurance, the auditor assesses the evidence collected as a result of procedures conducted and expresses a conclusion. The degree of satisfaction achieved and, therefore, the level of assurance which may be provided is determined by the procedures performed and their results.

However, the types of services described in the given situation falls in the related services domain. These are, in the nature, of agreed-upon procedures to be carried out by the auditor. The auditor cannot issue an assurance report while providing such kind of services. He can only issue a report stating facts as they are without providing any sort of assurance. He can report only facts.

Therefore, the auditor cannot give a report providing assurance for such type of services. He can only issue a factual report.

SRS 4410- Compilation Engagements

Question 1

Your engagement team member, Mr. Shyam, is engaged as practitioner for compilation of historical financial information of Rama Ltd.

You as a senior audit engagement team in-charge, you are required to examine the practitioner's responsibilities as he is engaged to assist management with the preparation and presentation of historical financial information without obtaining any assurance on that information. (MTP 4 Marks, March 18)

Answer 1

As per SRS 4410 "Compilation Engagements", the engagement partner shall take responsibility for-

(i) The overall quality of each compilation engagement to which that partner is assigned; and

(ii) The engagement being performed in accordance with the firm's quality control policies and procedures, by:

(1) Following appropriate procedures regarding the acceptance and continuance of client relationships and engagements;

(2) Being satisfied that the engagement team collectively has the appropriate competence and capabilities to perform the compilation engagement;

(3) Being alert for indications of non-compliance by members of the engagement team with relevant ethical requirements, and determining the appropriate action if matters come to the engagement partner's attention indicating that members of the engagement team have not complied with relevant ethical requirements;

(4) Directing, supervising and performing the engagement in compliance with professional standards and applicable legal and regulatory requirements; and

(5) Taking responsibility for appropriate engagement documentation being maintained.

Question 1

List out few intended purposes of a "compilation engagement." (SRS 4410)

Answer 1

Financial information that is the subject of a compilation engagement may be required for various purposes including-

- To comply with mandatory periodic finance reporting requirements established in law or regulation, if any or
- For purposes unrelated to mandatory financial reporting under relevant law or regulation, including for example
  - For management or those charged with governance, prepared on abasis appropriate for their particular purposes (such as preparation of financial information for internal use).
  - For periodic financial reporting undertake for external parties under a contract or other form of agreement (such as financial information provided to a funding body to support provisioner or continuation of a grant).
  - For transactional purposes, for example to support a transaction involving changes to the entity's ownership or financing structure (such as for a merger or acquisition).

Question 2

A Chartered Accountant is offered appointment for a compilation engagement to be performed under SRS 4410. Is he required to comply with ethical requirements of Code of Ethics? Discuss briefly. (SRS 4410)

Answer 2

The practitioner shall comply with relevant ethical requirements. In complying with the Code of Ethics, threats to the practitioner's compliance with relevant ethical requirements are required to be identified and appropriately addressed.

Being in nature of non-assurance engagement, independence requirements do not apply to compilation engagements. However, laws or regulations may specify requirements or disclosure rules pertaining to independence

Question 3

How do "related services" differ from assurance engagements? (4400)

Answer 3

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

Not all engagements performed by practitioners are assurance engagements. Other frequently performed engagements which do not meet the definition of assurance engagements include-

- The preparation of tax returns where no conclusion conveying assurance is expressed.
- Consulting (or advisory) engagements such as management and tax consulting.
- Engagements covered by Standards for Related Services, such as agreed-upon procedures engagements and compilations of financial or other information.

Question 4

Discuss main documentation requirements to be taken care of by a practitioner while performing a compilation engagement under SRS 4410.

Answer 4

The practitioner shall include in the engagement documentation

(a) Significant matters arising during the compilation engagement and how those matters were addressed by the practitioner

(b) A record of how the compiled financial information reconciles with the underlying records, documents, explanations and other information, provided by management and

(c) A copy of the final version of the compiled financial information for which management or those charged with governance, as appropriate, has acknowledged their responsibility, and the practitioner's report.

The practitioner may consider also including in the engagement documentation a copy of the entity's trial balance, summary of significant accounting records or other information that the practitioner used to perform the compilation.

Question 5

CA. P has been appointed to compile the financial information oLfimX ited. CA P is confused whether he should apply the same procedures which are required to be applied to conduct an audit or there are some other procedures to discharge the duties under such an engagement. Define the characteristics Compilation Engagemen.t What should be the approach of CA P for performing the Engagement? (4410)

Answer 5

Compilation engagement is an engagement in which a practitioner applies accounting and financial reporting expertise to assist management in the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework and issues a report.

A compilation engagement is not an assurance engagement. A compilation engagement does not require the practitioner to verify the accuracy or completeness of the information provided by management for the compilation, or otherwise to gather evidence to express an audit opinion or a review conclusion on the preparation of the financial information.

- The practitioner shall obtain an understanding of the following matters sufficient to be able to perform the compilation engagement: -

a) The entity's business and operations, including the entity's accounting system and accounting records and

b) The applicable financial reporting framework, including its application in the entity's industry.

- The practitioner shall compile the financial informant using the records, documents, explanations and other information, including significant judgments, provided by management.
- The practitioner shall discuss with management, or those charged with governance appropriate, those significant judgments, for which the practitioner has provided assistance in the course of compiling the financial information.
- Prior to completion of the compilation engagement, the practitioner shall read the compiled financial information in light of the practitioner's understanding of the entity's business and operations, and of the applicable financial reporting framework.
- If, in the course of the compilation engagement, the practitioner becomes aware that the records, documents, explanations or other information, including significant judgments, provided by management for the compilation engagement are incomplete, inaccurate or otherwise unsatisfactory, the practitioner shall bring that to the attention of management and request the additional or corrected information.
- If the practitioner is unable to complete the engagement cause management has failed to provide records, documents, explanations or other information, including significant judgments, as requested, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing.
- If the practitioner becomes aware during the course of the engagement that: -

(a) The compiled financial information does not adequately refer to or describe the applicable financial reporting framework

(b) Amendments to the compiled financial information are required for the financial information not to be materially misstated; or

(c) The compiled financial information is otherwise misleading, the practitioner shall propose the appropriate amendments to management.

- If management declines, or does not permit the practitioner to make the proposed amendments to the compiled financial information, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing.

- If withdrawal from the engagement is not possible, the practitioner shall determine the professional and legal responsibilities applicable in the circumstances.
- The practitioner shall obtain an acknowledgement from management or those charged with governance, as appropriate, that they have taken responsibility for the final version of the compiled financial information.

Question 6

A company asks you to carry out process of confirmation of its accounts receivables having balances in excess of `10 lacs as per its books of accounts at the close of the year. The work to be performed only involves preparing and sending confirmation requests to such parties, analysis of variations on receipt of confirmations and submission of a report in accordance with professional standards. What points have to be kept in mind for inclusion in report specifically for such engagement? (4400)

Answer 6

The described engagement is an agreed-upon procedures engagement. Following points have to be kept in mind for being included in the report: -

- A statement that the procedures performed were those agreed-upon with recipient
- A statement that the engagement was performed in accordance with the Standard on Related Services applicable to agreed-upon procedures engagements
- Identification of the purpose for which the agreed-upon procedures were performed
- A listing of the specific procedures performed
- A description of the auditor's factual findings including sufficient details of errors and exceptions found
- A statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed
- A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported
- A statement that the report is restricted to those parties that have agreed to the procedures to be performed
- A statement that the report relates only to the elements, accounts, items or financial and nonfinancial information specified and that it does not extend to the entity's financial statements taken as a whole

Question 7

During the course of performing a compilation engagement in accordance with SRS 4410, it becomes known to you that client had suffered a theft loss of `100 lacs of its inventories over a period of time at a storage location visited infrequently. A claim was lodged by the client with insurance company which was repudiated due to certain technical reasons relating to coverage of policy. The client has not preferred a complaint or an appeal against said repudiation. The amount is reflected under the head "current assets" in trial balance of the client. Discuss, how you should proceed to deal with the matter? (4410)

Answer 7

In this instant case, amount of `100 lacs is reflected under the head "current assets" in trial balance. Since client's claim has been repudiated and no appeal has been preferred, it is a loss for the client and should be dealt accordingly. Therefore, amendments are required for the financial information not to be materially misstated.

If the practitioner becomes aware during the course of the engagement that amendments to the compiled financial information are required for the financial information not to be materially misstated or the compiled financial information is otherwise misleading, the practitioner shall propose the appropriate amendments to management.

If management declines, or does not permit the practitioner to make the proposed amendments to the compiled financial information, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing.

If withdrawal from the engagement is not possible, the practitioner shall determine the professional and legal responsibilities applicable in the circumstances.

INTEGRATED CASE SCENARIO

KM Limited has engaged your firm for compilation of financial statements in accordance with requirements of SRS 4410. You also come to know that company is setting up a new unit in Rourkela, Odisha. The company management has provided you with draft trial balance and requires assistance in preparation and presentation of its financial statements for year ended 31st March, 2023. The management requires such a preparation and presentation for its internal use.

During the course of engagement, it is noticed that: -

1) **There are apparent errors in few opening balances brought forward from previous year relating to some outstanding incentives receivable from government authorities. These have been swapped with some other balances in trial balance. However, there are no credit transactions in such incentive accounts or accounts whose balances have been swapped during the year.**
2) **One of the team members suggests that it is one of the duties to ensure that revenue figures stated in trial balance, at least, are verified to ensure that all revenues required to be booked by the company have, in fact, been booked.**

3) It is also suggested by this team member that even though it is a compilation engagement, quality control aspects like adhering to appropriate Standards needed to be followed.

4) Before signing and issuing report under SRS 4410, you once again read the financial information.

It comes to your notice that figures relating to setting up of a new unit of the company coming up in Rourkela in Odisha have not been properly disclosed in compiled financial statements. The expenditure was incurred from a bank account maintained in Rourkela and was omitted to be shown under appropriate heads. You are vacillating regarding above considering scope of compilation engagement.

5) The team has prepared detailed documentation during the course of engagement.

Keeping in view above, answer the following questions: -

1. In respect of errors in some of opening balances noticed as described in case, which of the following statements is most appropriate?

(a) Such errors should straight away lead to the qualification of a report to be issued.

(b) Such errors should be brought to the knowledge of management.

(c) Knowledge of such type of errors has no effect on compliance of ethical requirements by the firm.

(d) The above said matter relates to SA 510 Initial Audit Engagements-Opening Balances and has no effect on reporting obligations in a compilation engagement.

Ans: (b)

2. As regards the suggestion of one of the team members regarding the verification of all revenues of the company, which of the following statements is most appropriate?

(a) Suggestion of team member is proper as such verification is part and parcel of such an engagement.

(b) Suggestion of team member is proper as the absence of such verification may make financial statements misleading.

(c) Suggestion of team member is not proper as verifying the accuracy or completeness of the information provided by management is not required in such engagement.

(d) Suggestion of team member is not proper as compliance with qualitative requirements is not required in such engagement.

Ans: (c)

3. In view of the team member's suggestion relating to adherence to appropriate Standards for quality control, which of the following statements is relevant in context of above said engagement?

(a) SA 220 is applicable in this engagement and has to be followed by the engagement partner meticulously.

(b) SQC 1 is applicable in this engagement.

(c) Both SA 220 and SQC 1 are applicable in this engagement.

(d) SA 220 and SQC 1 are not applicable in this engagement. However, SRS 4410 lays down detailed quality control requirements for such type of engagement.

Ans: (b)

4. Which of the following statements is most appropriate as regards omission of expenditure under appropriate heads pertaining to the Rourkela unit in compiled financial statements?

(a) The above-noted omission can be misleading. By disregarding such an omission, the fundamental principle of integrity is violated and engagement cannot be performed in accordance with ethical requirements.

(b) The above-noted omission can be misleading. By disregarding such an omission, the fundamental principle of objectivity is violated and engagement cannot be performed in accordance with ethical requirements.

(c) The above noted omission has no effect on performing such compilation engagement.

(d) The above-noted omission has no effect on performing and issuing reports under such compilation engagement.

Ans: (a)

5. The detailed documentation is maintained during the course of compilation engagement. Which of the following statements is most appropriate regarding assembly of the final engagement file?

a) Final engagement file should be assembled in not more than 60 days after the date of the report.

b) Final engagement file should be assembled in not more than 120 days after the date of the report.

c) Final engagement file should be assembled on a timely basis after the engagement report has been finalized in accordance with the time limits set by the firm.

d) There is no requirement of assembling of final engagement file in a compilation engagement

Ans: (c)

RELATED SERVICES

10 CHAPTER

REVIEW OF FINANCIAL INFORMATION

Question 1

Discuss why "inquiry" is important as an audit procedure in an engagement to review financial statements. (SRE 2400)

Answer 1

Inquiry: In a review, inquiry includes seeking information from management and other persons within the entity, as the practitioner considers appropriate in the engagement circumstances.

Inquiries may include matters such as those relating to making of accounting estimates, identification of related parties, about significant, complex or unusual transactions, existence of any actual, suspected or alleged fraud, events occurring between the date of the financial statements and practitioner's report, basis for management's assessment of the entity's ability to continue as a going concern, events or conditions that appear to cast doubt on the entity's ability to continue as a going concern, material commitments, contractual obligations or contingencies that have affected or may affect the entity's financial statements including disclosures and material non-monetary transactions or transactions for no consideration in the financial reporting period under consideration.

The practitioner may also extend Inquiries to obtain non-financial data if appropriate. Evaluating the responses provided by the management is integral to the inquiry process.

Depending on the engagement circumstances, inquiries may also include inquiries about:

- Actions taken at meetings of owners, those charged with governance and committees thereof, and proceedings at other meetings, if any, that affect the information and disclosures contained in the financial statements.
- Communications the entity has received, or expects to receive or obtain, from regulatory agencies.
- Matters arising in the course of applying other procedures.

When performing further inquiries in relation to identified inconsistencies, the practitioner considers the reasonableness and consistency of management's responses in light of the results obtained from other procedures, and the practitioner's knowledge and understanding of the entity and the industry in which it operates.

Question 2

CA. Aditya Jain is auditor of a listed company. He is also required to carry out quarterly review of financial statements of company in terms of regulatory requirements is He already well versed with business of company and has deep understanding of the company. Discuss, any five procedures, by which he can update his understanding of the company for carrying out quarterly review. (SRE 2410)

Answer 2

Some of the procedures performed by the auditor to update the understanding of the entity and its environment, including its internal control, ordinarily include the following

- Reading the documentation, to the extent necessary, of the preceding year's audit and reviews of prior interim period(s) of the current year and corresponding interim period(s) of the prior year, to enable the auditor to identify matters that may affect the current-period interim financial information.
- Considering any significant risks, including the risk of management override of controls, that were identified in the audit of the prior year's financial statements.
- Reading the most recent annual and comparable prior period interim financial information.
- Considering materiality with reference to the applicable financial reporting framework as it relates to interim financial information to assist in determining the nature and extent of the procedures to be performed and evaluating the effect of misstatements.
- Considering the nature of any corrected material misstatements and any identified uncorrected immaterial misstatements in the prior year's financial statements.
- Considering significant financial accounting and reporting matters that may be of continuing significance such as material weaknesses in internal control.
- Considering the results of any audit procedures performed with respect to the current year's financial statements.
- Considering the results of any internal audit performed and the subsequent actions taken by the management.
- Inquiring of management about the results of management's assessment of the risk that the interim financial information may be materially misstated as a result of fraud.
- Inquiring of management about the effect of changes in the entity's business activities.
- Inquiring of management about any significant changes in internal control and the potential effect of any such changes on the preparation of interim financial information.
- Inquiring of management of the process by which the interim financial information has been prepared and the reliability of the underlying accounting records to which the interim financial information is agreed or reconciled.

REVIEW OF FINANCIAL INFORMATION

Question 3

What is significance of "date of report in" a review report? (SRE 2400)

Answer 3

The date of the practitioner's repo: the practitioner shall date the report no earlier than the date on which the practitioner has obtained sufficient appropriate evidence as the basis for the practitioner's conclusion on the financial statements, including being satisfied that: -

(1) All the statements that comprise the financial statements under the applicable financial reporting framework, including the related notes where applicable, have been prepared and

(2) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Question 4

CA. Pankaj Chaturvedi has issued a review report dated 28.7.2022 for financial results of a company for quarter ending 30.6.2022. Describe his responsibility, if any, for events occurring from 1.7.2022 till date of review report in accordance with SRE 2410.

Answer 4

The auditor should inquire whether management has identified all events up to the date of the review report that may require adjustment to or disclosure in the interim financial information.

Question 5

Roma Limited has entered into a contract with Dorma Limited. There is a condition in the contract by virtue of which Roma Limited is required to get its financial statements reviewed for a year on a quarterly basis in accordance with the financial reporting provisions of the contract. Can Roma Limited get its financial statements reviewed from a professional accountant in practice?

Answer 5

The above financial statements are prepared in accordance with special purpose framework in accordance with requirements of a contract. Financial statements prepared in accordance with special purpose framework can also be reviewed by a professional accountant in practice and review report may be issued in accordance with SRE 2400.

Question 6

You are conducting a review of the financial statements of a company. It is gathered upon inquiry that there is a possibility of material misstatements in financial statements. Discuss, how you would proceed further in the matter under SRE 2400.

Answer 6

If the practitioner becomes aware of matters that causes the practitioner to believe the financial statements may be materially misstated, the practitioner shall design and perform additional procedures sufficient to enable the practitioner to: -

a) Conclude that the matter(s) is not likely to cause the financial statements as a whole to be materially misstated or

b) Determine that the matter(s) causes the financial statements as a whole to be materially misstated. Additional procedures focus on obtaining sufficient appropriate evidence to enable the practitioner to form a conclusion on matters that the practitioner believes may cause the financial statements to be materially misstated. The procedures may be:

- Additional inquiry or analytical procedures, for example, being performed in greater detail or being focused on the affected items (i.e., amounts or disclosures concerning the affected accounts or transactions as reflected in the financial statements); or
- Other types of procedures, for example, substantive test of details or external confirmations.

Question 7

During review of quarterly results of a company of which you are auditor, it is gathered on inquiries made that there has been a major fire in fabric processing plant of the company during the quarter. It has resulted in massive disruption in operations of the company. Worse still, machinery and inventories of plant were uninsured due to carelessness of concerned staff leading to substantial losses. The matter has been disclosed in interim financial information appropriately. Discuss, how you would proceed to deal with the same in review report?

Answer 7

Uninsured assets in a disaster are examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. As a result of fire, there is massive disruption in operations of the company. Besides, the company would have to bear losses as its damaged assets are uninsured.

In accordance with SRE 2410, if, as a result of inquiries or other review procedures, a material uncertainty relating to an event or condition comes to the auditor's attention that may cast significant doubt on the entity's ability to continue as a going concern, and adequate disclosure is made in the interim financial information, the auditor modifies review report by adding an emphasis of matter paragraph.

Therefore, Emphasis of matter paragraph should be added in review report.

REVIEW OF FINANCIAL INFORMATION

Question 8

CA. Seerat is conducting review of the quarterly financial information of a company of which she is also auditor. She believes that it is necessary to make a material adjustment to the quarterly financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework. She has communicated the matter to CFO and audit committee. However, no response was received even after waiting for a reasonable time. What are the options available to her?

Answer 8

In such a case, options available to her in accordance with SRE 2410 are: -

a) Whether to modify the report or

b) The possibility of withdrawing from the engagement and

c) The possibility of resigning from the appointment to audit the annual financial statements.

Integrated Case Scenario

Below is given an incomplete draft text of the review report on the review of financial results of Fast Operations Limited, a listed company in accordance with SEBI regulations. The review is a compulsory requirement under SEBI (Listing Obligations and Disclosure Requirements) Regulations. The incomplete areas of the report have been marked as XXXX.

INDEPENDENT AUDITOR'S REVIEW REPORT ON REVIEW OF INTERIM STANDALONE FINANCIAL RESULTS TO XXXX

1. **We have reviewed the accompanying Statement of Standalone unaudited financial results of Fast Operations Limited ("the Company"), for the quarter and six months ended September 30, 2022 ("the Statement"), being submitted by the Company pursuant to the requirement of Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended.**
2. **This Statement, which is the responsibility of the Company's Management and approved by the Company's Board of Directors, has been prepared in accordance with the recognition and measurement principles laid down in the Indian Accounting Standard 34 "Interim Financial Reporting" ("Ind AS 34"), prescribed under Section 133 of the Companies Act, 2013 read with relevant rules issued thereunder and other accounting principles generally accepted in India. Our responsibility XXXXXXXXXXX.**
3. **We conducted our review of the Statement in accordance with the Standard XXXX, issued by the Institute of Chartered Accountants of India (ICAI). A review of interim financial information consists of making inquiries, primarily of the company's personnel responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially XXXXXXXXXXXXXXXXXXXXXXXX.**

4. Based on our review conducted as stated in paragraph 3 above, XXXXXXXXXXXXXXXXXX Using your knowledge, answer the following questions to complete the draft text of review report of Fast Operations Limited-

1. The name of addressee is missing from text of draft review report. Identify the appropriate option:

a) Audit Committee

b) Board of Directors

c) CFO

d) Stock exchange on which shares of company are listed

Ans: (b)

2. Under para 2 of the case study, choose the appropriate sentence beginning with "Our responsibility XXXX":

a) Our responsibility is to express an opinion on the Statement based on our review.

b) Our responsibility is to express a conclusion on the Statement based on our review.

c) Our responsibility is to provide a reasonable assurance on the Statement based on our review.

d) Our responsibility is to express a compliance statement on the Statement based on our review.

Ans: (b)

3. Given the description of case study which of the following engagement standards is most appropriate to be stated in para 3?

a) SRE 2410 'Review of Interim Financial Information Performed by the Independent Auditor of the Entity'.

b) SRE 2400 Engagements to Review Historical Financial Statements.

c) SA 700 Forming an Opinion and Reporting on Financial Statements.

d) SA 810 Engagements to Report on Summary Financial Statements.

Ans: (a)

4. Which of the following statements is most appropriate to be inserted in sentence beginning with" A review is substantially XXXX" in para 3?

a) A review is substantially broader in scope than an audit conducted in accordance with Standards on Auditing specified under section 143(10) of the Companies Act, 2013 and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in a review. Accordingly, we do not express an audit opinion.

b) A review is substantially broader in scope than an audit conducted in accordance with Standards on Auditing specified under section 143(10) of the Companies Act, 2013 and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

c) A review is substantially narrower in scope than an audit conducted in accordance with Standards on Auditing specified under section 143(10) of the Companies Act, 2013 and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in a review. Accordingly, we do not express an audit opinion

d) A review is substantially less in scope than an audit conducted in accordance with Standards on Auditing specified under section 143(10) of the Companies Act, 2013 and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Ans: (d)

5. Complete the paragraph 4 of case study from following options: -

a) Nothing has come to our attention that causes us to believe that the accompanying Statement, prepared in accordance with the recognition and measurement principles laid down in the aforesaid Indian Accounting Standard and other accounting principles generally accepted in India, has not disclosed the information required to be disclosed in terms of Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended, including the manner in which it is to be disclosed, or that it contains any material misstatement.

b) Nothing has come to our attention that causes us to believe that the accompanying Statement, prepared in accordance with the recognition and measurement principles laid down in the aforesaid Indian Accounting Standard and other accounting principles generally accepted in India, has disclosed the information required to be disclosed in terms of Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended, including the manner in which it is to be disclosed, or that it does not contain any material misstatement.

c) The accompanying Statement, prepared in accordance with the recognition and measurement principles laid down in the aforesaid Indian Accounting Standard and other accounting principles generally accepted in India, has disclosed the information required to be disclosed in terms of Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended, including the manner in which it is to be disclosed, or that it does not contain any material misstatement.

d) The accompanying Statement, prepared in accordance with the recognition and measurement principles laid down in the aforesaid Indian Accounting Standard and other accounting principles generally accepted in India, has disclosed the information required to be disclosed in terms of

Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended, including the manner in which it is to be disclosed, or that it does not contain any material misstatement and gives a true and fair view of the state of affairs of the company as on date of interim financial statements.

Ans: (a)

REVIEW OF FINANCIAL INFORMATION

11 CHAPTER PROSPECTIVE FINANCIAL INFORMATION AND OTHER ASSURANCE SERVICES

SAE 3400- Examination of Prospective Financial Information

Question 1

MIM & Co. wants to issue a prospectus, to provide potential investors with information about future expectations of the Company. You are hired by MIM & Co. to examine the projected financial statements and give report thereon. What audit evidence will be obtained for reporting on projected financial statements? (MTP 4 Marks, Oct 18, RTP May'18) (New SM)

Answer 1

Audit evidence to be obtained for Reporting on Projected Financial Statements: The auditor should document matters, which are important in providing evidence to support his report on examination of prospective financial information, and evidence that such examination was carried out.

The audit evidence in form of working papers will include:

1. the sources of information,
2. basis of forecasts,
3. the assumptions made in arriving the forecasts,
4. hypothetical assumptions, evidence supporting the assumptions,
5. management representations regarding the intended use and distribution of the information, completeness of material assumptions,
6. management's acceptance of its responsibility for the information,
7. audit plan,
8. the nature, timing and extent of examination procedures performed, and,
9. in case the auditor expresses a modified opinion or withdraws from the engagement, the reasons forming the basis of such decision.

Question 4

You are engaged by M/s Active Ltd. to examine and report on prospective financial information which the management of the company has prepared for presentation at an Investor meet program organized by a State Government to attract investment in their state. The company in its vision document descripted various plans and proposals of the company with projected

financial goals and means to achieve the same and various benefits accruing to the economic development of the State.

What important matters will be considered by you while determining the nature, timing and extent of examination procedure to be applied in the review of the same? (PYP 5 Marks, May 2019) (New SM)

Answer 4

Examination Procedures: As per SAE3400, "The Examination of Prospective Financial Information", when determining the nature, timing and extent of examination procedures, the auditor should consider matters such as:

(i) The knowledge obtained during any previous engagements;

(ii) Management's competence regarding the preparation of prospective financial information;

(iii) the likelihood of material misstatement;

(iv) the extent to which the prospective financial information is affected by the management's judgment;

(v) the sources of information considered by the management for the purpose, their adequacy, reliability of the underlying data, including data derived from third parties, such as industry statistics, to support the assumptions;

(vi) the stability of entity's business; and

(vii) the engagement team's experience with the business and the industry in which the entity operates and with reporting on prospective financial information.

PROSPECTIVE FINANCIAL INFORMATION AND OTHER ASSURANCE SERVICES

Question 1

Ayurda Ltd.is a fast growing and award-winning SaaS software company which is headquartered in Mumbai.

It also has offices in the UK and provides cloud base professional services automation (PSA) software solutions to professional services organizations around the world. They want to engage you to provide assurance report for one of its major clients over the controls it operates as a service organization. Can you provide such an assurance report? (SAE 3402)

Answer 1

SAE 3402 applies only when the service organization is responsible for, or otherwise able to make an assertion about, the suitable design of controls. It does not deal with assurance engagements

(a) To report only on whether controls at a service organization operated as described or

(b) To report only on controls at a service organization other than those related to a service that is likely to be relevant to user entities' internal control as it relates to financial reporting (for example, controls that affect user entities' production or quality control).

Hence Yes, we can provide such an Assurance Report.

Question 2

Discuss the significance of Pro forma financial information included in prospectus of a company.

Answer 2

Pro forma financial information refers to financial information shown together with adjustments to illustrate the impact of an event or transaction on unadjusted financial information as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration.

The Pro forma financial information is, normally, used in the offer documents to demonstrate the effect of a transaction on the financial statements of a company as if those transactions had occurred at an earlier date.

The Pro forma financial information may take the form of Statement of Profit and Loss and Balance Sheet to illustrate how the transactions might have affected the assets, liabilities and earnings of the Issuer. They also include notes in relation to the significant aspects of the transactions, assumptions used to prepare the Pro forma financial information and the adjustments made.

Question 3

Discuss the term "Pro forma adjustment" under SAE 3420.

Answer 3

In relation to unadjusted financial information, Pro forma adjustments include

(a) Adjustments to unadjusted financial information that illustrate the impact of a significant event or transaction as if the event had occurred or the transaction had been undertaken at an earlier date selected for purposes of the illustration and

(b) Adjustments to unadjusted financial information that are necessary for the pro forma financial information to be compiled on a basis consistent with the applicable financial reporting framework of the reporting entity and its accounting policies under that framework.

Question 4

Discuss, how, a Chartered Accountant can be associated with prospective financial information without violating relevant provisions of the Chartered Accountants Act, 1949 (SAE 3400)

Answer 4

Traditionally, the attest function performed by a Chartered Accountant in practice has been in relation to "historical financial information". Recognizing the professional skill and competence of Chartered accountants, varied stakeholders like banks, financial institutions and prospective investors intend to place greater reliance on reports of projected cash flow and profitability statements examined and signed by Chartered accountants.

Clause 3 of the Second Schedule to the Chartered Accountants Act, 1949 states that that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast. The above clause does not preclude Chartered accountant from associating his name with prospective financial statements. A chartered accountant can participate in the preparation of profit or financial forecasts and can review them, provided he indicates clearly in his report the sources of information, the basis of forecasts and also the major assumptions made in arriving at the forecasts and so long as he does not vouch for the accuracy of the forecasts.

The same also applies to projections made on the basis of hypothetical assumptions about future events and management actions which are not necessarily expected to take place so long as vouching for the accuracy of the projection is not made.

Question 5

A company has approached CA. Hemant for an assurance report in respect of prospective financial information of a project. On going through the project details, it is noticed that depreciation reflected on proposed fixed assets to be acquired in prospective financial information has been calculated in accordance with provisions of the Income Tax Act. No disclosure is made in this respect too. How the matter should be proceeded with?

PROSPECTIVE FINANCIAL INFORMATION AND OTHER ASSURANCE SERVICES

Answer 5

In such types of engagements, it is the duty of a professional accountant to see that prospective financial information is based on a consistent basis with historical financial statements using appropriate accounting principles.

In the case of a company, historical financial statements are prepared considering the requirements of the Companies Act, and depreciation is calculated accordingly. However, in the given situation, depreciation has been calculated in accordance with Income Tax Act which is not consistent with historical financial statements.

Therefore, it is not proper.

The fact that the projection has not been prepared on a consistent basis with the historical financial statements, using appropriate accounting principles needs to be stated.

Further, when presentation and disclosure are not adequate, a qualified or adverse opinion should be given or withdrawal from engagement should be made as appropriate.

Question 6

Bansi Group is a leading institution running prestigious post graduate courses in the field of management.

Its financial statements are audited by an independent auditor. Before the start of this academic session, the Board of the institution had outsourced its entire process of inviting student applications, submission of applications, and collection of application fees including late fees and such matters to Easy Solutions Limited.

The auditors of Bansi Group want to be sure about the design and operating effectiveness of controls at Easy Solutions Limited. What should be the nature of the report to be provided by auditors of Easy Solutions Limited specifically for use by Bansi Group and its auditors in this regard in terms of SA 3402?

Answer 6

In such a case, the auditors of Bansi Group want to be sure about the design and operating effectiveness of controls at the organization which is providing services to their client. Type 2 report is a report on the description, design and operating effectiveness of controls operating at the service organization. Auditors of Easy Solutions Limited should provide such a report giving assurance on these matters. It should also include details of tests of controls performed and details of deviations, if any.

Question 7

The management of S Ltd. requests you to accept an engagement to report on the compilation of pro forma financial information to be included in a prospectus. In light of SAE 3420, what factors you will consider regarding the company acknowledging and understanding its responsibility in this matter before accepting engagement?

Answer 7

The company's responsibility has to be acknowledged for the following matters: -

(i) Adequately disclosing and describing the applicable criteria to the intended users if these are not publicly available

(ii) Compiling the pro forma financial information on the basis of the applicable criteria and

(iii) Providing the practitioner with: -

a) Access to all information (including, when needed for purposes of the engagement, information of the acquiree(s) in a business combination), such as records, documentation and other material, relevant to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria

b) Additional information that the practitioner may request from the responsible party for the purpose of the engagement

c) Access to those within the entity and the entity's advisors from whom the practitioner determines it necessary to obtain evidence relating to evaluating whether the pro forma financial information has been compiled, in all material respects, on the basis of the applicable criteria; and

d) When needed for purposes of the engagement, access to appropriate individuals within the acquiree(s) in a business combination.

Integrated Case Scenario

Below is given draft text of the "Report on Examination of Prospective Financial formation" of Top Edge Limited in relation to the company's upcoming project prepared by a staff member in a CA firm unfamiliar with drafting such reports. The report has been drafted in a casual manner and may consist of omissions and errors.

Report on Examination of Prospective Financial Information

To

The Board of Directors Top Edge Limited

We have examined the projection of the upcoming project to come up at Ratnagiri of Top Edge Limited for the period from April 2023 to March 2030 as given in the Prospective Financial Information from page 1 to 250 in accordance with Standard on Assurance Engagement 3400, "The Examination of Prospective Financial Information issued by the Institute of Chartered Accountants of India.

The preparation and presentation of the projection is the responsibility of the Management and has been approved by the Board of Directors of the company.

Our responsibility is to examine the evidence supporting the assumptions (excluding the hypothetical assumption) and other information in the prospective financial information.

PROSPECTIVE FINANCIAL INFORMATION AND OTHER ASSURANCE SERVICES

The projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur.

We have carried out our examination of the prospective financial information thoroughly.

Further, in our opinion the projection is properly prepared on the basis of the assumptions as set out in Note 1 to 50 to the Prospective Financial Information and on a consistent basis with the historical financial statements, using appropriate accounting principles. Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

For PCK & Co.

Chartered Accountants

Signature

Designation

Membership number

Based on your knowledge and description of the case, answer the following question

1) Whose responsibility is to list out assumptions underlying prospective financial information?

a) Professional Accountant issuing report on prospective financial information.

b) Auditor of Company issuing report on prospective financial information.

c) Management of company.

d) Banker of company.

Ans: (c)

2) Which of the following statements is most appropriate regarding "use of prospective financial information" to be included in such report?

a) Intended use of projection is required to be disclosed. It is further necessary to caution the users regarding inappropriateness of projections for other purposes.

b) It is discretionary to state intended use of projection in such a report.

c) Intended use of projection is required to be disclosed. It is not necessary to caution the users regarding inappropriateness of projections for other purposes.

d) It is prerogative of management to use report in the manner it deems fit.

Ans: (a)

PROSPECTIVE FINANCIAL INFORMATION AND OTHER ASSURANCE SERVICES

3) What should be language of such an unmodified assurance report regard underlying assumptions?

a) Positively worded to suggest assumptions are a reasonable basis.

b) Negatively worded to suggest assumptions are not on a reasonable basis.

c) Neither positively worded nor negatively worded about assumptions.

d) Depends upon the professional judgment of the Chartered Accountant.

Ans: (b)

4) Which of the following statements is most appropriate regarding the examination of prospective financial information by a Chartered accountant in accordance with SAE 400?

a) Accuracy of projections is vouched for based upon performing procedures thoroughly.

b) Projections can go haywire; It depends upon the professional judgment of the Chartered Accountant to vouch for the accuracy of projections.

c) Accuracy of projections is not at all vouched for in an assurance report on prospective financial information.

d) The matter of accuracy of projections or otherwise is not domain of such an examination. Therefore, there is no reporting requirement under SAE 3400.

Ans: (c)

5) Which of the following statements is most appropriate regarding UDIN in context examination of prospective financial information by a Chartered Accountant?

a) It is mandatory to state UDIN in such type of reports.

b) It is desirable to state UDIN in such type of reports.

c) It is not required to state UDIN in such type of reports as it is not an audit engagement.

d) It is not required to state UDIN in such type of reports as it is not an engagement related to historical financial information.

Ans: (a)

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CHAPTER

DIGITAL AUDITING AND ASSURANCE

Special Aspects of Auditing In an Automated Environment

Question 1

Wrote a short note on: Understanding and documenting automated environment (RTP May 20)

Answer 1

Understanding and Documenting Automated Environment: 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:

• The applications that are being used by the company;

• Details of the IT infrastructure components for each of the application;

• The organization structure and governance;

• The policies, procedures and processes followed;

• IT risks and controls.

The auditor is required to document the understanding of a company's automated environment as per SA 230.

Question 2

CA Vipin has been appointed as Statutory Auditor by IG Insurance Co. Ltd. for 3 of its branches for the F.Y.

2019-2020. 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? (PYP 4 Marks, Nov '20)

Answer 2

As per SA315, understanding of the automated environment of a company is required. The auditor's understanding of the automated environment should include the following:

i. The applications that are being used by the company;

ii. Details of the IT infrastructure components for each of the application;

iii. The organization structure and governance;

iv. The policies, procedures and processes followed;

v. IT risks and controls.

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.

Question 3

Beta Hotel operates in an automated environment and uses application softwares for front desk, Guest reservations, Restaurant and kitchen orders and billing for which CA Anil has been appointed as an auditor. Guide CA Anil the various key aspects that needs to be considered by him while understanding of the automated environment of the Company in accordance with SA 315. Is he required to document the same? If yes, illustrate by giving one example. (PYP 4 Marks May '22)

Answer 3

Understanding and Documenting Automated Environment: 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:

1. The applications that are being used by the company;

2. Details of the IT infrastructure components for each of the application;

3. The organization structure and governance;

4. The policies, procedures and processes followed;

5. IT risks and controls.

The auditor is required to document the understanding of a company's automated environment as per SA

230. The illustration below is an example of how an auditor can document details of an automated environment:

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Application	Used for	Database	Operating System	Network	Server and Storage
SAP ECC/ HANA	Integrated application software	Oracle 19c	HP-UX	LAN, WAN	HP Server and NAS
REVS	Front Desk, Guest Reservations	MS-SQL Server 2018	Windows 2016 Server	In-house developed	HP Server Internal HDD
KOTS	Restaurant and Kitchen Orders	MS-SQL Server 2018	Windows 2016 Server	In-house developed	HP Server Internal HDD
BILLSYS	Billing	Oracle 12c	Windows 2016 Server	Packaged Software	HP Server Internal HDD

Multiple Choice Questions (MCQs)

Question 1

KJ Private Ltd. is engaged in the business of e-commerce wherein most of the operations are automated.

The company has SAP at its ERP package and is planning to upgrade the SAP version.

Currently, the version of SAP being used is fine but the higher version would lead to increased efficiencies and hence the company is considering this plan which will also involve a huge outlay.

KPP & Associates, were appointed as the statutory auditors of this company for the year ended 31 March 2019 and the statutory audit firm has been working in this industry for long but most of the work which the firm did was more of risk advisory or internal audit.

For the first time, this audit will be conducted and that's why the audit team started obtaining understanding of the operations of the company which included understanding of the SAP system of the company.

However, the management of the company was not comfortable with this approach of the audit team particularly because audit team was spending good time on understanding of the IT systems of the company.

The management suggested that the auditors should limit their understanding and should perform audit procedures rather than getting into business/ operations.

But the auditors have a different view on this matter and because of which work has got stuck.

In the given situation, please suggest what should be the course of action.

(a) The approach of audit team to obtain detailed understanding of the company before starting with the audit procedures is absolutely fine. If the auditors don't understand the systems properly the audit procedures may not be appropriate.

(b) The management's concern regarding the approach of the auditors seems reasonable. The auditors are spending time on understanding of the systems/ business and not performing their audit procedures.

(c) This being a private company and that too into the business of e-commerce, the auditors should have knowledge about the operations of the company through their understanding of the industry and hence should not get into this process of obtaining detailed understanding at the client place.

(d) The audit team could have planned their work differently. They should involve IT experts who would have knowledge of the systems of the company and hence lot of time can be saved. Further in case of such type of industry, involvement of IT experts is anyways required mandatorily as per the legal requirements. (RTP Nov 19)

Ans: (a).

Question 1

Briefly describe the advantages and challenges of Auditing digitally.

Answer 1

Following are key features or advantages of Auditing Digitally:

(i) Improved Quality of Audits: The impact on quality is evident, through automation, data analytics techniques we can easily move from sample auditing to full population of transactions being reviewed or re-performed. This ultimately free up time for audit teams to analyses the information and better understand the business they audit. Technology requires an element of upfront investment, and it can be challenging to implement with regards to resources and people, but the value once it is up and running is undeniable.

(ii) Decreasing human dependency: Using technology minimizes the manual intervention which ultimately results in reducing the risk of manual errors. Technology helps in streamlining the process of testing for auditors which decreases the errors which occur from the judgement of different individuals.

(iii) Increases Transparency: With the technological advancement transparency has been increased. New ERPs and tools have audit trail feature available to trace the transaction end to end. It helps the management or auditors to review the details like the date on which any change is made, who made the change, what has been changed, all such details are captured and can be used while performing audit.

(iv) Automation and Ease: Automating tasks like recording work in repositories, extracting data and sampling have improved the quality of audit and reduced the manual error. Using dashboards (e.g., Power BI) for reporting helps in understanding the position and helps the auditor to form his opinion.

(v) Improved Efficiency: What used to take weeks to learn and programme using deep experts, is now easily available to auditors after some simple training and digital upskilling. The result may be increased efficiency and fewer errors, but the benefits are wider reaching and personal. This also results in improved retention of talent and confidence.

(vi) Better risk assessment: With usage of automation and technology in audit, auditor may focus on the real challenges and assess the potential risk precisely. It gives time to auditors to focus on the bigger picture rather than being involved with repetitive tasks. Dashboards, visual presentations and other tools helps in understanding where the risk lies and what all areas need more attention.

Challenges – Reluctance to change, challenges with data security and governance, choosing the right tool and automating the right process, ensuring standardization and correct configurations to avoid error and bias, evaluating business benefits the organization wants to achieve with automation and the roadmap for digital strategy.

Question 2

What are the stages involved in understanding the IT environment and what key considerations auditor should consider?

Answer 2

Key Areas for an Auditor to Understand IT Environment are as follows:

1. **Understand the flow of transaction:** The auditor's understanding of the IT environment may focus on identifying and understanding the nature and number of the specific IT applications and other aspects of the IT environment that are relevant to the flows of transactions and processing of information in the information system. Changes in the flow of transactions, or information within the information system may result from program changes to IT applications, or direct changes to data in databases involved in processing or storing those transactions or information.

2. **Identification of Significant Systems:** The auditor may identify the IT applications and supporting IT infrastructure concurrently with the auditor's understanding of how information relating to significant classes of transactions, account balances and disclosures flows into, through and out the entity's information system.

3. **Identification of Manual and Automated Controls:** An entity's system of internal control contains manual elements and automated elements (i.e., manual and automated controls and other resources used in the entity's system of internal control). An entity's mix of manual and automated elements varies with the nature and complexity of the entity's use of IT. The characteristics of manual or automated elements are relevant to the auditor's identification and assessment of the risks of material misstatement.

4. **Identification of the technologies used:** The need to understand the emerging technologies implemented and the role they play in the entity's information processing or other financial reporting activities and consider whether there are risks arising from their use.

   Given the potential complexities of these technologies, there is an increased likelihood that the engagement team may decide to engage specialists and/or auditor's experts to help understand whether and how their use impacts the entity's financial reporting processes and may give rise to risks from the use of IT.

Some examples of emerging technologies are:

- Blockchain, including cryptocurrency businesses (e.g., token issuers, custodial services, exchanges, miners, investors)
- Robotics
- Artificial Intelligence
- Internet of Things
- Biometrics
- Drone

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5. **Assessing the complexity of the IT environment:** Not all applications of the IT environment have the same level of complexity. The level of complexity for individual characteristics differs across applications.

   Complexity is based on the following factors – automation used in the organization, entity's reliance on system generated reports, customization in IT applications, business model of the entity, any significant changes done during the year and implementation of emerging technologies.

   After considering the above factors for each application the over complexity is assessed of the IT environment.

Question 3

Auditor should scope in ITGCs to tests when there are IT dependencies identified in the system. Briefly describe the types of IT dependencies.

Answer 3

There are five types of IT dependencies as described below:

Type	Description
Automated Controls	Automated controls are designed into the IT environment to enforce business rules. For example, Purchase order approval via workflow or format checks (e.g., only a particular date format is accepted), existence checks (e.g., Duplicate customer number cannot exist), and/or reasonableness checks (e.g., maximum payment amount) when a transaction is entered.
Reports	System generated reports are information generated by IT systems. These reports are often used in an entity's execution of a manual control, including business performance reviews, or may be the source of entity information used by us when selecting items for testing, performing substantive tests of details or performing a substantive analytical procedure. E.g. (Vendor master report, customer ageing report)
Calculations	Calculations are accounting procedures that are performed by an IT system instead of a person. For example, the system will apply the 'straight-line' depreciation formula to calculate depreciation of an asset (i.e., cost of the asset, less the residual value of the asset at the end of its useful life divided by the useful life of the asset) or the system will calculate the value of the amount invoiced to a customer by multiplying the item price times the quantity shipped.
Security	Security including segregation of duties is enabled by the IT environment to restrict access to information and to determine the separation of roles and responsibilities that could allow an employee to perpetrate and conceal errors or fraud, or to process errors that go undetected.
Interfaces	Interfaces are programmed logic that transfer data from one IT system to another. For example, an interface may be programmed to transfer data from a payroll sub-ledger to the general ledger.

Question 4

What does cyber risk explain it with some examples?

Answer 4

A cyber-attack is an attempt to gain unauthorized access to a computing system or network with the intent to cause damage, steal, expose, alter, disable, or destroy data.

Regulators across the globe have placed the topic of cyber risk management under increasing scrutiny, requiring financial institutions to assess the maturity of their cybersecurity program, manage cyber risks, and enhance resiliency against cyber-attacks. Most common types of cyber- attacks are:

• **Malware:** Malware or malicious software is any program or code that is created with the intent to do harm to a computer, network or server. Malware is the most common type of cyberattack, its subsets are ransomware, fileless Malware trojans, viruses etc.

Type	Description
Ransomware	In a ransomware attack, an adversary encrypts a victim's data and offers to provide a decryption key in exchange for a payment. Ransomware attacks are usually launched through malicious links delivered via phishing emails, but unpatched vulnerabilities and policy misconfigurations are used as well.
Fileless Malware	Fileless malware is a type of malicious activity that uses native, legitimate tools built into a system to execute a cyber-attack. Unlike traditional malware, fileless malware does not require an attacker to install any code on a target's system, making it hard to detect.
Trojan	A trojan is malware that appears to be legitimate software disguised as native operating system programs or harmless files like free downloads. Trojans are installed through social engineering techniques such as phishing or bait websites.
Mobile Malware	Mobile malware is any type of malware designed to target mobile devices. Mobile malware is delivered through malicious downloads, operating system vulnerabilities, phishing, smishing, and the use of unsecured Wi-Fi.
	Domain appears to be legitimate at first glance, but a closer look will reveal subtle differences.
Email Spoofing	Email spoofing is a type of cyberattack that targets the businesses by using emails with forged sender addresses. Because the recipient trusts the alleged sender, they are more likely to open the email and interact with its contents, such as a malicious link or attachment.

- **Identity-Based Attacks:** When a valid user's credentials have been compromised and an adversary is pretend to be that user. For e.g., people often use the same user ID and password across multiple accounts. Therefore, possessing the credentials for one account may be able to grant access to other, unrelated account.
- **Insider Threats:** When current or former employees that pose danger to an organization because they have direct access to the company network, sensitive data, and intellectual property (IP), as well as knowledge of business processes, company policies or other information that would help carry out such an attack.
- **DNS Tunneling:** DNS Tunneling is a type of cyberattack that leverages domain name system (DNS) queries and responses to bypass traditional security measures and transmit data and code within the network. This tunnel gives the hacker a route to unleash malware and/or to extract data, IP or other sensitive information by encoding it bit by bit in a series of DNS responses.
- **IoT-Based Attacks:** An IoT attack is any cyberattack that targets an Internet of Things (IoT) device or network.

  Once compromised, the hacker can assume control of the device, steal data, or join a group of infected devices

Question 5

Briefly describe the cyber security Framework.

Answer 5

Cybersecurity framework includes how management is identifying the risk, protecting and safeguarding its assets (including electronic assets) from the risk. Management preparedness to detect the attacks, anomalies and responsiveness to the adverse event.

Identify the risk:

Auditor has to determine whether the entity's risk assessment process considers cybersecurity risks. Entity should conduct a periodic risk assessment & develop a management strategy which identifies cybersecurity risks around IT system failure affecting the entity's primary business or potential loss of data or inability to access data as required, Risk of unauthorized access to the IT network.

The entity should maintain and periodically reviews an inventory of their information assets- i.e., Asset Management (e.g., intellectual property, patents, copyrighted material, trade secrets and other intangibles).

The entity should classify and prioritize protection of their information assets based on sensitivity and business value and periodically reviews the systems connected to the network on which digital assets reside.

From the governance perspective management should review how cybersecurity risks affect internal controls over financial reporting. In case of adverse attack how management is going to assess the impact on the recoverability of financial data and impact on revenue recognition.

Management needs to identify if any established a risk-based cybersecurity program can be leveraged e.g. (NIST, ISO etc.)

To determine overall responsibility for cybersecurity in the business environment entity should establish roles and responsibilities over cybersecurity (CISO, CIO). Further the risk assessment should be discussed with those charged with governance (e.g., the Audit Committee or Board of Directors).

Protect the risk

Obtained an understanding of the entity's processes for safeguarding of assets subject to cybersecurity. Entity monitors whether there has been unauthorized access to electronic assets and any related impact on financial reporting.

Formal training should be conducted to make the teams aware of the risk associated with cyber-attacks. Entity should implement effective controls for data security. Entity should have a process & procedures in place for identifying material digital/electronic assets on the balance sheet subject to cybersecurity risk (e.g., intellectual property, patents, copyrighted material, trade secrets) and prioritizing their protection based on criticality.

Detect The risk

Entity should have controls and procedures that enable it to identify cybersecurity risks and incidents and to assess and analyse their impact on the entity's business, evaluate the significance associated with such risks and incidents, and consider timely disclosures.

Review entity's processes to monitor and detect security breaches or incidents. If management has implemented anti-virus in the system to secure it from anomalies or if firewall logs are being continuously monitored to detect any repetitive attacks. A monitoring process should be established to review how many such events have been denied by the firewall. Monitoring process should also include if any upgrades or updates are required to safeguard the systems from vulnerabilities.

Respond to the risk

In case of material cybersecurity or data breach has been identified management should capture the details of nature of incident and how the incident or data breach was identified. Entity should have a response planning in place to capture the details of nature of incident and the same needs to be communicated with those who are ultimately responsible for this framework and with those charge with governance.

The security incident response plan helps in analysing the impact and severity of the attack and helps the organisation in taking the appropriate actions. Management should assess Litigation costs, Regulatory investigation costs and Remediation costs as a part of mitigation process and improvement management should assess the future action plans that needs to be taken to safeguard the organisation from such attacks.

Recover from risk

Entity should undertake appropriate actions to recover from the attack and make sure the business is up and running.

Once the impact evaluated and communicated with the regulators the recovery plan needs to be implemented to overcome the impact. Necessary improvements – like patch upgrades, better controls, improved technology in terms of firewall, anti-virus, tools etc needs to be implemented to safeguard the entity.

Question 6

What are the advantages and disadvantages of remote audit?

Answer 6

ADVANTAGES	DISADVANTAGES
Cost and time effective: No travel time and travel costs involved.	Due to network issues, interviews and meetings can be interrupted.
Comfort and flexibility to the audit team as they would be working from home environment,	Limited or no ability to visualize facility culture of the organization, and the body language of the auditees. Time zone issues could also affect the efficiency of remote audit session
Time required to gather evidence can spread over several weeks, instead of concentrated into a small period that takes personnel from their daily activities.	The opportunity to present doctored documents and to omit relevant information is increased. This may call for additional planning, some additional/different audit procedures, Security and confidentiality violation.
Auditor can get first-hand evidence directly from the IT system as direct access may be provided.	Remote access to sensitive IT systems may not be allowed. Security aspects related to remote access and privacy needs to be assessed
Widens the selection of auditors from global network of experts.	Cultural challenges for the auditor. Lack of knowledge for local laws and regulations could impact audit. Audit procedures like physical verification of assets and stock taking cannot be performed.

Question 7

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 such data analytics techniques.

Answer 7

Generating and preparing meaningful information from raw system data using processes, tools, and techniques is known as Data Analytics. Audit analytics or audit data analytics involves analyzing large sets of data to find actionable insights, trends, draw conclusions and for informed decision making. The use of audit analytics enables greater efficiencies and more accurate findings from the review process.

As a result, businesses will be able to create strategies based on verifiable data and professional assumptions and auditors can improve the audit quality. It allows auditors to more effectively audit the large amounts of data held and processed in IT systems in larger clients.

Some of the popular tools used across the industry as part of CAATs are listed below:

1. ACL - Audit Command Language (ACL) Analytics is a data extraction and analysis software used for fraud detection and prevention, and risk management. It samples large data sets to find irregularities or patterns in transactions that could indicate control weaknesses or fraud.

2. Alteryx - Alteryx is used to consolidate financial or operational data to assess controls. A fully transparent audit trail of every action is performed in Alteryx in form of a workflow which makes it easier for the user to learn as no prior knowledge of coding or scripting is required. Alteryx can also be leveraged to automate analytics and perform Machine Learning to search for patterns indicative of fraud or irregularities speed up your processes like accounting close, tax filings, regulatory reporting, forecast creation etc. It can also be used to automate set procedures that are performed periodically like reconciliations, consolidations, marketing workflows, system integrations, continuous audits etc.

3. Power BI – Power Bi is a business intelligence (BI) platform that provides nontechnical business users with tools for aggregating, analyzing, visualizing and sharing data. From audit perspective, such visualization tools can be used to find the outliers in the population, it can also be used for reporting purpose (audit reports) in an interactive dashboard to the higher management.

4. CaseWare – CaseWare is a data analysis software & provide tools that helps in conducting audit and assurance engagements quickly, accurately and consistently. It shares analytical insights which help in taking better informed decisions. It helps in streamlining processes and eliminating the routine tasks. Used by accounting firms, governments and corporations worldwide, this trusted platform integrates everything you need to conduct assurance and reporting engagements.

DIGITAL AUDITING AND ASSURANCE

Question 8

Enterprises are adopting emerging technologies at a rapid pace to create synergies and harness the latest technologies. Give 3 examples of automated tools used as a part of emerging technologies along with the risk and audit considerations associated with these tools.

Answer 8

Enterprises are adopting emerging technologies at a rapid pace to create synergies and harness the latest technologies.

Robotic process automation (RPA), blockchain, machine learning, Internet of Things (IOT) and artificial intelligence (AI) are some prime examples of automation.

Internet of Things

IoT is the concept of connecting any device (cell phones, coffee makers, washing machines, and so on) to the internet. Key components of IoT are data collection, analytics, connectivity, and people and process. IoT not only changes the business model, but also affects the strategic objectives of the organization. The risk profile of the entity changes with exposure to new laws and regulations.

Audit Implications

A shift to connected devices and systems may result in auditors not being able to rely only on manual controls.

Instead, auditors may need to scope new systems into their audit. Audit firms may need to train and upskill auditors to evaluate the design and operating effectiveness of automated controls.

Consumer-facing tools that connect to business environments in new ways can impact the flow of transactions and introduce new risks for management and auditors to consider. Consider payment processing tools that allow users to pay via credit card at a retail location through a mobile device This could create a new path for incoming payments that may rely, in part, on a new service provider supplying and routing information correctly. Auditors would need to consider the volume of those transactions and the processes and controls related to it.

Common risks of IoT:

The key risks associated with IoT, including, device hijacking, data siphoning, denial of service attacks, data breaches and device theft.

AI (Artificial intelligence)

Artificial intelligence (AI) refers to a system or a machine that can think and learn. AI systems utilize data analysis and algorithms to make decisions based on predictive methods. Complex algorithms are developed to propose decisions based on a pattern or behavior learned over time.

Siri to help find your Air Pods or told Amazon Alexa to turn off the lights, quick commands to open a phone camera or start a particular playlist, AI to predict when to book the lowest prices for flights, hotels, car and vacation home rentals. Using historical flight and hotel data, AI will also recommend to the user whether the booking has reached its lowest price point or if the user should hold out a bit longer for the price to drop.

Auditor Implications

Given the invisible nature of algorithms, audits must focus on the logical flow of processes. A review of AI should ascertain whether unintended bias has been added to the algorithms. Auditors should assess the effectiveness of algorithms and whether their output is appropriately reviewed and approved. Because AI is built on software modules, auditors must also consider cybersecurity and search for possible bugs and vulnerabilities that can be exploited to impact AI functionality. Auditors should confirm their understanding of how the use of AI affects the entity's flows of transactions, including the generation of reports or analytics used by management. Auditors also should consider whether the AI is making decisions—or being utilized by management as part of the decision-making process.

If management shifts its focus on oversight by relying on AI, auditors should understand what shift occurred, how new risks might be addressed, and whether existing risks may not be getting the same level of attention.

Understanding these changes could drive changes in the audit approach.

Common risks for AI

AI comes with list of risks. Security is one of the key risks – the more data the system uses, from more sources, the more entry points and connections are formed and the greater the potential risks. Inappropriate configuration - AI may also be used to diagnose medical conditions. If it is badly configured or malfunctions, it could harm people before the problem is spotted. Data privacy - The data used and shared should have the necessary explicit consent from data providers.

Blockchain

Blockchain is based on a decentralized and distributed ledger that is secured through encryption. Each transaction is validated by the blockchain participants, creating a block of information that is replicated and distributed to all participants. All blocks are sequenced so that any modification or deletion of a block disqualifies the information.

Despite resistance, the benefits associated with blockchain technology are being recognized across a variety of other industries.

Audit Implications

Auditors should consider the appropriate governance and security transactions around the transactions. Although blockchain's core security premise rests on cryptography, there are risk factors associated with it. As blockchain interacts with legacy systems and business partners, concerns related to insecure application programming interfaces (APIs), data confidentiality and privacy cannot be ignored.

Weak blockchain application development protocols are something auditors cannot overlook. Similarly, data privacy laws and regulations may be area of concern as data are communicated across geographic boundaries.

Auditors must be able to determine whether the data put on blockchain will expose the enterprise to liability for noncompliance with applicable laws and regulations.

DIGITAL AUDITING AND ASSURANCE

Common risks for blockchain technology

The strengths of blockchain can also be its weaknesses. The inability to reverse transactions and to access data without the required keys make the system secure, but also mean that organisations need specific protocols and management processes to ensure that they are not locked out and have clear contingency plans. Operating through network nodes could also expose the organisation to cyber-attacks and data hacks, so security issues are important. Auditors should also ensure that the organisation has the necessary data management processes and complies with regulations. The regulatory landscape is still evolving for blockchain, so audit teams should check that compliance managers are following developments constantly and adapting processes accordingly.

Question 9

Emerging technologies can bring great benefits, but they also come with a varied set of substantial risks.

Give some examples of technology risks of digital system and the control considerations to consider while assessing technology risk.

Answer 9

The strength of the auditing profession is the assessment of risks and controls. As they address the challenge of assessing technology risk, auditors can and should focus on the following control considerations:

1. Auditors should gain a holistic understanding of changes in the industry and the information technology environment to effectively evaluate management's process for initiating, processing, and recording transactions and then design appropriate auditing procedures.
2. Auditors, as appropriate, should consider risks resulting from the implementation of new technologies and how those risks may differ from those that arise from more traditional, legacy systems.
3. Auditors should consider whether digital upskilling or specialists are necessary to determine the impact of new technologies and to assist in the risk assessment and understanding of the design, implementation, and operating effectiveness of controls. E.g., cybersecurity control experts, IT specialists in the team etc.

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both
- Unauthorized access to data that might result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions or inaccurate recording of transactions (specific risks might arise when multiple users access a common database)
- The possibility of information technology personnel gaining access privileges beyond those necessary to perform their assigned duties, thereby leading to insufficient segregation of duties

- Unauthorized or erroneous changes to data in master files
- Unauthorized changes to systems or programs
- Failure to make necessary or appropriate changes to systems or programs
- Inappropriate manual intervention
- Potential loss of data or inability to access data as required
- Risks introduced when using third-party service providers
- Cybersecurity risks

Question 10

Give example of emerging technologies available for Next Generation Audit along with the risks associated with it

Answer 10

Examples of Emerging Technologies available for Next Generation Audit:

1. **Drone Technology:** Using drone technology in the remote locations for stock counts. Drones have great payload capacity for carrying sensors and cameras, thus they can photograph and physically examine the count of large quantities of fixed assets and inventory.

   Drone captured audit information can be combined with various alternative sources of information such as QR code readers, handheld bar scanners, manual counts etc. to optimise quality of deliverables, consolidate audit information and enhance the execution speed while ensuring correctness and completeness of data.

2. **Augmented reality:** The technology allows users to view the real-world environment with augmented (added) elements, generated by digital devices.

   One famous example was Pokémon Go, a game for mobile devices in which players chase imaginary digital creatures (visible on their mobile phones) around physical locations.

3. **Virtual reality:** VR goes a step forward and replaces the real world entirely with a simulated environment, created through digitally generated images, sounds, and even touch and smell. Using special equipment, such as a custom headset, the user can explore a simulated world or simulate experiences such as flying or skydiving.

4. **Metaverse:** The metaverse is the emerging 3-D digital space that uses virtual reality, augmented reality, and other advanced internet technology to allow people to have lifelike personal and business experiences online. It represents a convergence of digital technology to combine and extend the reach and use of Cryptocurrency, Artificial Intelligence (AI), Augmented Reality (AR) and Virtual Reality (VR) The internet offers many experiences today, but tomorrow's Metaverse will feel more interconnected than ever before. We are heading towards mature landscape of virtual spaces with transferable identities and assets enabled by blockchains (NFTs) that are interoperable or interchangeable. It further includes highly automated systems, immersive interfaces, hyperconnected networks and digital reflections.

5. **Virtual Banking and Transactions:** A forward-thinking financial institution, establishes a presence in the metaverse to offer virtual banking services. Users can create virtual bank accounts, access personalized financial dashboards, and perform transactions using virtual currencies. Customers can seamlessly transfer funds, make virtual purchases, and engage in virtual commerce, all within the immersive environment of the metaverse. XYZ Bank leverages the metaverse to provide a convenient and interactive banking experience, attracting tech-savvy customers who value digital innovation.

6. **Digital Asset Management:** A digital asset management company, recognizes the growing popularity of virtual assets in the metaverse. They launch a virtual asset trading platform within the metaverse, allowing users to buy, sell, and trade NFTs and other digital assets. Investors can diversify their portfolios, participate in virtual auctions, and even showcase their virtual art collections in virtual galleries. Crypto Investments Ltd. leverages the metaverse's decentralized and secure infrastructure to facilitate transparent and efficient transactions of virtual assets.

7. **Virtual Financial Education and Training:** A Financial Learning Academy aims to enhance financial literacy using the metaverse. They create a virtual classroom environment where participants can attend interactive financial education sessions. Students can engage in simulated investment activities, learn about budgeting and financial planning, and gain hands- on experience through virtual trading simulations. Financial Learning Academy leverages the immersive nature of the metaverse to provide an engaging and practical financial education platform, preparing individuals for real-world financial challenges.

8. **Virtual Meetings and Conferences:** For a leading industry even an organisation hosts a virtual conference within the metaverse. Participants from around the world can access the conference through their virtual avatars. They can attend keynote speeches, panel discussions, and networking events in virtual conference halls. Attendees can interact with industry experts, explore virtual exhibition booths, and establish valuable connections in the financial sector. Global Finance Summit leverages the metaverse to create a global and inclusive conference experience, fostering collaboration and knowledge sharing.

9. **Data Visualization and Analytics:** A company utilizes the metaverse to offer advanced data visualization and analytics tools to financial professionals. Their virtual analytics platform allows users to visualize complex financial data in interactive and immersive 3D environments. Users can explore data trends, conduct simulations, and analyze financial performance through intuitive interfaces within the metaverse.

   Analytics Solutions Inc. leverages the metaverse's immersive capabilities to enhance data-driven decisionmaking, enabling financial professionals to gain deeper insights into market trends and make informed investment decisions.

Common Risks associated:

Beyond their potential, these technologies also come with challenges such as public safety, cybersecurity, data privacy, data protection, lack of standards and technical challenges. Since they often track movements and data, massive amounts of data are generated about the whereabouts of users. It also raises questions about taxation, jurisdiction, and customer protection. Regulators and auditors have to think of the controls around privacy, data security, governance to make it more regulated.

Question 11

Sukanya, a CA final student, is of the view that cyber risks are issues of IT and result only in information loss to an entity. She also feels that many cyber-attacks are not directly targeted at financial systems and do not pose risk of material misstatements to financial statements of an entity.

Is her view proper?

Answer 11

The cyber risks are not an issue of IT alone. Rather, it is a business risk and has an effect on whole business organization. It affects entity's reputation and can lead to many other consequences which are listed below: -

- Regulatory costs
- Business interruptions causing an operational challenge for an organization.
- Data loss, reputational loss and litigation.
- Ransomware - more common these days where entire systems are encrypted
- Intellectual property theft which may not only take the competitive advantage, but we may also result in any impairment/impediment charge because of the loss of IP.
- Incident response cost which could be for investigations & remediation's
- Breach of Privacy, if personal data of a consumer is hacked it could have a significant impact on the organization.
- Fines and penalties

  It may happen that many cyber-attacks are not directly targeted at financial systems. However, the access gained by the attackers may provide them the ability to:

- Manipulate or modify financial records
- Modify key automated business rules
- Modify automated controls relied upon by the management.

Further, auditor should consider whether cyber risk (like other business risks) represents a risk of material misstatement to the financial statement as part of the audit risk assessment activities. Focus should be on understanding the cyber risks affecting the entity and the actions being taken to address these risks.

DIGITAL AUDITING AND ASSURANCE

Question 12

CA Y is planning to use CAATs extensively in audit of a company-be it for compliance tests or substantive tests. Can you list out examples of few situations (in brief) of tests performed by him using CAATs?

Answer 12

(i) **Identify exceptions:** Identify exceptional transactions based on set criteria. For example, cash transactions above ` 10,000

(ii) **Identify errors:** Identify data, which is inconsistent or erroneous. For e.g.: account number which is not numeric.

(iii) **Verify calculations:** Re-perform various computations in audit software to confirm the results from application software confirm with the audit software. For e.g.: TDS rate applied as per criteria.

(iv) **Existence of records:** Identify fields, which have null values. For example: invoices which do not have vendor name.

(v) **Data completeness:** Identify whether all fields have valid data. For example: null values in any key field such as date, invoice number or value or name.

(vi) **Data consistency:** Identify data, which are not consistent with the regular format. For example: invoices which are not in the required sequence.

(vii) **Duplicate payments:** Establish relationship between two or more tables as required. For example, duplicate payment for same invoice.

(viii) **Accounts exceeding authorized limit:** Identify data beyond specified limit. For example, transactions entered by user beyond their authorized limit or payment to vendor beyond amount due or overdraft allowed beyond limit.

Question 13

A company is planning to use Robotics process automation (RPA) to streamline its hiring process. Earlier, the company used to hire from campuses of various management institutes leading to high recruitment costs, inefficient hire yield and resultant lack of diversity. How RPA can be used to automate the hiring process? List out tentative few such steps. What could be likely benefits of using RPA in hiring process?

Answer 13

RPA can be used to streamline hiring process in a company. The tentative steps could include: -

• Place advertisements on social media/career advice sites.

• Link redirects candidate to a career site.

- Career site pulls information of candidate.
- An algorithm scans applicants for desired and suitable roles.
- Selected candidates may be asked to play online games to assess their skills.
- A certain percentage of those applicants are called for a video interview using an interview software.

The automated hiring process will reduce full time effort involvement, provide with a wider assessment range, reduce the impact of recruiter biases, increase the efficiency of mapping of interested candidates, reduce recruiting costs, increase hire yield, reduce time to hire, increase diversity.

CASE STUDY

What has happened:

The CEO of a hotel realized their business had become the victim of wire fraud when the accounts payable executive began to receive insufficient fund notifications for regularly recurring bills.

A review of the accounting records exposed a serious problem. Upon investigating it was noted that the CEO had clicked on a link in an email that he thought was from the trusted source. However, it wasn't and when he clicked the link and entered his credentials, the cyber criminals captured the CEO's login information, giving them full access to intimate business and personal details.

Type of Attack: Social engineering, phishing attack.

A phishing attack is a form of social engineering by which cyber criminals attempt to trick individuals by creating and sending fake emails that appear to be from an authentic source, such as a business or colleague. The email might ask you to confirm personal account information such as a password or prompt you to open a malicious attachment that infects your computer with malware.

Result: The hotel's cash reserves were depleted. The fraudulent transfers amounted to more than ₹1 million.

The hotel also contacted a cybersecurity firm to help them mitigate the risk of a repeat attack.

Impact: The business lost ₹1 million, and the funds were not recovered. Further there was loss of business reputation too.

Lessons Learned:

- **Train the staff about the dangers of clicking on unsolicited email links and attachments, and the need to stay alert for warning signs of fraudulent emails. Engage in regular email security training.**
- **Implement stringent wire transfer protocols and include a secondary form of validation (Multi Factor Authentication)**
- **Have a cyber-incident response plan ready to implement.**

DIGITAL AUDITING AND ASSURANCE

CASE STUDY

XY Bank, headquartered in New York, offers a broad range of financial services including asset management, commercial banking, investment banking, and treasury and securities services.

The Five Indian banks in partnership with XY bank, provide a comprehensive range of banking services and products encompassing retail banking, corporate banking, international banking, and other financial services.

All these banks have been significant contributors to the digitalization of banking services in India.

Under the pilot programme, the Indian banks will open on-chain Nostro accounts with XY Bank branch in Gift City. The blockchain-based system is expected to facilitate instant, 24×7 settlement between the accounts held at the US bank. Essentially, it will create a private intra-correspondent banking network, redefining the traditional banking hours and enabling seamless money transfer.

Following are the illustrative steps for performing audit of above said block chain:

a) **Obtain a comprehensive understanding of the blockchain-based pilot program, including its objectives, scope, and key processes involved.**

b) **Review the partnership agreements, contracts, and legal documentation governing the relationship between the Indian banks and XY Bank.**

c) **Identify the specific blockchain technology used, its functionalities, and the underlying smart contracts.**

d) **Assess Internal Controls:**

   Review policies and procedures related to the on-chain Nostro accounts, settlement processes, and money transfer mechanisms.

   Assess the governance framework, risk management practices, and compliance procedures established by the Indian banks and XY Bank.

e) **Review Security Measures:**

   Assess encryption methods, cryptographic key management, and secure transmission protocols used for data protection.

   Review measures taken to prevent unauthorized access, cyber threats, and potential vulnerabilities in the blockchain network.

f) **Test Transaction Validity and Accuracy:**

   Validate that transactions are recorded and settled accurately on the blockchain, ensuring adherence to relevant regulations and contractual obligations.

   Perform reconciliations between on-chain Nostro accounts and the corresponding accounts held at XY

Bank to confirm the accuracy of balances and transactions.

g) **Evaluate Compliance and Regulatory Requirements:**

Review documentation and procedures related to customer due diligence, transaction monitoring, and reporting obligations.

Ensure that the pilot program adheres to industry-specific standards and best practices.

h) **Assess Business Continuity and Disaster Recovery:**

Evaluate the adequacy of backup and recovery procedures, redundancy measures, and failover mechanisms to ensure uninterrupted operations.

Test the effectiveness of these plans by conducting simulations or examining historical incidents and response procedures.

i) **Report Findings and Recommendations:**

Provide recommendations for improving internal controls, security measures, compliance procedures, and overall efficiency and effectiveness of the pilot program.

Communicate the audit results to the relevant stakeholders, highlighting areas of concern and suggesting remedial actions.

Integrated Case Scenario:

Consider the following five situations: -

A. Safe Health Insurance Limited is a company working in field of health insurance sector. It is now using a claim management system where incoming claims can be immediately identified on the website itself. A form is issued to the customer who signs it. The details are verified by the system against data present in it. Such a system has allowed faster processing of claims, error-free data validation and increased customer satisfaction.

B. During the course of audit of a company, it is noticed that a cyber attack took place on the data in which files were encrypted and computers got locked. The hacker then demanded a booty for decryption of files which was to be paid in bitcoins.

C. CA X, auditor of a company, is looking into cyber security risks of the company. He is making inquiries regarding processes and controls relating to privileged account access, patch management program, vendor risk management program. He has also performed external network penetration testing.

D. "Verificatory" is an entity which can stamp e-mails or any files. It simplifies certifying of e-mails by just e-mailing to them to an e-mail specifically created for each customer. Many law firms can use this service to certify documents. The information is secured by networks of thousands of computers distributed across the globe. It uses cryptographic algorithms. The information can be verified from anywhere in the world. Its hashing and time stamping is of significant evidentiary value.

DIGITAL AUDITING AND ASSURANCE

E. CA X is planning for audit of an entity. The timelines are agreed in a meeting with key management person on an electronic meeting platform. The entity also agrees to provide data electronically. Video-conference meetings are to be held from time to time with the client.

Keeping in view above situations, answer the following questions: -

1. In respect of situation regarding working of insurance company in health insurance sector, which of following technologies has likely been used?

a) Internet of things

b) Data analytics

c) Robotic process automation

d) Power BI

Ans: (c)

2. Which type of cyber-attack is referred to situation described in para [B]?

a) Ransomware

b) Trojan

c) Denial of service attacks

d) File less Malware

Ans: (a)

3. In situation described at [C] above, which is not part of risk assessment procedures to assess cyber security risks?

a) Making inquiries regarding processes and controls relating to privileged account access

b) Making inquiries regarding processes and controls relating to patch management program

c) Making inquiries regarding processes and controls relating to vendor risk management program

d) Performing external network penetration testing

Ans: (d)

4. The kind of services being provided by an entity described at [D] above, are example of use of: -

a) Blockchain technology

b) Internet of things

c) Ethical hacking

d) Cyber attestation

Ans: (a)

5. Which of following is false in an audit described at para [E]?

a) The opportunity to present doctored documents and to omit relevant information is decreased.

b) Remote access to sensitive IT systems may not be allowed.

c) It provides comfort and flexibility to the audit team as they would be working from their office/ home environment.

d) Time zone issues could also affect the efficiency of audits.

Ans: (a)

13 CHAPTER GROUP AUDITS

Question 1

Atishaya Ltd. holds the ownership of 10% of voting power and control over the composition of Board of Directors of Neenu Ltd. While planning the statutory audit of Atishaya Ltd., what factors would be considered by you as the statutory auditors of Atishaya Ltd for the audit of its consolidated financial statements prepared under Ind AS? (MTP 5 Marks, April 21, Old & New SM)

Answer 1

10% Voting Power and Control over the composition of Board of Directors: In this case, Atishaya Ltd. holds only 10 percent of the voting power but has control over the composition of the Board of Directors of Neenu Ltd.

In such a case, Atishaya Ltd shall be considered as a parent of Neenu Ltd and, therefore, it would consolidate Neenu Ltd in its consolidated financial statements as a subsidiary.

The auditor should verify Atishaya Ltd's management's assessment of having control in Neenu Ltd despite having only 10% voting power as per the requirements of Ind AS 110. Auditor would need to verify as to how Atishaya Ltd controls the composition of the Board of Directors or corresponding governing body of Neenu Ltd.

There can be various means by which such kind of control can be established. In this regard, the auditor may verify the minutes of Board meetings, shareholder agreement entered into by the parent, agreements with Neenu Ltd to which the parent might have provided any technology or know how, enforcement of statute, etc.

Further, the auditor should verify that the adjustments warranted by Ind AS 110 have been made wherever required and have been properly authorised by the management of the parent. The preparation of consolidated financial statements gives rise to permanent consolidation adjustments and current period consolidation adjustments. The auditor should make plan, among other things, for the understanding of accounting policies of the Atishaya Ltd and Neenu Ltd and determining and programming the nature, timing, and extent of the audit procedures to be performed etc.

Further, the duties of an auditor with regard to reporting of transactions with any other related parties are given in SA 550 on Related Parties. As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity are considered as Related Party.

In forming an opinion on the financial statements, the auditor shall evaluate whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with Ind AS 110 and Schedule III and whether the effects of the related party relationships and transactions prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks) or cause the financial statements to be misleading (for compliance frameworks).

Question 2

Moon Ltd. acquired 51% shares of Star Ltd. during the year ending 31-3-2017. During the financial year 2017-18 the 20% shares of Star Ltd. were sold by Moon Ltd. Moon Ltd. while preparing the financial statements for the year ending 31-3-2017 and 31-3-2018 did not consider the financial statements of Star Ltd. for consolidation. As a statutory auditor how would you deal with it? (MTP 5 Marks, Oct 18, MTP 5 Marks, March 18, RTP Nov '18)

OR

R Ltd. owns 51% voting power in S Ltd. It however, holds and discloses all the shares as "Stock-in-trade" in its accounts. The shares are held exclusively with a view to their subsequent disposal in the near future.

R Ltd. represents that while preparing Consolidated Financial Statements, S Ltd. can be excluded from the consolidation. As a Statutory Auditor, how would you deal? (Old & New SM)

Answer 2

Accounting Standard 21 "Consolidated Financial Statements", states that a subsidiary should be excluded from consolidation when control is intended to be temporary because the shares are acquired and held exclusively with a view to its subsequent disposal in the near future.

Where an enterprise owns majority of voting power by virtue of ownership of the shares of another enterprise and all the shares are acquired & held exclusively with a view to their subsequent disposal in the near future, the control by the first mentioned enterprise would be considered temporary and the investments in such subsidiaries should be accounted for in accordance with AS 13 "Accounting for Investments".

In the case of an entity which is excluded from consolidation on the ground that the relationship of parent with the other entity as subsidiary is temporary, the auditor should verify that the intention of the parent, to dispose the subsidiary, in the near future, existed at the time of acquisition of the subsidiary. The auditor should also verify that the reasons for exclusion are given in the consolidated financial statements.

As per Ind AS 110, there is no such exemption for 'temporary control', or "for operation under severe longterm funds transfer restrictions" and consolidation is mandatory for Ind AS compliant financial statement in this case.

However, as per section 129(3) of the Companies Act, 2013 where a company having subsidiary, which is not required to prepare consolidated financial statements under the applicable Accounting Standards, it shall be sufficient if the company complies with the provisions on consolidated financial statements provided in Schedule III to the Act.

Conclusion: In the given case, Parent Ltd. has acquired 51% shares of Child Ltd. during the year ending 31.03.2016 and sold 20% shares during the year 2016-17. Parent Ltd. did not consolidate the financial statements of Child Ltd. for the year ending 31.03.2016 and 31.03.2017.

The intention of Parent Ltd. is quite clear that the control in Child Ltd. is temporary as the former company disposed off the acquired shares in the next year of its purchase. Therefore, Parent Ltd. is not required to prepare consolidated financial statement as per AS 21 however, for the compliance of provisions related to consolidation of financial statements given under section 129(3) of the Companies Act, 2013, Parent Ltd. is required to made disclosures in the financial statements as per the provisions provided in Schedule III to the Companies Act' 2013.

However, if the Parent Ltd. is required to prepare its financial statements under Ind AS, it shall have to prepare Consolidated Financial Statements in accordance with Ind AS 110 as exemption for 'temporary control', or "for operation under severe long-term funds transfer restrictions" is not available under Ind AS 110. Paragraph 20 of Ind AS 110 states that "Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee".

Question 3

CA. V is the auditor of Superb Ltd., a parent company which presents Consolidated Financial Statements.

The management of Superb Ltd. has provided the list of the components included in the Consolidated Financial Statements. As an auditor of Consolidated Financial Statements, CA V has to verify that all the components have been included in the Consolidated Financial Statements and review the information provided by the management in identifying the components. State the procedures to be followed by CA.

V in respect of completeness of this information. (MTP 5 Marks Oct 21, RTP May 23, PYP 5 Marks Nov'20)

Answer 3

A parent which presents consolidated financial statements is required to consolidate all its components in the consolidated financial statements other than those for which exceptions have been provided in the relevant accounting standards under the applicable financial reporting framework.

The auditor should obtain a listing of all the components included in the consolidated financial statements and review the information provided by the management of the parent identifying the components. The auditor should verify that all the components have been included in the consolidated financial statements unless these components meet criterion for exclusion.

In the given case, Superb Ltd has provided the list of components included in the consolidated financial statements (CFSs). CA V shall verify that all the components have been included in the CFSs.

Further, in respect of completeness of this information, CA V should perform the following procedures:

i. review his working papers for the prior years for the known components;

ii. review the parent's procedures for identification of various components;

iii. make inquiries of the management to identify any new components or any component which goes out of consolidated financial statements;

iv. review the investments of parent as well as its components to determine the shareholding in other entities;

v. review the joint ventures and joint arrangements as applicable;

vi. review the other arrangements entered into by the parent that have not been included in the consolidated financial statements of the group;

vii. review the statutory records maintained by the parent, for example registers under section 186, 190 of the Companies Act, 2013;

viii. Identify the changes in the shareholding that might have taken place during the reporting period.

Question 4

Sambhav & Co., a Chartered Accountant Firm, is appointed as the principal auditor of a listed company, Moksh Ltd.

Figures of income and net-worth of five out of seven components of Moksh Ltd., which are its unlisted subsidiaries, is tabulated below for the immediate preceding financial year along with the consolidated amount:

Particulars	Consolidated	Component 'A'	Component 'B'	Component 'C'	Component 'D'	Component 'E'
Income	600	70	20	140	130	40
Net Worth	1,600	80	40	280	360	100

The remaining two components i.e., Component 'F' & Component 'G' of Moksh Ltd. were unaudited. According to Mr. Sambhav, the engagement partner, Component 'F' is material to the consolidated financial statements whereas Component 'G' is not material to consolidated financial statements and this fact has also been discussed in writing with those charged with governance of Moksh Ltd.

(i) Which of the components of Moksh Ltd. can be termed as "material subsidiary" and in the Board of which of the unlisted subsidiaries at least one independent director of Moksh Ltd. needs to be appointed or would be appointed? (MTP 4 Marks April 22, MTP 4 Marks Mar'21)

GROUP AUDITS

(ii) What shall be the audit consideration in relation to reporting in case of unaudited components of Moksh Ltd. by Sambhav & Co. and how Sambhav & Co. as a principal auditor shall report in case of Component 'F' & Component 'G', respectively? (MTP 5 Marks April 22, MTP 5 Marks Mar'21)

Answer 4

As per Regulation 16(c) of the SEBI (LODR) Regulations, 2015, "material subsidiary" shall mean a subsidiary, whose income or net worth exceeds ten percent of the consolidated income or net worth respectively, of the listed entity and its subsidiaries in the immediately preceding accounting year. [Explanation- The listed entity shall formulate a policy for determining 'material' subsidiary.]

Regulation 24(1) of the SEBI (LODR) Regulations, 2015, provides that at least one independent director on the board of directors of the listed entity shall be a director on the board of directors of an unlisted material subsidiary, whether incorporated in India or not.

[Explanation- For the purposes of Regulation 24(1), notwithstanding anything to the contrary contained in regulation 16, the term "material subsidiary" shall mean a subsidiary, whose income or net worth exceeds twenty percent of the consolidated income or net worth respectively, of the listed entity and its subsidiaries in the immediately preceding accounting year]

On the basis of above provisions, following information is tabulated as below:

Particulars	Share in Consolidated Income	Share in Consolidated Net Worth
Component 'A'	11.67%	5%
Component 'B'	3.33%	2.5%
Component 'C'	23.33%	17.5%
Component 'D'	21.67%	22.5%
Component 'E'	6.67%	6.25%

It can be observed that Component 'A', Component 'C' and Component 'D', respectively, can be termed as "material subsidiary" as their shares in either consolidated Income or net worth exceeds 10%.

Further, at least one independent director from the board of directors of Moksh Ltd. shall be appointed or would have been appointed on the board of Component 'C' and Component 'D', respectively, as their shares in either consolidated income or net worth exceeds 20 %.

(ii) Generally, the financial statements of all components included in consolidated financial statements should be audited or subjected to audit procedures in the context of a multi - location group audit. Such audits and audit procedures can be performed by the auditor reporting on the consolidated financial statements or by the components' auditor.

Where the financial statements of one or more components continue to remain unaudited, the auditor reporting on the consolidated financial statements should consider unaudited components in evaluating a possible modification to his report on the consolidated financial statements. The evaluation is necessary because the auditor (or other auditors, as the case may be) has not been able to obtain sufficient appropriate audit evidence in relation to such consolidated amounts/balances. In such cases, the auditor should evaluate both qualitative and quantitative factors on the possible effect of such amounts remaining unaudited when reporting on the consolidated financial statements using the guidance provided in SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

In the given situation, two out of seven components of Moksh Ltd. have remained unaudited where Component 'F' is material and Component 'G' is not material to the consolidated financial statements. Thus, in case of Component 'F', the Principal Auditor needs to consider its impact on the auditor's opinion on the consolidated financial statements of the group, in terms of the principles laid down in SA 705, Modifications to the Opinion in the Independent Auditor's Report. Whereas in case of Component 'G', the principal auditor should make appropriate reporting under the "Other Matters" paragraph, pursuant to SA 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs, in the Independent Auditor's Report.

Question 5

T Ltd. is holding 68% share of B Ltd, 51% share of C Ltd. RS & Co. Chartered Accountants are the statutory auditors of T Ltd. MN & Co. Chartered Accountants are the statutory auditors of B Ltd. and C Ltd. MN & Co have qualified the report of B Ltd. due to material discrepancies in standalone financial statement.

While framing the opinion on Consolidated Financial Statement of T Ltd., RS & Co. (Principal Auditor) have ignored the qualification of B Ltd. considering it not material at Group Level. Comment. (MTP 5 Marks Oct '22)

Answer 5

In carrying out the audit of the standalone financial statements, the computation of materiality for the purpose of issuing an opinion on the standalone financial statements of each component would be done component-wise on a standalone basis. However, with regard to determination of materiality during the audit of consolidated financial statements (CFS), the auditor should consider the following:

- The auditor is required to compute the materiality for the group as a whole. This materiality should be used to assess the appropriateness of the consolidation adjustments (i.e. permanent consolidation adjustments and current period consolidation adjustments)
- The parent auditor can also use the materiality computed on the group level to determine whether the component's financial statements are material to the group to determine whether they should scope in additional components, and consider using the work of other auditors as applicable.
- The principal auditor also computes materiality for each component and communicates to the component auditor, if he believes is required for true and fair view on CFS.
- The principal auditor also obtains certain confirmations from component auditor like independence, code of ethics, certain information required for consolidation and disclosure requirements etc.

GROUP AUDITS

However, while considering the observations (for instance modification and /or emphasis of matter in accordance with SA 705/706) of the component auditor in his report on the standalone financial statements, the principles of SA 600 needs to be considered., The parent auditor should comply with the requirements of SA 600, "Using the Work of Another Auditor". Therefore, the concept of materiality would be considered while considering the observations of the component auditor. Hence RS & Co. cannot ignore the qualification of B Ltd. while framing the opinion on consolidated financial statements of T Ltd.

Question 6

CA Tushar is engagement partner conducting audit of consolidated financial statements of a group which includes parent entity and its 3 subsidiaries. The standalone financial statements of its subsidiaries are audited by component auditors. He is considering accepting such appointment. What specific considerations have to be kept in mind by him before accepting appointment as principal auditor of the group?

After acceptance, he is in quandary with regard to determination of materiality during audit of consolidated financial statements. What specific considerations have to be kept in mind while determining materiality during audit of above group? (MTP 5 Marks Oct '23)

Answer 6

SA 600 requires auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor. For this purpose, the auditor would consider: -

(i) the materiality of the portion of the financial information which the principal auditor audits

(ii) the principal auditor's degree of knowledge regarding the business of the components

(iii) the risk of material misstatements in the financial information of the components audited by the other auditor and

(iv) the performance of additional procedures as set out in SA 600 regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

With regard to determination of materiality during the audit of consolidated financial statements (CFS), the auditor should consider the following: -

- The auditor is required to compute the materiality for the group as a whole. This materiality should be used to assess the appropriateness of the consolidation adjustments (i.e., permanent consolidation adjustments and current period consolidation adjustments) that are made by the management in the preparation of CFS.
- The parent auditor can also use materiality computed on the group level to determine whether the component's financial statements are material to the group to determine whether they should scope in additional components and consider using the work of other auditors as applicable.

- While considering the observations (for instance, modification and /or emphasis of matter/other matter in accordance with SA 705/706) of the component auditor in his report on the standalone financial statements, the parent auditor should comply with the requirements of SA 600 "Using the Work of Another Auditor".

Question 7

You are appointed as an auditor of Nawab Limited, a listed company which is a main supplier to the UK building and construction market. With a turnover of Rs.2.9 billion, the company operates through 11 business units and has nearly 1,80 branches across the countries .

As an auditor, how will you draft the report in case:

(a) When the Parent's Auditor is also the Auditor of all its Components?

(b) When the Parent's Auditor is not the Auditor of all its Components?

(c) When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework Different than that of the Parent?

(d) When the Component(s) Auditor Reports under an Auditing Framework Different than that of the Parent?

(e) Where the financial statements of one or more components is not audited? (RTP May 18, Old & New SM)

OR

You are appointed as an auditor of Najib Limited, a listed company which is a main supplier to the USA building and construction market. With a turnover of Rs. 1.9 billion, the company operates through 11 business units and has nearly 1,70 branches across the countries.

As an auditor, how will you draft the report in case:

(I) When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework Different than that of the Parent?

(II) (II) When the Component(s) Auditor Reports under an Auditing Framework Different than that of the Parent? (MTP 5 Marks, Aug' 18 , Nov 21 & Sep'23)

OR

You are appointed as an auditor of Azad Limited, a listed company which is a main supplier to the USA building and construction market. With a turnover of Rs.1.6 billion, the company operates through 9 business units and has nearly 135 branches across the countries. As an auditor, how will you draft the report in case (i) When the Parent's Auditor is also the Auditor of all its Components? and (ii) When the Parent's Auditor is not the Auditor of all its Components? (MTP 5 Marks, May 20)

GROUP AUDITS

OR

You are appointed as an auditor of Nawab Limited, a listed company which is a main supplier to the UK building and construction market. With a turnover of Rs. 2.9 billion, the company operates through 11 business units and has nearly 1,80 branches across the countries. As an auditor, how will you draft the report in case (a) When the Parent's Auditor is also the Auditor of all its Components? and (b) When the Parent's Auditor is not the Auditor of all its Components? (MTP 5 Marks, April 18)

Answer 7

a) When the Parent's Auditor is also the Auditor of all its Components

While drafting the audit report, the auditor should report:

- Whether principles and procedures for preparation and presentation of consolidated financial statements as laid down in the relevant accounting standards have been followed.
- In case of any departure or deviation, the auditor should consider the requirements given in SA 705, Modifications to the Opinion in the Independent Auditor's reports in the audit report so that users of the consolidated financial statements are aware of such deviation.
- Auditor should issue an audit report expressing opinion whether the consolidated financial statements give a true and fair view of the state of affairs of the Group as on balance sheet date and as to whether consolidated profit and loss statement gives true and fair view of the results of consolidated profit or losses of the Group for the period under audit.
- Where the consolidated financial statements also include a cash flow statement, the auditor should also give his opinion on the true and fair view of the cash flows presented by the consolidated cash flow statements.

b) When the Parent's Auditor is not the Auditor of all its Components

In a case where the parent's auditor is not the auditor of all the components included in the consolidated financial statements, the auditor of the consolidated financial statements should also consider the requirement of SA 600.

As prescribed in SA 706, if the auditor considers it necessary to make reference to the audit of the other auditors, the auditor's report on the consolidated financial statements should disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s).

This may be done by stating aggregate rupee amounts or percentages of total assets, revenues and cash flows of components included in the consolidated financial statements not audited by the parent's auditor.

Total assets, revenues and cash flows not audited by the parent's auditor should be presented before giving effect to permanent and current period consolidation adjustments.

Reference in the report of the auditor on the consolidated financial statements to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors of the parent and its subsidiaries.

c) When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework Different than that of the Parent

The parent may have components located in multiple geographies outside India applying an accounting framework (GAAP) that is different than that of the parent in preparing its financial statements. Foreign components prepare financial statements under different financial reporting frameworks, which may be a well-known framework (such as US GAAP or IFRS) or the local GAAP of the jurisdiction of the component.

Local component auditors may be unable to report on financial statements prepared using the parent's GAAP because of their unfamiliarity with such GAAP.

When a component's financial statements are prepared under an accounting framework that is different than that of the framework used by the parent in preparing group's consolidated financial statements, the parent's management perform a conversion of the components' audited financial statements from the framework used by the component to the framework under which the consolidated financial statements are prepared. The conversion adjustments are audited by the principal auditor to ensure that the financial information of the component(s) is suitable and appropriate for the purposes of consolidation.

A component may alternatively prepare financial statements on the basis of the parent's accounting policies, as outlined in the group accounting manual, to facilitate the preparation of the group's consolidated financial statements. The group accounting manual would normally contain all accounting policies, including relevant disclosure requirements, which are consistent with the requirements of the financial reporting framework under which the group's consolidated financial statements are prepared.

The local component auditor can then audit and issue an audit report on the components financial statements prepared in accordance with "group accounting policies".

When applying the approach of using group accounting policies as the financial accounting framework for components to report under, the principal/parent auditors should perform procedures necessary to determine compliance of the group accounting policies with the GAAP applicable to the parent's financial statements. This ensures that the information prepared under the requirements of the group accounting policies will be directly usable and relevant for the preparation of consolidated financial statements by the parent entity, eliminating the need for auditing by the auditor, the differences between the basis used for the component's financial statements and that of the consolidated financial statements. The Principal auditor can then decide whether or not to rely on the components' audit report and make reference to it in the auditor's report on the consolidated financial statements.

d) When the Component(s) Auditor Reports under an Auditing Framework Different than that of the Parent

Normally, audits of financial statements, including consolidated financial statements, are performed under auditing standards generally accepted in India ("Indian GAAS").

In order to maintain consistency of the auditing framework and to enable the parent auditor to rely and refer to the other auditor's audit report in their audit report on the consolidated financial statements, the components' financial statements should also be audited under a framework that corresponds to Indian GAAS.

e) Components Not Audited

Generally, the financial statements of all components included in consolidated financial statements should be audited or subjected to audit procedures in the context of a multi-location group audit. Such audits and audit procedures can be performed by the auditor reporting on the consolidated financial statements or by the components' auditor.

Where the financial statements of one or more components continue to remain unaudited, the auditor reporting on the consolidated financial statements should consider unaudited components in evaluating a possible modification to his report on the consolidated financial statements. The evaluation is necessary because the auditor (or other auditors, as the case may be) has not been able to obtain sufficient appropriate audit evidence in relation to such consolidated amounts/balances. In such cases, the auditor should evaluate both qualitative and quantitative factors on the possible effect of such amounts remaining unaudited when reporting on the consolidated financial statements using the guidance provided in SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

Question 8

Write a short note on: Auditor's objectives in an audit of consolidated financial statements. (RTP Nov 19)

Answer 8

The auditor's objectives in an audit of consolidated financial statements are:

(i) to satisfy himself that the consolidated financial statements have been prepared in accordance with the requirements of applicable financial reporting framework;

(ii) to enable himself to express an opinion on the true and fair view presented by the consolidated financial statements;

(iii) to enquire into the matters as specified in section 143(1) of the Companies Act, 2013; and. to report on the matters given in the clauses (a) to (i) of section143(3) of the Companies Act, 2013, for other matters under section 143(3)(j) read with rule 11 of the Companies (Audit and Auditors) Rules, 2014, to comment on the matters specified in sub-rule (a),(b) and (c)1 to the extent applicable;

The auditor should also validate the requirement of preparation of CFS for the company as per applicable financial reporting framework.

Question 9

Write a short note on the following: Responsibility of holding company for preparation of Consolidated Financial Statements. (RTP Nov '21, Old & New SM)

Answer 9

Responsibility of holding company for preparation of Consolidated Financial Statements: The responsibility for the preparation and presentation of consolidated financial statements, among other things, is that of the management of the parent. This includes:

(a) identifying components, and including the financial information of the components to be included in the consolidated financial statements;

(b) where appropriate, identifying reportable segments for segmental reporting;

(c) identifying related parties and related party transactions for reporting;

(d) obtaining accurate and complete financial information from components;

(e) making appropriate consolidation adjustments;

(f) harmonization of accounting policies and accounting framework; and

(g) GAAP conversion, where applicable.

Apart from the above, the parent ordinarily issues instructions to the management of the component specifying the parent's requirements relating to financial information of the components to be included in the consolidated financial statements. The instructions ordinarily cover the accounting policies to be applied, statutory and other disclosure requirements applicable to the parent, including the identification of and reporting on reportable segments, and related parties and related party transactions, and a reporting timetable.

Question 10

Jambu & Sudharma Investments Ltd. is a company having paid up share capital of ₹ 1 crore, it has a subsidiary, Investors Fund Management Ltd. Major business of Jambu & Sudharma Investments Ltd. is to pool money from investors on a collective basis and invest this money in various funds. This company pooled ₹ 12 crore from a number of clients, which represent the Company's shareholders.

While auditing books of accounts of Jambu & Sudharma Investments Ltd. CA Vardhman observed that whole amount of ₹ 12 crore pooled has been invested in shares and debentures of various companies and profit earned due to appreciation of the prices of these shares has been distributed to various shareholders of the company. Performance of all of its investments is measured on fair value basis.

Now, CA Vardhman raised an issue while auditing financial statements of Jambu & Sudharma Investments Ltd. whether the consolidated financial statements are required as per Section 129(3) of the Companies Act, 2013? Analyse the above issue and give your opinion. (RTP Nov'22, PYP 5 Marks Dec '21)

GROUP AUDITS

Answer 10

According to Section 129(3) of the Companies Act, 2013, where a company has one or more subsidiaries, including associate company and joint venture, it shall, in addition to its own financial statements prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own.

As per sub-section 6 of the section 129 of the Companies Act, 2013, the Central Government may, on its own or on an application by a class or classes of companies, by notification, exempt any class or classes of companies from complying with any of the requirements of section 129 or the Rules made thereunder.

An investment entity is an entity that:

(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;

(b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and

(c) measures and evaluates the performance of substantially all of its investments on a fair value basis. An investment entity need not present consolidated financial statements if it is required, in accordance with paragraph 31 of Ind AS 110, to measure all of its subsidiaries at fair value through profit or loss. A parent shall determine whether it is an investment entity.

However, as per paragraph 33 of Ind AS 110, parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity subsidiary, unless the parent itself is an investment entity.

Applying the above to the given case of Jambu & Sudharma Investments Ltd., which fulfils all the conditions stated above, it is an investment entity. By applying Para 31 and 33 of Ind AS 110, it can be concluded that Jambu & Sudharma Investments Ltd.is not required to consolidate as per Section 129 (3) of the Companies Act, 2013.

Question 11

H Co. Ltd., is a holding company with two subsidiaries R Co. Ltd., and S Co. Ltd. The H Co. Ltd., adopts straight line method of depreciation for its assets whereas S Co. Ltd., follows written down value or diminishing value method. Though R Co. Ltd., follows straight line method of depreciation, it does not give effect to component accounting of depreciation in respect of high value assets. While consolidating the financials of the R Co. Ltd., and S Co. Ltd., with those of H Co. Ltd., determine the possible issues that you have to ensure for compliance in the light of above facts. (PYP 5 Marks, May '18)

Answer 11

When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework is Different than that of the Parent: A component may alternatively prepare financial statements on the basis of the parent's accounting policies, as outlined in the group accounting manual, to facilitate the preparation of the group's consolidated financial statements. The group accounting manual would normally contain all accounting policies, including relevant disclosure requirements, which are consistent with the requirements of the financial reporting framework under which the group's consolidated financial statements are prepared. Thus, using group accounting policies as the financial accounting framework for components to report under, the principal/parent auditors should perform procedures necessary to determine compliance of the group accounting policies with the GAAP applicable to the parent's financial statements.

It may be noted that change in the selection of the method of depreciation is an accounting estimate and not an accounting policy as per Ind-AS 8. Accordingly, the entity should select the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method should be applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits in separate financial statements as well as consolidated financial statements.

Therefore, there can be different methods for calculation of depreciation for its assets, if their expected pattern of consumption is different. The method once selected in the stand- alone financial statements of the subsidiary should not be changed while preparing the consolidated financial statements.

In the given case, assets of R Co. Ltd. (subsidiary company) is depreciated using straight line method, assets of S Co. Ltd. (subsidiary company) are depreciated using written down value method and assets of parent company (H Co. Ltd.) are depreciated using straight line method, is in order. However, each part of an item of Property Plant and Equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately under Component Method of Depreciation as per AS 10 on Property, Plant and Equipment. Thus, R Co. Ltd., though adopting straight line method but does not giving effect to component accounting of depreciation in respect of high value assets , is not in compliance with Ind AS 16/Accounting Standard 10 Property Plan and Equipment.

Question 12

H Limited is an Investment Company preparing its Financial Statements in accordance with Ind AS. The Company obtains funds from various investors and commits its performance for fair return and capital appreciation to its investors. During the year under audit, it had been observed that the Company had invested 25% in S1 Ltd., 50% in S2 Ltd. and 60% in S3 Ltd. of the respective share capitals of the Investee Companies. When checking the investment schedule of the Company, an issue cropped as to whether there would arise any need to consolidate accounts of any such investee companies with those of H Limited in accordance with section 129(3) of the Companies Act, 2013 which contains no exclusion from consolidation.

GROUP AUDITS

Analyze the issues involved and give your views. (PYP 4 Marks, Nov '18, Old & New SM, RTP Nov '23)

Answer 12

Consolidated Financial Statements: According to Section 129(3) of the Companies Act, 2013, where a company has one or more subsidiaries, including associate company and joint venture, it shall, in addition to its own financial statements prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own.

Further, as per Companies (Accounts) Rules, 2014, the consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III to the Act and the applicable accounting standards. However, a company which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

However, an investment entity need not present consolidated financial statements if it is required, in accordance with Ind AS 110'Consolidated Financial Statements', to measure all of its subsidiaries at fair value through profit or loss. A parent shall determine whether it is an investment entity.

(An investment entity is an entity that(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services; (b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and (c) measures and evaluates the performance of substantially all of its investments on a fair value basis.)

In the given case, H Limited is an investment company preparing its financial statements in accordance with Ind AS and the company had invested 25% in SI Ltd., 50% in S2 Ltd. and 60% in S3 Ltd. of the respective share capitals of the investee companies. In view of provisions discussed in Ind AS 110, the Company is not required to prepare consolidated financial statements however, for the compliance of Companies (Accounts) Rules, 2014, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

Thus, it can be concluded that ultimate authority on consolidation is AS / Ind AS as prescribed by law and if they give some exemption it should be followed. If out of exemption some subsidiaries are not consolidated, then list should be disclosed in notes to accounts with reason.

Question 13

JRS Limited holds the majority ownership of R Ltd. & K Ltd. S Ltd. is an intermediate subsidiary of JRS Limited in Surat. The JRS Limited presents the consolidated financial statements for audit purposes to MMT & Co. As a statutory auditor MMT & Co. obtain a listing of all the components and verify that all the components included in financial statements unless any component meet criterion for exclusion.

Explain any two reasons which are considered by MMT & Co. for exclusion of components

from the consolidated financial statements and reporting of reasons of exclusion thereof. (PYP 5 Marks, Jan '21)

Answer 13

Where a component is excluded from the consolidated financial statements, the auditor should examine the reasons for exclusion and whether such exclusion is in conformity with the applicable financial reporting framework.

(i) Under Companies (Accounting Standards) Rules, 2006, there could be two reasons for exclusion of subsidiary, associate or jointly controlled entity- one, that the relationship of parent with the subsidiary, associate or jointly controlled entity is intended to be temporary or the subsidiary, associate or joint venture operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.

(ii) Similarly, under the Companies Act, 2013, intermediate subsidiary in India is not required to present consolidated financial statements. Ind AS 110 also prescribes certain criteria where consolidated financial statements are not required. In such cases, the auditor should satisfy himself that the exclusion made by the management falls within these categories, example in the case of an entity which is excluded from consolidation on the ground that the relationship of parent with the other entity as subsidiary, associate or joint venture is temporary, the auditor should verify that the intention of the parent, to dispose off the subsidiary, investment in associate or interest in jointly controlled entity, in the near future, existed at the time of acquisition of the subsidiary, making investment in associate or jointly controlled entity.

(iii) The auditor should also verify that the reasons for exclusion are given in the consolidated financial statements. If an entity is excluded from the consolidated financial statements for reasons other than those allowed by the applicable financial reporting framework, the auditor should consider its effect on the auditor's report to be issued.

Question 14

ABC Limited holds 51% equity of BBB Limited, 63% equity of TTT Limited. There are different information and explanations which are disclosed by the respective companies in the notes to their financial statements. At the time of consolidation, management of ABC Limited has consolidated all the information and explanations disclosed in the notes as well. The principal auditor is of the view that only those information and explanations should form part of the notes to the consolidated financial statements which are relevant at group level. Please mention any five aspects which are given in the notes to the separate financial statements of the parent and the subsidiaries, need not be included in the consolidated financial statements. (PYP 5 Marks Nov 22)

Answer 14

The Ind AS 110 does not give a list of information which is part of the separate financial statement of the components but that need not be reported in the notes and other explanatory material of the consolidated financial statements, however, based on section 129(4) and circular issued by MCA, it can be construed that, even in consolidated financial statements under Ind AS, only those disclosures should be given which are relevant to consolidated financial statements.

Based on the above discussion, in case of companies, the information such as the following given in the notes to the separate financial statements of the parent and/or the subsidiary, need not be included in the consolidated financial statements.

(i) Source from which bonus shares are issued, e.g., capitalization of profits or reserves or from securities premium account.

(ii) Disclosure of all unutilized monies out of the issue indicating the form in which such unutilized funds have been invested.

(iii) Disclosure required under Micro, Small and Medium Enterprises Development Act, 2006.

(iv) A statement of investments (whether shown under "financial assets or non-financial assets as stockin-trade) separately classifying trade investments and other investments, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investment so made in each such body corporate.

(v) Value of imports calculated on C.I.F. basis by the company during the financial year in respect of:

(a) raw materials;

(b) components and spare parts;

(c) capital goods.

(vi) Expenditure in foreign currency during the financial year on account of royalty, know- how, professional and consultation fees, interest, and other matters.

(vii) Value of all imported raw materials, spare parts and components consumed during the financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption.

(viii) The amount remitted during the year in foreign currencies on account of dividends, with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends were due and the year to which the dividends related.

(ix) Earnings in foreign exchange classified under the following heads, namely:

(a) export of goods calculated on F.O.B. basis;

(b) royalty, know-how, professional and consultation fees;

(c) interest and dividend;

(d) other income, indicating the nature thereof.

Multiple Choice Questions MCQ

Question 1

Brown Ltd is a holding company with two subsidiaries Black Ltd and White Ltd. You have been given the task of covering the valuation of non-current tangible assets in the consolidated financial statements. You note that Black Ltd and Brown Ltd. adopt straight line method of depreciation for its assets whereas White Ltd, follows written down method for calculating the depreciation. Which of the following adjustment would be considered as correct in respect of the consolidated financial statements preparation?

(a) White Ltd is required to depreciate the assets adopting straight line method of depreciation which is the method adopted by the holding company.

(b) Brown Ltd is required to make suitable adjustments as to the depreciation charged by White Ltd, at the time of consolidation.

(c) Brown Ltd and Black Ltd are required to depreciate the assets adopting written down value as to facilitate the harmonization of accounting policies.

(d) No adjustment is required as there can be different methods of calculation of depreciation for its assets for the group companies. (MTP 2 Marks Mar 19)

Answer 1 : (d)

Question 2

B Limited controls entity C Limited (75%) and entity A Limited (an investment company). Entity B Limited reduced the control of entity C Limited from 75% to 60%. With regard to that certain adjustments were made to account for the change in the shareholding of entity C Limited which is consolidated. These adjustments are known as:

(a) Memorandum adjustments.

(b) Current period consolidation adjustments.

(c) Permanent consolidation adjustments.

(d) Temporary period consolidation adjustments. (MTP 1 Marks, March 21)

Answer 2 : (c)

Question 3

NT 22 Group is a large group comprising of 22 subsidiary companies, 14 associate companies and 19 joint ventures. NT Ltd. is the holding company which is also listed on Bombay Stock Exchange and New York Stock Exchange. The Group prepares its consolidated financial statements every quarter for various reporting requirements – SEBI (Stock and Exchange Board of India), Stock

Exchanges, Registrar of Companies in India and others. The turnover of the Group is INR 15,000 crores and many of its components have significant operations at standalone level.

The Group is audited by one audit firm, Seema & Co LLP. For the purpose of group audit of the current year, the auditors have considered perfoming testing of journal entries across the group to address the significant risk, however, the auditors are facing challenges to perform this audit procedure across the group because of the volume and limitation of resources. Please suggest the correct options in respect of this matter. (MTP 2 Marks, April 19)

(a) The Group auditors have a choice to test journal entries of the components which is also backed up by the auditing standards.

(b) The Group auditors must test journal entries of all components.

(c) The Group auditors need not test journal entries of components requiring analytical response at group level.

(d) The Group auditors need not test journal entries of components scoped with com prehensive approach.

Answer 3 : (c)

Question 4

Shrenik Ltd. was set up initially as a private limited company. Subsequently, it got converted into a public company. The company's management has plans of expansion, but the business was not growing in an organic manner. Therefore, the management decided to acquire the competitors. During the financial year ended 31st March, 2021, the company acquired two companies in India and France in September, 2020 and January, 2021 respectively. The company controls both of these companies as per the criteria's laid down in the Companies Act, 2013 as well as the applicable accounting standards.

The management started discussions with the auditors regarding the audit wherein it was also pointed out by the auditors that the management should also prepare consolidated financial statements, if they want.

Management needs your advise on the same.

(a) Management must prepare the consolidated financial statements as per the requirements of the Companies Act, 2013.

(b) Management has a choice not to prepare consolidated financial statements but should go for that considering that its true performance and financial position can then be demonstrated.

(c) Management could have prepared consolidated financial statements if the acquired companies would have completed at least one year post acquisition.

(d) Management must prepare consolidated financial statements, but it should include only the company acquired in India. (MTP 1 Mark Oct 21)

Answer 4 : (a)

Question 5

Rimmi Ltd. was set up initially as a private limited company. Subsequently, it got converted into a public company. The company's management has plans of expansion but the business was not growing in an organic manner. Therefore, the management decided to acquire the competitors. During the financial year ended 31st March, 2021, the company acquired two companies in India and France in September, 2020 and January, 2021 respectively. The company controls both of these companies as per the criteria laid down in the Companies Act, 2013 as well as the applicable accounting standards.

The management started discussions with the auditors regarding the audit wherein it was also pointed out by the auditors that the management should also prepare consolidated financial statements (CFS), if they want. Management needs your advise on the same.

(a) Management must prepare the CFS as per the requirements of the Companies Act, 2013.

(b) Management has a choice not to prepare CFS but should go for that considering that its true performance and financial position can then be demonstrated.

(c) Management could have prepared CFS if the acquired companies would have completed at least one year post acquisition.

(d) Management must prepare CFS but it should include only the company acquired in India. (MTP 1 Mark April 22)

Answer 5 : (a)

Question 6

Shanti Ltd is in the business of construction and infrastructure. The company is listed in India having an annual turnover of INR 3500 crore. The company has various projects offices/ operations in India and outside India. The functional currency of the company and its project offices is INR. The company has five joint ventures and various jointly controlled operations. The company has been audi ted by Sudarshan & Associates, a firm of Chartered Accountants, since beginning. During the year ended 31 March 2022, new auditors were appointed as the statutory auditors of the company for the audit of the financial statements for the year ended 31 March 2022. New statutory auditors have raised various points related to the consolidation procedures followed by the company. Management did not agree to the observations of the auditors as they have been following this since many years now and there was no observation of previous auditors in respect of the same. Auditors have highlighted a point that joint ventures have been consolidated by the company in its standalone financial statements. However, management has an argument that those are in the nature of its operations and hence to reflect the true and fair view it would be appropriate to consolidate the same in the standalone financial statements. Please advise as auditors how would you deal with this matter.

a. Since the matter is related to consolidation, which is more relevant for consolidated financial statements, hence no reporting in respect of this matter would be required in the auditor's report for the year ended 31 March 2022.

b. Auditor should look at the materiality and conservatism principle. Company has included extra information in the financials which can be considered by the auditors and basis that clean audit report should be given.

c. Management should restate the financials to adjust the error related to consolidation of joint ventures in standalone financial statements. Otherwise, auditor may modify his opinion on current year's financial statements considering the materiality.

d. As per the requirements of IND AS, joint venture if consolidated in standalone financial statements should not be consolidated again in the consolidated financial statements. Basis that this point should be dropped by the auditor. (MTP 1 Mark March '23, RTP May'19)

Answer 6 : (c)

Question 7

WCO Private Ltd is a joint venture of WCO Gmbh and MSON Ltd. WCO Gmbh is a company based out of Germany and is also listed in Germany. WCO Gmbh prepares its financial statements as per IFRS. MSON Ltd is a company based out of India and is also listed in India. MSON Ltd prepares its financial statements as per Ind AS. For the purpose of reporting of financial information to WCO Gmbh and MSON Ltd for consolidation purposes, WCO Private Ltd uses reporting package (which comprises of balance sheet, profit and loss and other notes to accounts). WCO Private Ltd prepares its financial statements as per Ind AS.

WCO Private Ltd has taken useful life of some fixed assets in its Ind AS financial statements based on their useful lives which is different from the useful lives of similar nature fixed assets taken by WCO Gmbh (in line with their accounting policies). The reporting package of WCO Private Ltd is audited before reporting to WCO Gmbh. The auditor audits the reporting package which is prepared in line with the Group accounting policies of WCO Gmbh and mentions in his report that the reporting package has been prepared as per the Group accounting policies of WCO Gmbh.

WCO Private Ltd makes an adjustment for changes in useful lives in the reporting package on the basis of Group accounting policies of WCO Gmbh. The auditor has asked the management to take same useful lives of fixed assets in the reporting package which have also been taken by them in its Ind AS financial statements. Management has not agreed with the view of the auditor. Please suggest the right course of action.

(a) Position taken by the management is correct.

(b) Position suggested by the auditor is correct and if the management does not agree then auditor may have to modify his report on the basis of materiality.

(c) The matter relates to an estimate (i.e. useful life) which may be subject to changes under different GAAPs and hence auditor should ignore this point.

(d) The report would be for special purpose which should always be a clean report. (RTP May 19)

Answer 7 The answer is (a).

Question 1

Whether preparation of consolidated financial statements is mandatory? If yes, please elaborate on the requirements under the statute.

Answer 1

According to Section 129(3) of the Companies Act, 2013, where a company has one or more subsidiaries, including associate company and joint venture, it shall, in addition to its own financial statements prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own. Further, section 129(4) of the said Act, provides that the provisions applicable to the preparation, adoption and audit of the financial statements of a holding company shall, mutatis mutandis, also apply to its the consolidated financial statements.

However, the requirement related to preparation of consolidated financial statements shall not apply to a company if it meets the following conditions:
(i) it is a wholly-owned subsidiary, or is a partially-owned subsidiary of another company and all its other members, including those not otherwise entitled to vote, having been intimated in writing and for which the proof of delivery of such intimation is available with the company, do not object to the company not presenting consolidated financial statements;
(ii) it is a company whose securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; and
(iii) its ultimate or any intermediate holding company files consolidated financial statements with the Registrar which are in compliance with the applicable Accounting Standards.

Question 2

Please elaborate on the situations wherein the requirement related to preparation of consolidated financial statements may not apply.

Answer 2

The requirement related to preparation of consolidated financial statements shall not apply to a company if it meets the following conditions:

(i) it is a wholly-owned subsidiary, or is a partially-owned subsidiary of another company and all its other members, including those not otherwise entitled to vote, having been intimated in writing and for which the proof of delivery of such intimation is available with the company, do not object to the company not presenting consolidated financial statements;

(ii) it is a company whose securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India; and

(iii) its ultimate or any intermediate holding company files consolidated financial statements with the Registrar which are in compliance with the applicable Accounting Standards.

GROUP AUDITS

Question 3

While doing the audit of Consolidated Financial Statements, which current period consolidation adjustments are to be taken into account?

Answer 3

Current period consolidation adjustments primarily relate to the elimination of intra-group transactions and account balances including:

(a) intra-group interest paid and received, or management fees, etc.;

(b) unrealised intra-group profits on assets acquired/ transferred from/ to other subsidiaries;

(c) record deferred taxes on unrealised intercompany profits elimination in accordance with Ind AS 12;

(d) intra-group indebtedness;

(e) adjustments related to harmonising the different accounting policies being followed by the parent and its components;

(f) adjustments to the financial statements (of the parent and the components being consolidated) for recognized subsequent events or transactions that occur between the balance sheet date and the date of the auditor's report on the consolidated financial statements of the group.

(g) adjustments for the effects of significant transactions or other events that occur between the date of the components balance sheet and not already recognised in its financial statements and the date of the auditor's report on the group's consolidated financial statements when the financial statements of the component to be used for consolidation are not drawn upto the same balance sheet date as that of the parent;

(h) In case of a foreign component, adjustments to convert a component's audited financial statements prepared under the component's local GAAP to the GAAP under which the consolidated financial statements are prepared;

(i) determination of movement in equity attributable to the minorities interest/non-controlling interest since the date of acquisition of the subsidiary. It should also be noted that under Ind AS, non-controlling interest can also result in negative balance. Unlike earlier AS, as per paragraph 28 of Ind AS 27, if the net worth of subsidiary is negative, non-controlling interest could have deficit balance;

(j) adjustments of deferred tax on account of temporary differences arising out of elimination of profit and losses resulting from intragroup transactions and undistributed profits of the component in case of consolidated financial statements prepared under Ind AS.

Question 4

Write a short note on

a) Responsibility of holding company for preparation of Consolidated Financial Statements.

b) Permanent Consolidated Adjustments.

Answer 4

(a) The responsibility for the preparation and presentation of consolidated financial statements, among other things, is that of the management of the parent. This includes:

(a) identifying components, and including the financial information of the components to be included in the consolidated financial statements;
(b) where appropriate, identifying reportable segments for segmental reporting;
(c) identifying related parties and related party transactions for reporting;
(d) obtaining accurate and complete financial information from components;
(e) making appropriate consolidation adjustments;
(f) harmonization of accounting policies and accounting framework; and
(g) GAAP conversion, where applicable.

Apart from the above, the parent ordinarily issues instructions to the management of the component specifying the parent's requirements relating to financial information of the components to be included in the consolidated financial statements. The instructions ordinarily cover the accounting policies to be applied, statutory and other disclosure requirements applicable to the parent, including the identification of and reporting on reportable segments, and related parties and related party transactions, and a reporting timetable.

(b) Permanent consolidation adjustments are those adjustments that are made only on the first occasion or subsequent occasions in which there is a change in the shareholding of a particular entity which is consolidated. Permanent consolidation adjustments are:

1. Determination of goodwill or capital reserve as per applicable accounting standards
2. Determination of amount of equity attributable to minority/ non- controlling interests

The auditor should verify that the above calculations have been made appropriately.

- The auditor should pay particular attention to the determination of pre-acquisition reserves of the components. Date(s) of investment in components assumes importance in this regard.
- The auditor should also examine whether the pre-acquisition reserves have been allocated appropriately between the parent and the minority interests/ non-controlling interests of the subsidiary.
- The auditor should also verify the changes that might have taken place in these permanent consolidation adjustments on account of subsequent acquisition of shares in the components, disposal of the components in the subsequent years.

GROUP AUDITS

It may happen that while working out the permanent consolidation adjustments, in the case of one subsidiary, goodwill arises and in the case of another subsidiary, capital reserve arises. The parent may choose to net off these amounts to disclose a single amount in the consolidated balance sheet where permitted by the applicable financial reporting framework. In such cases, the auditor should verify that the gross amounts of goodwill and capital reserves arising on acquisition of various subsidiaries have been disclosed in the notes to the consolidated financial statements to reflect the excess/shortage over the parents' portion of the subsidiary's equity.

Question 5

R Ltd. owns 51% voting power in S Ltd. It however, holds and discloses all the shares as "Stock-in-trade" in its accounts. The shares are held exclusively with a view to their subsequent disposal in the near future. R Ltd. represents that while preparing Consolidated Financial Statements, S Ltd. can be excluded from the consolidation. As a Statutory Auditor, how would you deal?

Answer 5

Consolidation of Financial Statement: As per Ind AS 110, there is no such exemption for 'temporary control', or "for operation under severe long-term funds transfer restrictions" and consolidation is mandatory for Ind AS compliant financial statement in this case. Paragraph 20 of Ind AS 110 states that "Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee".

However, as per Section 129(3) of the Companies Act, 2013 read with rule 6 of the Companies (Accounts) Rules, 2014, where a company having subsidiary, which is not required to prepare consolidated financial statements under the Accounting standards, it shall be sufficient if the company complies with the provisions on consolidated financial statements provided in Schedule III to the Act.

In the given case, R Ltd's intention is to dispose off the shares in the near future as shares are being held as stock in trade and it is quite clear that the control is temporary, Therefore, R Ltd. is required to prepare Consolidated Financial Statements in accordance with Ind AS 110 as exemption for 'temporary control' is not available under Ind AS 110.

Question 6

A Ltd. holds the ownership of 10% of voting power and control over the composition of Board of Directors of B Ltd. While planning the statutory audit of A Ltd., what factors would be considered by you as the statutory auditors of A Ltd for the audit of its consolidated financial statements prepared under Ind AS?

Answer 6

10% Voting Power and Control over the composition of Board of Directors: In this case, A Ltd. holds only 10 percent of the voting power but has control over the composition of the Board of Directors of B Ltd.

In such a case, A Ltd shall be considered as a parent of B Ltd and, therefore, it would consolidate B Ltd in its consolidated financial statements as a subsidiary.

The auditor should verify A Ltd's management's assessment of having control in B Ltd despite having only 10% voting power as per the requirements of Ind AS 110. Auditor would need to verify as to how A Ltd controls the composition of the Board of Directors or corresponding governing body of B Ltd.

There can be various means by which such kind of control can be established. In this regard, the auditor may verify the minutes of Board meetings, shareholder agreement entered into by the parent, agreements with B Ltd to which the parent might have provided any technology or know how, enforcement of statute, etc.

Further, the auditor should verify that the adjustments warranted by Ind AS 110 have been made wherever required and have been properly authorised by the management of the parent. The preparation of consolidated financial statements gives rise to permanent consolidation adjustments and current period consolidation adjustments. The auditor should make plan, among other things, for the understanding of accounting policies of the A Ltd and B Ltd and determining and programming the nature, timing, and extent of the audit procedures to be performed etc.

Further, the duties of an auditor with regard to reporting of transactions with any other related parties are given in SA 550 on Related Parties. As per SA 550 on, "Related Parties", the auditor should review information provided by the management of the entity identifying the names of all known related parties. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity are considered as Related Party.

In forming an opinion on the financial statements, the auditor shall evaluate whether the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with Ind AS 110 and Schedule III and whether the effects of the related party relationships and transactions prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks) or cause the financial statements to be misleading (for compliance frameworks).

Question 7

You are appointed as an auditor of Nawab Limited, a listed company who is a main supplier to the UK building and construction market. With a turnover of ` 2.9 billion, the company operates through 11 business units and has nearly 180 branches across the countries.

As an auditor, how will you draft the report in case:

a) When the Parent's Auditor is also the Auditor of all its Components?

b) When the Parent's Auditor is not the Auditor of all its Components?

c) When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework Different than that of the Parent?

d) When the Component(s) Auditor Reports under an Auditing Framework Different than that of the Parent?

e) Where the financial statements of one or more components is not audited?

GROUP AUDITS

Answer 7

a) When the Parent's Auditor is also the Auditor of all its Components

While drafting the audit report, the auditor should report:

- Whether principles and procedures for preparation and presentation of consolidated financial statements as laid down in the relevant accounting standards have been followed.
- In case of any departure or deviation, the auditor should consider the requirements given in SA 705, Modifications to the Opinion in the Independent Auditor's reports in the audit report so that users of the consolidated financial statements are aware of such deviation.
- Auditor should issue an audit report expressing opinion whether the consolidated financial statements give a true and fair view of the state of affairs of the Group as on balance sheet date and as to whether consolidated profit and loss statement gives true and fair view of the results of consolidated profit or losses of the Group for the period under audit.
- Where the consolidated financial statements also include a cash flow statement, the auditor should also give his opinion on the true and fair view of the cash flows presented by the consolidated cash flow statements.

b) When the Parent's Auditor is not the Auditor of all its Components

In a case where the parent's auditor is not the auditor of all the components included in the consolidated financial statements, the auditor of the consolidated financial statements should also consider the requirement of SA 600.

As prescribed in SA 706, if the auditor considers it necessary to make reference to the audit of the other auditors, the auditor's report on the consolidated financial statements should disclose clearly the magnitude of the portion of the financial statements audited by the other auditor(s).

This may be done by stating aggregate rupee amounts or percentages of total assets, revenues and cash flows of components included in the consolidated financial statements not audited by the parent's auditor.

Total assets, revenues and cash flows not audited by the parent's auditor should be presented before giving effect to permanent and current period consolidation adjustments.

Reference in the report of the auditor on the consolidated financial statements to the fact that part of the audit of the group was made by other auditor(s) is not to be construed as a qualification of the opinion but rather as an indication of the divided responsibility between the auditors of the parent and its subsidiaries.

c) When the Component(s) Auditor Reports on Financial Statements under an Accounting Framework Different than that of the Parent

The parent may have components located in multiple geographies outside India applying an accounting framework (GAAP) that is different than that of the parent in preparing its financial statements. Foreign components prepare financial statements under different financial reporting frameworks, which may be a well-known framework (such as US GAAP or IFRS) or the local GAAP of the jurisdiction of the component.

Local component auditors may be unable to report on financial statements prepared using the parent's GAAP because of their unfamiliarity with such GAAP.

When a component's financial statements are prepared under an accounting framework that is different than that of the framework used by the parent in preparing group's consolidated financial statements, the parent's management perform a conversion of the components' audited financial statements from the framework used by the component to the framework under which the consolidated financial statements are prepared. The conversion adjustments are audited by the principal auditor to ensure that the financial information of the component(s) is suitable and appropriate for the purposes of consolidation.

A component may alternatively prepare financial statements on the basis of the parent's accounting policies, as outlined in the group accounting manual, to facilitate the preparation of the group's consolidated financial statements. The group accounting manual would normally contain all accounting policies, including relevant disclosure requirements, which are consistent with the requirements of the financial reporting framework under which the group's consolidated financial statements are prepared.

The local component auditor can then audit and issue an audit report on the components financial statements prepared in accordance with "group accounting policies".

When applying the approach of using group accounting policies as the financial accounting framework for components to report under, the principal/parent auditors should perform procedures necessary to determine compliance of the group accounting policies with the GAAP applicable to the parent's financial statements. This ensures that the information prepared under the requirements of the group accounting policies will be directly usable and relevant for the preparation of consolidated financial statements by the parent entity, eliminating the need for auditing by the auditor, the differences between the basis used for the component's financial statements and that of the consolidated financial statements. The Principal auditor can then decide whether or not to rely on the components' audit report and make reference to it in the auditor's report on the consolidated financial statements.

d) When the Component(s) Auditor Reports under an Auditing Framework Different than that of the Parent

Normally, audits of financial statements, including consolidated financial statements, are performed under auditing standards generally accepted in India ("Indian GAAS").

In order to maintain consistency of the auditing framework and to enable the parent auditor to rely and refer to the other auditor's audit report in their audit report on the consolidated financial statements, the components' financial statements should also be audited under a framework that corresponds to Indian GAAS.

e) Components Not Audited

Generally, the financial statements of all components included in consolidated financial statements should be audited or subjected to audit procedures in the context of a multi-location group audit. Such audits and audit procedures can be performed by the auditor reporting on the consolidated financial statements or by the components' auditor.

Where the financial statements of one or more components continue to remain unaudited, the auditor reporting on the consolidated financial statements should consider unaudited components in evaluating a possible modification to his report on the consolidated financial statements. The evaluation is necessary because the auditor (or other auditors, as the case may be) has not been able to obtain sufficient appropriate audit evidence in relation to such consolidated amounts/balances. In such cases, the auditor should evaluate both qualitative and quantitative factors on the possible effect of such amounts remaining unaudited when reporting on the consolidated financial statements using the guidance provided in SA 705, "Modifications to the Opinion in the Independent Auditor's Report".

Question 8

M Ltd. acquired 51 % shares of S Ltd. on 01-04-2019 and sold 25% of these shares during the financial year 2019-20. M Ltd. did not prepare Consolidated Financial Statements for the financial year 2019-20 on the plea that the control was only temporary. Do you agree with the view of M Ltd.? Decide, assuming, that M Ltd. is required to prepare its financial statements under Ind AS.

Answer 8

Consolidation of Financial Statement: As per Ind AS 110, there is no such exemption for 'temporary control', or "for operating under severe long-term funds transfer restrictions" and consolidation is mandatory for Ind AS compliant financial statement in this case.

Ind AS 110 states that "Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee".

In the given case, M Ltd acquired 51% shares of S Ltd on 01.04.2019 and sold 25% shares during the year ended 2019-20. M Ltd did not consolidate the financial statements of S Ltd for the year ended 31.03.2020 on the plea that control was only temporary. The intention of M Ltd. is quite clear that the control in S Ltd. is temporary as the former company disposed of the acquired shares in the same year of its purchase.

However, even though the intention of M Ltd. is for temporary holding of shares in S Ltd. as per Ind AS, M Ltd is required to prepare Consolidated Financial Statements in accordance with Ind AS 110 as exemption for 'temporary control' is not available under Ind AS 110. However, "Consolidation of an investee shall begin from the date the investor obtains control of the investee and cease when the investor loses control of the investee". Here, due to sale of investment in S Ltd. up to 25%, M Ltd. loses control of S Ltd.

Accordingly, M Ltd., is required to prepare consolidated statement till the date of disposal of the 25% shares to comply with the same.

Question 9

H Limited is an Investment Company preparing its Financial Statements in accordance with Ind AS. The Company obtains funds from various investors and commits its performance for fair return and capital appreciation to its investors. During the year under audit, it had been observed that the Company had invested 25% in S1 Ltd., 50% in S2 Ltd. and 60% in S3 Ltd. of the respective share capitals of the Investee Companies. When checking the investment schedule of the Company, an issue cropped as to whether there would arise any need to consolidate accounts of any such investee companies with those of H Limited in accordance with section 129(3) of the Companies Act, 2013 which contains no exclusion from consolidation.

Analyse the issues involved and give your views.

Answer 9

Consolidated Financial Statements: According to Section 129(3) of the Companies Act, 2013, where a company has one or more subsidiaries, including associate company and joint venture, it shall, in addition to its own financial statements prepare a consolidated financial statement of the company and of all the subsidiaries in the same form and manner as that of its own.

Further, as per Companies (Accounts) Rules, 2014, the consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III to the Act and the applicable accounting standards. However, a company which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

However, an investment entity need not present consolidated financial statements if it is required, in accordance with Ind AS 110'Consolidated Financial Statements', to measure all of its subsidiaries at fair value through profit or loss. A parent shall determine whether it is an investment entity.

(An investment entity is an entity that(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services; (b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and (c) measures and evaluates the performance of substantially all of its investments on a fair value basis.)

In the given case, H Limited is an investment company preparing its financial statements in accordance with Ind AS and the company had invested 25% in SI Ltd., 50% in S2 Ltd. and 60% in S3 Ltd. of the respective share capitals of the investee companies. In view of provisions discussed in Ind AS 110, the Company is not required to prepare consolidated financial statements however, for the compliance of Companies (Accounts) Rules, 2014, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.

Thus, it can be concluded that ultimate authority on consolidation is AS / Ind AS as prescribed by law and if they give some exemption it should be followed. If out of exemption some subsidiaries are not consolidated, then list should be disclosed in notes to accounts with reason.

GROUP AUDITS

Question 10

Venus Ltd. is a company engaged in the manufacture of stainless steel items. The company operates through 5 business units and has 35 branches across India. Manglam & Associates are being appointed as the principal auditor of the company. While accepting the audit assignment as the principal auditor, what will be the points of consideration for the principal auditor of the company?

Answer 10

Acceptance as Principal Auditor: The principal auditor, Manglam & Associates, should consider whether their own participation is sufficient to be able to act as the principal auditor. For this purpose, the auditor would consider:

a) the materiality of the portion of the financial information which the principal auditor audits;

b) the principal auditor's degree of knowledge regarding the business of the components;

c) the risk of material misstatements in the financial information of the components audited by the other auditor; and

d) the performance of additional procedures as set out in this SA regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

Question 11

Venus Ltd. is a curtain manufacturing company having its corporate office in Punjab. The company is in the process of expansion and has acquired four companies during the year. Pradyuman & Co.is the principal auditor of the company while the audit of all the companies acquired during the year is being conducted by Jha & Jha Associates. During the course of audit, CA Pradyuman, the engagement partner asked the management of Venus Ltd. at the corporate office that in order to conduct the audit of the consolidated financial statements, his audit firm is required to conduct audit of the financial statements of all the components also (Companies acquired during the year). To this, the management asked CA Pradyuman to consider the audit reports of the component auditor already provided to his audit team and to communicate with the component auditor for any discussion they wish to have. CA Pradyuman contended that for the purpose of audit of consolidated financial statements either his firm is required to conduct an audit of all the component's financial statements or he needs the working papers of the component auditors. Is the contention of CA Pradyuman correct?

Answer 11

As per SA 600, "Using the work of Another auditor", the principal auditor is normally entitled to rely upon the work of component auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list.

The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor.

The principal auditor should consider the significant findings of the other auditor.

The principal auditor may consider it appropriate to discuss with the other auditor and the management of the component, the audit findings or other matters affecting the financial information of the components. He may also decide that supplemental tests of the records or the financial statements of the component are necessary. Such tests may, depending upon the circumstances, be performed by the principal auditor or the other auditor.

Accordingly, CA Pradyuman, can perform the above mentioned audit procedures. However, the audit of the component's financial statements by the principal auditor is not required.

So, the contention of CA Pradyuman that for the purpose of audit of consolidated financial statements he is required to conduct an audit of the components financial statements is not correct.

Further, SA 230 issued by ICAI on Audit Documentation, and "Standard on Quality Control (SQC) 1, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Accordingly, it is the discretion of the component auditor as the working papers with respect to the components examined by the component auditor are the property of the component auditor.

So, the contention of CA Pradyuman is not correct.

Question 12

Kukreja & Associates is the principal auditor of MN Ltd. The company is engaged in the manufacture of sports items and operates through its 14 branches all over India. With respect to the audit of branches, the company has appointed seven Chartered Accountant firms, each firm conducting the audit of two branches.

The audit reports in respect of accounts of branches have already been sent to the principal auditor. While analysing the work of the branch auditors, CA Kukreja, the engagement partner, asked the branch auditors to share with him a summary of the audit procedures and findings in respect of the accounts of the branches examined by them. CA Kukreja also asked one of the branch auditor to share his working paper with respect to the two branches examined by that branch auditor for his review and return. Is the principal auditor correct in asking the branch auditors for sharing the summary and the working papers for his review?

GROUP AUDITS

Answer 12

In terms of SA 600 "Using the Work of Another auditor", where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. When planning to use the work of another auditor, the principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.

The principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list.

Accordingly, CA Kukreja is correct in asking the branch auditors to share with him the summary of their audit procedures and findings in respect of the accounts of the branches examined by them.

Further, CA Kukreja has asked one of the branch auditors to share with him the working papers with respect to the branches examined by such branch auditor for the former's review and return.

SA 230 issued by ICAI on Audit Documentation, and "Standard on Quality Control (SQC) 1, provides that, unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

Accordingly, it is the discretion of the branch auditor as the working papers with respect to the branches examined by the branch auditor are the property of the branch auditor.

So, CA Kukreja is not correct in asking the branch auditor to share with him the working papers with respect to the branches examined by the branch auditor.

Question 13

CA. Mukund is in the second year of his term as statutory auditor of Style Marks Limited (Holding company), its subsidiaries and joint ventures. At the time of planning audit, he wants to be sure that all the components have been included in the consolidated financial statements. List out some procedures he should perform to verify completeness of this information.

Answer 13

The auditor should verify that all the components have been included in the consolidated financial statements unless these components meet criterion for exclusion. In respect of completeness of this information, the auditor should perform the following procedures:

(a) review his working papers for the prior years for the known components

(b) review the parent's procedures for identification of various components

(c) make inquiries of management to identify any new components or any component which goes out of consolidated financial statements

(d) review the investments of parent as well as its components to determine the shareholding in other entities

(e) review the joint ventures and joint arrangements as applicable

(f) review the other arrangements entered into by the parent that have not been included in the consolidated financial statements of the group

(g) review the statutory records maintained by the parent, for example registers under section 186, 190 of the Companies Act, 2013

(h) also identify the changes in the shareholding that might have taken place during the reporting period.

Question 14

CA. Kajal Gupta is nearing completion of audit of consolidated financial statements of Rubic Paints and Chemicals Limited. She requires written representations from the parent's management on matters material to the consolidated financial statements. What specific matters such written representations can include?

Answer 14

The auditor of the consolidated financial statements should obtain written representations from parent 's management on matters material to the consolidated financial statements. Examples of such representations include:

(a) Completeness of components included in the consolidated financial statements;

(b) Identification of reportable segments for segment reporting

(c) Identification of related parties and related party transactions for reporting

(d) Appropriateness and completeness of permanent and current period consolidation adjustments, including the elimination of intra-group transactions.

Question 15

CA.MV Chitale is auditor of consolidated financial statements of "D and D Limited" for year 2022-23. The consolidated financial statements consist of financial statements and financial information of 8 subsidiaries audited by other auditors. Such financial statements, financial information and auditor's reports of subsidiaries have been furnished by management of the "D and D Limited" to him. Following further information is also available in respect of these 8 subsidiaries for year 2022-23: -

Total assets ₹ 1500 crore

Total revenues ₹ 1000 crore

Net cash outflows ₹ 10 crore

Two of these subsidiaries are located outside India whose financial statements have been prepared in accordance with accounting principles generally accepted in their respective countries and which have been audited by other auditors under generally accepted auditing standards applicable in their respective countries.

Where and how such information should be included in independent auditor's report on consolidated financial statements of company? Also draft a suitable para by making necessary assumptions.

Answer 15

In a case where the parent's auditor is not the auditor of all the components included in the consolidated financial statements, then as prescribed in SA 706, if the auditor considers it necessary to make reference to the audit of the other auditors, the auditor's report on the consolidated financial statements should disclose clearly the magnitude of the portion of the financial statements audited by the other auditors. This may be done by stating aggregate rupee amounts or percentages of total assets, revenues and cash flows of components included in the consolidated financial statements not audited by the parent's auditor.

It should be included in Other Matter paragraph of independent auditor's report. The draft "Other Matter Paragraph" is as under: -

Other Matter Paragraph

We did not audit the financial statements and other financial information, in respect of eight (8) subsidiaries, whose financial statements include total assets of Rs.1500 crores as at March 31, 2023, and total revenues of Rs.1,000 crores and net cash outflow of Rs. 10 crores for the year ended on that date. These financial statements and other financial information have been audited by other auditors and such financial statements, other financial information and auditor's reports have been furnished to us by the management of the Holding Company.

Our opinion on the consolidated financial statements, in so far as it relates to the amounts and disclosures included in respect of these subsidiaries and joint ventures, and our report in terms of sub-sections (3) of Section 143 of the Act, in so far as it relates to the aforesaid subsidiaries is based solely on the reports of such other auditors.

Two of these subsidiaries are located outside India whose financial statements and other financial information have been prepared in accordance with accounting principles generally accepted in their respective countries and which have been audited by other auditors under generally accepted auditing standards applicable in their respective countries. The Holding Company's management has converted the financial statements of such subsidiaries from accounting principles generally accepted in their respective countries to accounting principles generally accepted in India.

We have audited these conversion adjustments made by the Holding Company's management. Our opinion in so far as it relates to the balances and affairs of such subsidiaries is based on the report of other auditors and the conversion adjustments prepared by the management of the Holding Company and audited by us.

Our opinion on the consolidated financial statements, and our report on Other Legal and Regulatory Requirements is not modified in respect of the above matters with respect to our reliance on the work done and the reports of the other auditors and the financial statements and other financial information certified by the Management.

Integrated Case Scenario

While auditing consolidated financial statements of YK Industries Limited for the year 2022-23, a manufacturing company whose financial statements are required to be prepared in accordance with Division II of Schedule III of Companies Act, 2013, CA. Palash Shah notices as under: -

a) The notes to accounts in respect of consolidated financial statements disclose additional information pertaining to the holding company and its subsidiaries. It provides disclosure regarding percentages of consolidated net assets, of consolidated profit and loss and of total comprehensive income along with their respective amounts pertaining to holding company and its subsidiaries.

b) It is noticed by him that financial statements of one foreign subsidiary included in consolidated financial statements are drawn up to 31st December, 2022 in accordance with legal requirements in US. He feels it to be weird and is of the view that consolidated financial statements of group could present a distorted picture. The management, in turn, informs him that it is not practicable to draw the financial statements of foreign subsidiary to 31st March, 2023.

c) During the year 2022-23, goodwill of Rs.50 crore had arisen on account of the acquisition of a subsidiary during the year and there is no impairment loss as on the balance sheet date. Besides, adjustments have been made in consolidated financial statements with respect to intra-group indebtedness and those related to harmonizing different accounting policies being adopted by parent and its subsidiaries.

d) It is noticed by him that one subsidiary was acquired on 15.6.22. He is in a dilemma as regards to the correctness of consolidation of its financial statements in group financial statements.

Besides, he is also in the process of finalizing audit report including matters to be reported under CARO, 2020 in respect of consolidated financial statements. However, he is in a fix in respect of manner of reporting under CARO,2020 relating to consolidated financial statements.

Based upon above information and description, answer the following questions: -

1. Considering disclosure of additional information in consolidated financial statements as stated in para (A) of case study, which of the following statements is correct?

a) The said disclosure is not proper as percentage of consolidated revenue from operations along with respective amount pertaining to holding company and its subsidiaries is also required.

b) The said disclosure is not proper as percentage of other comprehensive income along with respective amount pertaining to holding company and its subsidiaries is also required.

c) The said disclosure is not proper as percentages of consolidated revenue from operations as well as other comprehensive income along with their respective amounts pertaining to holding company and its subsidiaries are also required.

d) The said disclosure is proper.

Ans: (b)

2. What should be auditor's proper course of action pursuant to situation highlighted in para [B] relating to financial statements of a foreign subsidiary?

a) The auditor should insist for drawing up of financial statements of foreign subsidiary to 31St March,2023. The reason for impracticality is a mere excuse. In case of failure to redraw, he can modify his opinion in accordance with SA 705.

b) The auditor can accept management's version.

c) The auditor can accept management's version. However, it is his duty to verify adjustments made for effects of significant transactions or events occurring between 1st January 2023 and 31st March,2023.

d) The auditor should modify his opinion by quantifying the financial effects of such an inconsistency.

Ans: (c)

3. Which of the following statements is correct in respect of goodwill and other matters described in the case scenario?

a) Goodwill represents current period consolidation adjustments. Adjustments relating to intra-group indebtedness and those relating to harmonizing different accounting policies being adopted by the parent and its subsidiaries represent permanent consolidation adjustments.

b) Adjustments relating to goodwill, intra-group indebtedness and those relating to harmonizing different accounting policies being adopted by parent and its subsidiaries represent current period consolidation adjustments.

c) Goodwill represents permanent consolidation adjustments. Adjustments relating to intra-group indebtedness and those relating to harmonizing different accounting policies being adopted by the parent and its subsidiaries represent current-period consolidation adjustments.

d) Goodwill and adjustments relating to harmonizing different accounting policies being adopted by the parent and its subsidiaries represent permanent consolidation adjustments. Adjustments relating to intra-group indebtedness represent current- period consolidation adjustments.

Ans: (c)

GROUP AUDITS

4. Which of the following statements is most appropriate regarding consolidation of financial statements of a subsidiary acquired on 15.6.22?

a) The auditor should verify that income and expenses of subsidiary are included in consolidated financial statements from the date it gains control of subsidiary and further such income and expenses are based on the amounts of the assets and liabilities recognized in consolidated financial statements at the acquisition date.

b) The auditor should verify that income and expenses of subsidiary are included in consolidated financial statements for the complete financial year and further such income and expenses are based on the amounts of the assets and liabilities recognized in consolidated financial statements at the preceding reporting date.

c) The auditor should verify that income and expenses of subsidiary are included in consolidated financial statements from the date it gains control of subsidiary and further such income and expenses are based on the amounts of the assets and liabilities recognized in consolidated financial statements at the preceding reporting date.

d) The auditor should verify that income and expenses of subsidiary are included in consolidated financial statements for the complete financial year and further such income and expenses are based on the amounts of the assets and liabilities recognized in consolidated financial statements at the acquisition date.

Ans: (a)

5. As regards reporting under reporting CARO,2020 in respect of consolidated financial statements, which of the following is in accordance with requirements of law

a) A separate report providing Clause by Clause reporting under CARO,2020 is required in respect of specified matters pertaining to parent and all subsidiaries incorporated in India.

b) It would be sufficient if report under CARO,2020 in respect of standalone financial statements is supplemented with additional information in respect of all subsidiaries incorporated in India.

c) A separate report under CARO, 2020 in respect of all subsidiaries incorporated in India together is required. It should be annexed with report under CARO,2020 in respect of standalone financial statements.

d) Reporting of details of subsidiaries together with paragraph numbers of reports under CARO, 2020 of auditors of such companies incorporated in India containing qualifications or adverse remarks would serve the purpose.

Ans: (d)

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CHAPTER

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

Question 1

M/s. S Ltd. is a MSME unit. The company does multiple banking. The company is availing cash credit limit from U Bank of Rs. 25 crores. The limit availed remained less than Rs. 5.00 crores during all the days of F.Y. 2017-18. The company has not done any credit in cash credit account during the year as it is operating current account in newly opened another bank branch adjoining to company premises. The company is having sufficient security of stocks and debtors and DP of Rs.25.00 crores remains all over the year. The company is availing term loans from other bank branches. Now the Bank Manager is insisting to route the sale proceeds through U Bank, otherwise cash credit limit and term loan accounts with other banks will be treated as Non-Performing Accounts. Now company seeks your opinion. (MTP 4 Marks, Aug 18)

Answer 1

Classification of Account as NPA in case of Multiple Banking: If the account remains overdue for more than 90 days, the account becomes Non-Performing Assets. The account will also be called as overdue, if there are not sufficient credits in the cash credit account which even could not serve the interest charged. In this case, there are no credits in accounts, it means interest has not been served in the account. Thus, accounts become overdue after 90 days for non-credit of amounts which could even serve the interest amount. Thus, cash credits will become as NPA if no credits/sale proceeds are deposited in that account.

However, in multiple banking system, each bank is independent for classification of account as NPA. If SBI declares the account as NPA due to non-serving of interest amount, other bank will be free and will not classify the term loan accounts as NPA, if they are regular.

Question 2

INDO Bank appointed your firm of Chartered Accountants as a branch auditor for the financial year 2018-19. Being head-in-charge of the assignment, while planning, you distributed the work among your team members and assigned Mr. Pary for verification of bills payable. However, Mr. Pary, being fresh to the bank audits, needs your guidance. Kindly guide. (MTP 5 Marks, Oct 19)

Answer 2

Bills Payable: Evaluate the existence, effectiveness and continuity of internal controls over bills payable. Such controls should usually include the following-

- Drafts, mail transfers, traveler's cheques, etc. should be made out in standard printed forms.
- Unused forms relating to drafts, traveller's cheques, etc. should be kept under the custody of a responsible officer.

  The bank should have a reliable private code known only to the responsible officers of its branches, coding and decoding of the telegrams should be done only by such offic ers.
- The signatures on a demand draft should be checked by an officer with the specimen signature book.
- All the telegraphic transfers and demand drafts issued by a branch should be immediately confirmed by advices to the branches concerned. On payment of these instruments, the paying branch should send a debit advice to the originating branch.

Examine an appropriate sample of outstanding items comprised in bills payable accounts with the relevant registers. Reasons for old outstanding debits in respect of drafts or other similar instruments paid without advice should be ascertained.

Correspondence with other branches after the year-end (e.g., responding advices received from other branches, advices received from other branches in respect of drafts issued by the branch and paid by the other branches without advice) should be examined specially in so far as large value items outstanding on the balance sheet date are concerned.

Question 3

M/s CAS & Associates have been appointed as one of the statutory central auditors of FDMH Bank., for the Financial Year 2019-20. During the course of the audit, the auditor found that the bank has a balance with a Zurich based bank. The auditor understands that such balance is a matter of important consideration in the audit of the bank. Being head-in-charge of the assignment, while planning, you distributed the work among your team members and assigned Mr. Ansh for verification of Balances in account of the bank situated in foreign country. However, Mr. Ansh, being fresh to the bank audits, needs your guidance. Kindly guide. (MTP 4 Marks, May' 20)

Answer 3

Balances in Account of a Bank situated in a Foreign Country: The following procedure may be followed while verifying balances in account of a bank situated in a foreign country -

(i) Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.

(ii) Review the reconciliation statements and pay particular attention to the following.

(1) Examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken. This should be particularly observed when the bills collected, etc., are credited with net amount and entries for commission, etc. are not made separately in the statement of account.

(2) Examine that no cheque sent or received in clearing is outstanding. As per the practice prevalent among banks, any cheques returned unpaid are accounted for on the same day on which they were sent in clearing or on the following day.

(3) Examine that all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.

(iii) Examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.

(iv) Check original deposit receipts in respect of balances in deposit accounts in addition to confirmation certificates obtained from banks in respect of outstanding deposits.

(v) Check whether these balances are converted into the Indian currency at the exchange rates prevailing on the balance sheet date and ensure compliance with relevant Accounting Standard.

Question 4

In course of audit of Decent Samaritan Bank as at 31st March, 20 you observed the following:

The bank's advance portfolio comprised of significant loans against Life Insurance Policies. Write suitable audit program to verify these advances. (MTP 2 Marks, March' 21, New SM)

Answer 4

The Audit Programme to Verify Advances against Life Insurance Policies is as under-

(i) The auditor should inspect the policies and see whether they are assigned to the bank and whether such assignment has been registered with the insurer.

(ii) The auditor should also examine whether premium has been paid on the policies and whether they are in force.

(iii) Certificate regarding surrender value obtained from the insurer should be examined.

(iv) The auditor should particularly see that if such surrender value is subject to payment of certain premium, the amount of such premium has been deducted from the surrender value.

Question 5

A nationalized bank received an application from an export company seeking sanction of a term loan to expand the existing sea food processing plant. In this connection, the General Manager, who is in charge of Advances, approaches you to conduct a thorough investigation of this limited company and submit a confidential report based on which he will decide whether to sanction this loan or not.

Decide the points you will cover in your investigation before submitting your report to the General Manager. (MTP 5 Marks, March 18)

Answer 5

Investigation on Behalf of the Bank for Advances: A bank is primarily interested in knowing the purpose for which a loan is required, the sources from which it would be repaid and the security that would be available to it, if the borrower fails to pay back the loan. On these considerations, the investigating accountant, in the course of his enquiry, should attempt to collect information on the under mentioned points:

(i) The purpose for which the loan is required and the manner in which the borrower proposes to invest the amount of the loan.

(ii) The schedule of repayment of loan submitted by the borrower, particularly the assumptions made therein as regards amounts of profits that will be earned in cash and the amount of cash that would be available for the repayment of loan to confirm that they are reasonable and valid in the circumstances of the case. Institutional lenders now-a-days rely more for payment of loans on the reliability of annual profits and loss on the values of assets mortgaged to them.

(iii) The financial standing and reputation for business integrity enjoyed by directors and officers of the company.

(iv) Whether the company is authorized by the Memorandum or the Articles of As- sociation to borrow money for the purpose for which the loan will be used.

(v) The history of growth and development of the company and its performance during the past 5 years.

(vi) How the economic position of the company would be affected by economic, political and social changes that are likely to take place during the period of loan.

To investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by the borrower, as well as the value of the security in the form of assets of the business already possessed and those which will be created out of the loan, the investigating accountant should take the under - mentioned steps:

(a) Prepare a condensed income statement from the Statement of Profit and Loss for the previous five years, showing separately therein various items of income and expenses, the amounts of gross and net profits earned and taxes paid annually during each of the five years. The amount of maintainable profits determined on the basis of foregoing statement should be increased by the amount by which these would increase on the investment of borrowed funds.

(b) Compute the under-mentioned ratios separately and then include them in the statement to show the trend as well as changes that have taken place in the financial position of the company:

(i) Sales to Average Inventories held.

(ii) Sales to Fixed Assets.

(iii) Equity to Fixed Assets.

(iv) Current Assets to Current Liabilities.

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(v) Quick Assets (the current assets that are readily realisable) to Quick Liabilities.

(vi) Equity to Long Term Loans.

(vii) Sales to Book Debts.

(viii) Return on Capital Employed.

(c) Enter in a separate part of the statement the break-up of annual sales product- wise to show their trend. Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank- The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

(1) Fixed assets - A full description of each item, its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

(2) Inventory - The value of different types of inventories held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued.

Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of inventory subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.

If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.

(3) Trade Receivables, including bills receivable - Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.

Further, the total amount outstanding at the close of the period should be segregated as follows:

(i) debts due in respect of which the period of credit has not expired;

(ii) debts due within six months; and

(iii) debts due but not recovered for over six months.

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The recoveries out of various debts subsequent to the date of the Balance sheet should be stated.

(4) **Investments -** The schedule of investments should be prepared. It should disclose the date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.

(5) Secured Loans - Debentures and other loans should be included together in a separate schedule.

Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re-payment of a liability should be disclosed.

(6) Provision of Taxation - The previous years up to which taxes have been assessed should be ascertained. If provision for taxes not assessed appears in be inadequate, the fact should be stated along with the extent of the shortfall.

(7) Other Liabilities - It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade payables should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.

(8) Insurance - A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets.

(9) Contingent Liabilities - By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced those of machinery suppliers and the legal adviser, for example, the investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.

(10)The impact on economic position of the company by economic, political and social changes those are likely to take place during the period of loan.

Finally, the investigating accountant should ascertain whether any application for loan to another bank or any other party has been made. If so, the result thereof should be examined.

Question 6

Your firm has been appointed as Central Statutory Auditors of a Nationalized Bank. The Bank follows financial year as accounting year. The bank is a consortium member of Cash Credit Facilities of ` 50 crores to X Ltd Bank's own share is ` 10 crores only. During the last two quarters against a debit of ` 1.75 crores towards interest the credits in X Ltd.'s account are to the tune of ` 1.25 crores only. Based on the certificate of lead bank, the bank has classified the account of X Ltd as performing. Advise your views on the issue which were brought to your notice by your Audit Manager. (MTP 5 Marks, March 18, RTP Nov'18, New SM)

Answer 6

The bank is a consortium member of cash credit facilities of ` 50 crores to X Ltd. Bank's own share is ` 10 crores only. During the last two quarters against a debit of ` 1.75 crores towards interest, the credits in X

Ltd.'s account are to the tune of ` 1.25 crores only. Sometimes, several banks form a group (the 'consortium') under the leadership of a 'lead bank' to make advance to a large customer on same conditions and security with proportionate rights. In such cases, each bank may classify the advance given by it according to its own experience of recovery and other factors. Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as nonperforming asset.

Question 7

M/s Aadi & Co., Chartered Accountants, have been allotted the branch audit of a nationalized bank for the year ended 31st March, 2021. You are part of audit team and have been instructed by your partner to verify the following areas:

(i) Fulfilment of the criteria prescribed for NPA norms for government guaranteed advance.

(ii) Fulfilment of the criteria prescribed for NPA norms for the advances given for agricultural purposes.

(iii) Drawing power calculation from stock statements in respect of working capital accounts.

(iv) Accounts where regular/ad hoc limits are not reviewed within 180 days from the due date/ date of ad hoc sanction. What may be your areas of concern as regards matters specified above? (MTP 6 Marks Oct 21)

Answer 7

Area of Focus	Suggested Audit Procedures
Government Guaranteed Advances	• If government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realized. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked. This exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days. • In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.

Agricultural Advances	• Ensure that NPA norms have been applied in accordance with the crop season determined by the State Level Bankers' Committee in each State. Depending upon the duration of crops – short term/ long term - raised by an agriculturist, the NPA norms would also be made applicable to agricultural term loans availed of by them. Also ensure that these norms are made applicable to all direct agricultural advances listed in Master Circular on lending to priority sector.
	• In respect of agricultural loans, other than those specified in the circular, ensure that identification of NPAs has been done on the same basis as non- agricultural advances.
Drawing Power Calculation	• Ensure that the drawing power is calculated as per the extant guidelines (i.e. the Credit Policy of the Bank) formulated by the Board of Directors of the respective bank and agreed upon by the concerned statutory auditors. Special consideration should be given to proper reporting of sundry creditors for the purposes of calculating drawing power. • The stock audit should be carried out by the bank for all accounts having funded exposure of more than stipulated limit. The report submitted by the stock auditors should be reviewed during the course of the audit and special focus should be given to the comments made by the stock auditors on valuation of security and calculation of drawing power. The drawing power needs to be calculated carefully in case of working capital advances to companies engaged in construction business. The valuation of work in progress should be ensured in consistent and proper manner. It also needs to be ensured that mobilization advance being received by the contractors is reduced while calculating drawing power.
Limits not reviewed	Accounts where regular/ad hoc limits are not reviewed within 180 days from the due date/date of ad hoc sanction, should be considered as NPA. Auditors should also ensure that the ad hoc/short reviews are not done on repetitive basis. In such cases, auditor can consider the classification of account based on other parameters and functioning of the account.

Question 8

You are auditing a small bank branch with staff strength of the manager, cashier and three other staff P, Q and R. Among allocation of work for other areas, P who is a peon also opens all the mail and forwards it to the concerned person. He does not have a signature book so as to check the signatures on important communications. Q has possession of all bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.). He maintains a record meticulously which you have test checked also. However, no one

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among staff regularly checks that. You are informed that being a small branch with shortage of manpower, it is not possible to always check the work and records. Give your comments. (MTP 5 Marks Nov 21 & April '23, Old & New SM, RTP May'21)

Answer 8

Banks are required to implement and maintain a system of internal controls for mitigating risks, maintain good governance and to meet the regulatory requirements. Given below are examples of internal controls that are violated in the given situation:

In the instant case, P who is a peon opens all the mail and forwards it to the concerned person. Further, he does not have a signature book so as to check the signatures on important communications is not in accordance with implementation and maintenance of general internal control. As the mail should be opened by a responsible officer. Signatures on all the letters and advices received from other branches of the bank or its correspondence should be checked by an officer with the signature book.

All bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.) should be kept in the possession of an officer, and another responsible officer should verify the issuance and stock of such stationery. In the given case, Q has possession of all bank forms (e.g. cheque books, demand draft/pay order books, travelers' cheques, foreign currency cards etc.). He maintains a record meticulously which were also verified on test check basis.

Further, contention of bank that being a small branch with shortage of manpower they are not able to check the work and records on regular basis, is not tenable as such lapses in internal control pose risk of fraud.

The auditor should report the same in his report accordingly.

Question 9

Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The Bank follows financial year as accounting year. Your Audit Manager informed that the bank has recognised on accrual basis income from dividends on securities and Units of Mutual Funds held by it as at the end of financial year. The dividends on securities and Units of Mutual Funds were declared after the end of financial year.

Comment. (MTP 4 Marks April 22, MTP 4 Marks Oct'18, RTP Nov'18, Old & New SM)

Answer 9

Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its annual general meeting and the owner's right to receive payment is established. This is also in accordance with AS 9. In this case the dividends have been declared after the financial year end. Therefore, the re cognition of income by the bank on accrual basis is not in order.

In respect of income from government securities and bonds and debentures of corporate bodies, where interest rates on these instruments are pre-determined, income could be booked on accrual basis, provided interest is serviced regularly and as such is not in arrears. It was further, however, clarified that banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the Central Government or a State Government.

Question 10

CA Ram have been doing audit of branch of RICH Bank Ltd. The principal business of the branch is lending advances to large corporates. Since last one year, many large accounts have become Non-Performing Asset (NPA) as per guidelines. The Management of the Bank decided to sell one of the NPA account and consequently one NPA namely Shiva Ltd. amounting to ` 11.00 Crore was sold to Asset Reconstruction Company. What audit points CA Ram should keep in mind while doing audit of this transaction? (MTP 4 Marks Sep 22, PYP 5 Marks Jan'21)

Answer 10

CA. Ram conducting audit of branch of RICH Bank Ltd. whose principal business is lending money to large corporates. Many large accounts of this branch have turned NPA category and Management sold Shiva Ltd.'s NPA account amounting to ` 11 Crore to Asset Reconstruction Company.

CA. Ram should proceed as under:

In case of Sale of NPA by Bank, the auditor should examine

(i) the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers.

(ii) only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.

(iii) the assets have been sold "without recourse' only.

(iv) subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.

(v) the NPA has been sold at cash basis only.

(vi) on the sale of the NPA, the same has been removed from the books of the account.

(vii) the short fall in the net book value has been charged to the profit and loss account.

(viii) where the sale is for a value higher than the NBV, no profit is recognized and the excess provision has not been reversed but retained to meet the shortfall/ loss because sale of other non-performing financial assets.

Question 11

You are part of engagement team conducting statutory audit of a branch of nationalized bank. During the course of audit, it has come to your notice that there are large number o f cash credit accounts in the branch. Many of the cash credit accounts are only partially utilized during

substantial part of year. However, in the month of March, the accounts are fully utilized. On further scrutiny, it is observed that these account holders have made fixed deposits from these utilized amounts at the end of year. These deposits have been liquidated in first week of April of next financial year. Comment upon how this situation would be dealt by you as a statutory branch auditor? (MTP 4 Marks Oct '22)

Answer 11

In the given case, many of the cash credit accounts in the branch of a nationalized bank are only partially utilized during substantial part of year. However, in the month of March, the accounts are fully utilized. On further scrutiny, it is observed that these account holders have made fixed deposits from these utilized amounts at the end of year. These deposits have been liquidated in first week of April of next financial year.

This is an example of window dressing. The branch is resorting to window dressing by artificially boosting its advances and deposits. Utilization of advances and placing of fixed deposits at end of year in branch and again liquidation of deposits early next year indicate that branch is resort ing to window dressing to inflate its advances as well as deposits artificially.

The auditor has to verify whether the unavailed portion of the credit facilities (overdraft, cash credit) are used to boost the loans and deposits which might tantamount to window dressing.

The relevant regulatory guidelines also prohibit such type of practices and these might involve penal action in terms of Banking Regulation Act, 1949.

The same needs to be suitably reported in audit report and commented in LFAR also. In appropriate cases, making a suitable qualification in the main audit report has also to be considered

Question 12

In course of audit of Great Samaritan Bank as at 31st March, 2022 you observed the following:

I. In a particular account there was no recovery in the past 18 months. The bank has not applied the NPA norms as well as income recognition norms to this particular account. When queried the bank management replied that this account was guaranteed by the central government and hence these norms were not applicable. The bank has not invoked the guarantee. Please respond. Would your answer be different if the advance is guaranteed by a State Government? (MTP 4 Marks March '23, MTP 4 Marks Mar'21, MTP 4 Marks Apr'18, MTP 5 Marks Apr'19, RTP Nov'19, RTP May'20, New SM)

II. In the course of audit of Bank, you found that the Bank had sold certain of its non-performing assets.

Mention any two points of audit check that are very relevant to this area of checking. (MTP 2 Marks March '23)

Answer 12

(i) Government Guaranteed Advance: If a government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realized. However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked.

Since the bank has not invoked the guarantee, the question of repudiation does not arise. Hence the bank is correct to the extent of not applying the NPA norms for provisioning purpose. But this exemption is not available in respect of income recognition norms. Hence the income to the extent not recovered should be reversed.

The situation would be different if the advance is guaranteed by State Government because this exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days.

In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.

(ii) In case of Sale of NPA by Bank, the auditor should examine

(1) the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers.

(2) only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.

(3) the assets have been sold "without recourse' only.

(4) subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.

(5) the NPA has been sold at cash basis only.

(6) on the sale of the NPA, the same has been removed from the books of the account.

(7) the short fall in the net book value has been charged to the profit and loss account.

(8) where the sale is for a value higher than the NBV, no profit is recognised and the excess provision has not been reversed but retained to meet the shortfall/ loss because sale of other non-performing financial assets.

Question 13

Advances generally constitute the major part of the assets of the bank. There are substantial number of borrowers to whom a variety of advances are granted. The audit of advances requires major attention from the auditors. As an expert in bank audit, you are required to briefly discuss the area of focus and suggested audit procedures regarding the evaluation of internal controls over advances, substantive audit procedures and recoverability of advances. (5 Marks Sep '23) (RTP May 18)

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Answer 13

Audit Procedures - In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

Area of Focus	Suggested Audit Procedures
Evaluation of Internal Controls over Advances	• Examine loan documentation. • Examine the validity of the recorded amounts. • Examine the existence, enforceability and valuation of the security. • Ensure compliance with the terms of sanction and end use of funds. • Ensure compliance with Loan Policy of Bank as well as RBI norms including appropriate classification and provisioning • Review the operation of the accounts.
Substantive Audit Procedures	• Check that the advances represent amount due to the bank. • Verify that the advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements. • Check that appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices. • Examine all large advances while other advances may be examined on a sample basis. • Verify completeness and accuracy of interest being charged.
	• Ensure that there are no unrecorded advances. • Check that the stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation. • Check whether the amounts included in the balance sheet are outstanding as on the date of balance sheet. • Verify completeness and accuracy of interest being charged.
Recoverability of Advances	• Review periodic statements submitted by the borrowers indicating the extent of compliance with terms and conditions. • Review latest financial statements of borrowers. • Review reports on inspection of security. • Review Auditors' reports in the case of borrowers enjoying aggregate credit limits of Rupees 10 lakh or above for working capital from the banking system.

Question 14

CA X is conducting concurrent audit of a branch of MNB Bank (a nationalized bank) in industrial hub of Pune. It is a CBS branch, and its advances are to the tune of about ` 500 crores. The branch has borrowers / customers with cash credit, term loans, and export credit facilities, including pre - shipment and postshipment credits. Some customers in the branch are importers who regularly get letters of credit issued to foreign suppliers. During tenure of Mr. X as concurrent auditor, fresh credit facilities under aforesaid segments are being sanctioned every month to new customers. The branch is also considering requests of its existing customers for enhancements / fresh requirements in line with established norms.

As a result of the above, the staff of the advances department in the branch is always on its toes. The previous regular inspection of the branch (not pertaining to CA X's tenure) had pointed out huge revenue leakage in advances of the branch, raising alarm bells in the Zonal Office and Inspection Department.

Keeping in view the above situation, CA X is taking steps to ensure that there is no revenue leakage in advances of the branch and recoveries are made on the spot in case such leakages are detected. Discuss any five areas in this regard where concurrent auditor's audit procedures should be focused. (MTP 5 Marks Oct '23)

Answer 14

The major areas to plug revenue leakage where concurrent auditor should focus audit procedures include: -

(i) Verifying rates of interest as per terms of sanction in sanction letter vis-à-vis those fed in CBS as well as the calculation of interest through product rate sheets generated by CBS t o satisfy that interest has been charged on all the performing accounts and interest rates charged are in accordance with the bank's internal regulations, directives of the RBI and agreements with the respective borrowers.

(ii) Verification of renewal charges in respect of existing customers enjoying cash credit and export credit facilities. Similarly, for fresh borrowers, proposal processing charges, including upfront fees for term loan, needs to be verified in accordance with Bank's circulars to ensure that all charges are debited at time of release of facilities to new customers. These charges also need to be levied proportionately in respect of customers whose credit facilities have been enhanced.

(iii) Verification of penal charges for non-submission of stock statements on due dates in case borrowers availing cash credit and export credit facilities consisting of pre-shipment credit facilities.

(iv) Verification of commission /charges in case of letter of credit has been issued to importers in accordance with the Bank's circulars.

(v) As the branch has also granted export credit facilities in the nature of post -shipment credit facilities, verification of commission/charges on export bills purchased is required.

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Question 15

(a) ABC Chartered Accountants have been appointed as concurrent auditors for the branches of Effective Bank Ltd. for the year 2017-18. You are part of the audit team for Agra branch of the bank and have been instructed by your senior to verify the advances of the audit period. You are required to guide your assistant about the areas to be taken care while doing verification during the concurrent audit. (New SM)

(b) Write a short note on reversal of income under bank audit.(RTP May 19)

Answer 15

(a) Verification of Advances as a Concurrent Auditor:

(i) Ensure that loans and advances have been sanctioned properly (i.e. after due scrutiny and at the appropriate level).

(ii) Verify whether the sanctions are in accordance with delegated authority.

(iii) Ensure that securities and documents have been received and properly charged/ registered.

(iv) Ensure that post disbursement supervision and follow-up is proper, such as receipt of stock statements, instalments, renewal of limits, etc.

(v) Verify whether there is any mis utilisation of the loans and whether there are instances indicative of diversion of funds.

(vi) Check whether the letters of credit issued by the branch are within the delegated power and ensure that they are for genuine trade transactions.

(vii) Check the bank guarantees issued, whether they have been properly worded and recorded in the register of the bank. Whether they have been promptly renewed on the due dates.

(viii) Ensure proper follow-up of overdue bills of exchange.

(ix) Verify whether the classification of advances has been done as per RBI guidelines.

(x) Verify whether the submission of claims to DICGC and ECGC is in time.

(xi) Verify that instances of exceeding delegated powers have been promptly reported to controlling/ Head Office by the branch and have been got confirmed or ratified at the required level.

(xii) Verify the frequency and genuineness of such exercise of authority beyond the delegated powers by the concerned officials.

(b) Reversal of Income: If any advance, including bills purchased and discounted, becomes Non-Performing Assets as at the close of any year, the entire interest accrued and credited to income account in the past periods, should be reversed or provided for if the same is not realised. This will apply to Government guaranteed accounts also.

In respect of NPAs, fees, commission and similar income that have accrued should cease to accrue in the current period and should be reversed or provided for with respect to past periods, if uncollected.

Further, in case of banks which have wrongly recognised income in the past should reverse the interest if it was recognised as income during the current year or make a provision for an equivalent amount if it was recognised as income in the previous year(s).

Question 16

While auditing FAIR Bank, you observed that a lump sum amount has been disclosed as contingent liability collectively. You are, therefore, requested by the management to guide them about the disclosure requirement of Contingent Liabilities for Banks. (RTP Nov 19, New SM)

Answer 13

Contingent Liabilities for Banks: The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of the following as a footnote to the balance sheet-

(A) Contingent liabilities

(i) Claims against the bank not acknowledged as debts.

(ii) Liability for partly paid investments.

(iii) Liability on account of outstanding forward exchange contracts.

(iv) Guarantees given on behalf of constituents-

(1) In India.

(2) Outside India.

(v) Acceptances, endorsements and other obligations.

(vi) Other items for which the bank is contingently liable.

(B) Bills for collection.

Question 14

ABN Bank was engaged in the business of providing Portfolio Management Services to its customers, for which it took prior approval from RBI. Your firm has been appointed as the statutory auditors of the Bank's financial statements for the year 2019-20. Your senior has instructed you to verify the transactions of Portfolio Management Services (PMS). While verifying the transactions you noticed that the bank has not maintained separate record for PMS transactions from the Bank's own investments. As a statutory auditor what methodology will be adopted by you for verification of PMS transactions? (RTP Nov 20)

Answer 14

Separation of Investment Functions: The auditor needs to examine whether the bank, as required by the RBI, is maintaining separate accounts for the investments made by it on their own Investment Account, PMS clients' account, and on behalf of other Constituents (including brokers). As per the RBI guidelines, banks are required to get their investments under PMS separately audited by external auditors.

Thus, in the instant case, ABN Bank is required to prepare separate records for PMS and as per RBI guidelines PMS investments need to be audited separately by the external auditors and the auditors are required to give a certificate separately for the same. So, in the above case the auditor should not verify the PMS transactions and advise the bank to segregate the PMS transactions from its own investments and provide the certificate of external auditor as described above. In case ABN Bank does not provide the same the auditor may report accordingly.

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

Question 15

Gupta & Co. has been appointed as a statutory auditor of TCB Bank Ltd., a private sector bank, registered with RBI. Mr. Kaival Gupta, the engagement partner, while performing the audit as per the checklist, noted down the following points, which would be part of the audit queries, as tabulated below:

Sr. No.	Queries
1	Interest on State Government Guaranteed advance has been taken to income even though such advance has remained overdue for more than 90 days.
2	There is an account for which an ad hoc limit has not been reviewed for 180 days from the date of such ad hoc sanction and such account has been treated as a performing asset in the books.
3	One of the NPAs was sold for a value higher than the net book value. Profit was not recognized but the excess provision in respect of the same has been reversed.
4	In case of one of the accounts, an additional temporary limit has been sanctioned for 25% of the existing limit and for 120 days tenure.
5	On verification of outstanding forward exchange contracts, the 'net position' in respect of one of the foreign currencies was not squared and was uncovered by a substantial amount.

You are required to provide the reasons due to which such queries would have been raised by Mr. Kaival and describe the actions that may be taken by the person responsible on behalf of TCB Bank Ltd. for solving such queries. . (RTP Nov '21)

Answer 15

Sr. No.	Reason for such Query	Action that may be taken in response to the query
1	A State Government Guaranteed advance has to be treated as NPA even if it remains overdue for more than 90 days and in case of NPA, for the purpose of income recognition, interest on such advance should not be taken to income unless interest is realized.	Interest income recognized on such advance would be reversed and would be taken to income only when it is realized.
2	Accounts for which an ad hoc limit has not been reviewed for 180 days from the date of such ad hoc sanction, should be considered as NPA.	It's treatment in the books would be changed from performing asset to a non-performing asset from the date when such change in the treatment was required.

3	In case of sale of NPA, where the sale is for a value higher than the NBV, the auditor is required to ensure that no profit is recognized, and the excess provision has not been reversed but retained to meet the shortfall/ loss that may arise because of the sale of other non-performing financial assets.	The entry for reversal of the excess provision would be cancelled in the books and such excess provision would be retained to meet the shortfall/ loss that may arise because of the sale of other non-performing financial assets.
4	Additional temporary limit may be sanctioned, for a maximum of 20% of the existing limit and 90 days maximum tenure.	The terms of additional temporary limit in case of such account would be revised to 20% of the existing limit and for 90 days maximum tenure.
5	Net position in respect of each of the foreign currencies should be generally squared and should not be uncovered by a substantial amount.	The net "position" of the branch in relation to each foreign currency should be squared off and get covered by a substantial amount.

Question 16

CA Prachi was conducting statutory audit of branch of a nationalized bank for the year 2021-22. While reviewing operations and documents/papers of a borrower enjoying overdraft credit facilities of ` 50 crore (availed against security of stocks and book debts), following observations were jotted down by her: -

(i) The balance in overdraft credit facility as on 31st March,2022 was ` 55.65 crore. The balance in account exceeded sanctioned limit during the whole month of March 2022.

(ii) As per terms of sanction letter, stock/book debt statements were required to be submitted monthly.

Latest available stock/book debt statement for the month of February, 2022 showed drawing power of ` 48.50 crore only. However, stock/book debt statements of previous months showed adequate drawing power.

(iii) Stock audit of borrower was also conducted during the year by one of empanelled stock auditors of the bank. Stock audit report dated 31st December,2021 placed on the record showed adequate drawing power in the account. However, it has commented adversely on the declining turnover of borrower in year 2021 -22(till the date of stock audit report) as compared to proportionate turnover in preceding year.

(iv) The renewal of overdraft facilities was due on 20th October,2021. The account was short renewed by competent authority for a period of 3 months pending submission of complete papers.

However, borrower has not submitted complete renewal papers till 31 st March,2022. There is a request letter from borrower on record stating that valuation report of a property located at a faraway location was taking time.

The branch has classified the account as 'Standard Asset'. Considering above, CA Prachi is in dilemma relating to proper classification of above advance. Guide her. .(RTP Nov'22)

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

Answer 16

The borrower was enjoying overdraft credit facilities of ` 50 crore against security of stocks and debts. Further, though latest available stock statement for the month of February, 2022 showed inadequate drawing power, there was adequate drawing power available throughout the year. Stock audit report dated 31.12.2021 also reflected adequate drawing power. Hence, it shows that borrower had adequate drawing power during the year. Further, comment on declining sales is of general informative value to management for making credit decisions.

The fact of over drawings in account during the month of March, 2022 and inadequate drawing power in a month are in nature of temporary deficiencies and do not require account to be classified as NPA in accordance with asset classification and provisioning norms of RBI.

RBI instructions lay down that ordinarily credit limits need to be reviewed not later than three months from the due date. As per Guidance note on Audit of Banks, in case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/ review of credit limits is underway and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the credit limits have not been reviewed/ renewed within 180 days from the due date will be treated as NPA.

It would be pertinent to note that the counting of 180 days would be required to be done from the date of original due date for renewal and not from the date of expiry of short reviews / technical reviews. In the instant case, the original date of renewal was 20th October, 2021 and period of 180 days has still not expired as on balance sheet date.

Keeping in view all above factors, CA Prachi should accept classification of account as 'Standard Asset' made by branch.

Question 17

BOT Limited is enjoying cash credit facility sanctioned from Nariman Point, Mumbai branch of KNB Bank for `250 crore. However, for practical considerations, various sub-limits have been fixed for the borrower company for operation at Solapur, Pune and Nashik branches of the same bank.

The manager of the Solapur branch notices that there are no credit transactions in sub - limit account being operated at the Solapur branch for more than 90 days as on 31st March,2022.

Discuss the approach of CA. Muni, statutory branch auditor of Nariman Point branch, Mumbai of KNB Bank, in the matter of asset classification of the above borrower account. Also discuss considerations for classifying said account at the Solapur branch. (RTP May '23)

Answer 17

Sometimes, a customer is sanctioned a cash credit limit at one branch but is authorized to utilize such overall limit at several other branches also, for each of which a sub-limit is fixed.

In such a case, the determination of status of the account as NPA or otherwise should be determined at the limit-sanctioning branch with reference to the overall sanctioned limit/drawing power and not by each of the other branches where a sub-limit has been fixed.

The auditor of the limit-sanctioning branch should examine whether it receives particulars of all transactions in the account at sub-limit branches and whether status of the account has been determined considering the total position of operation of the account at all concerned branches. The standalone matter of no credit transactions for more than 90 days as on 31st March,2022 at Solapur branch is irrelevant.

Hence, keeping in view above, CA. Muni should consider asset classification considering the total position of operation of the account at all concerned branches.

Regarding sub-limit at branches, the classification adopted by the limit-sanctioning branch should be followed. Hence, the Solapur branch has to follow asset classification made by the limit-sanctioning branch.

Question 18

PQS & Associates are one of the joint auditors of KNO Bank for the year 2022 -23. While auditing KNO Bank, they are analysing industry data relating to NPAs in select public sector banks as part of risk assessment procedures: -

Name of Bank	Gross NPAs (in ` crore)	Net NPAs (in ` crore)	Ratio of Net NPAs to Net advances
BBI Bank	55,000	13,000	1.72%
DAB Bank	45,000	10,000	2.34%
CNI Bank	55,000	18,000	2.65%
KNO Bank	28,000	6,500	3.97%
BRB Bank	35,000	8,800	2.27%

In the above context, what do you understand by "Gross NPAs" and "Net NPAs" as on reporting date in the context of financial statements of a Bank? As an auditor of KNO Bank, what inference would you draw by comparing the "Ratio of net NPAs to net advances" with other public sector banks?(RTP Nov '23)

Answer 18

Gross NPAs represent opening balances of NPAs as increased by fresh NPAs during the year and reduced by upgradations, recoveries and write-offs during the year.

Net NPAs are arrived at after deducting amounts on account of the total provision held against NPAs/ balance in the interest suspense account to park accrued interest on NPAs and certain other adjustments.

The Net NPAs to Net advances ratio is higher in the case of KNO Bank as compared to other public sector banks. It shows that there is a risk that the bank could not have made the required provisions

in accordance with RBI guidelines. A higher net NPAs to Net advances ratio indicates the probability and risk of under-provisioning. Keeping in view the above, audit procedures have to be tailored towards the examination and verification of this crucial area.

Question 19

CA. Sundaram is an engagement partner conducting a statutory audit of a nationalised bank. The bank operates on the CBS platform, and the identification of NPAs is system based in accordance with RBI guidelines on asset classification. He wants to be assured of satisfactory operation of internal control in this respect. He wants to be sure that there exists an internal control system in the bank which not only prevents and reduces the risk of loan assets becoming non-performing at the initial stages but also sends out timely signals to the bank subsequently. He is putting considerable importance on effective credit appraisals due to their role in preventing NPA slippages.

While carrying out a walk-through of internal control over advances of banks especially in areas of "credit appraisals" and "credit monitoring", identify any four specific controls which you may be looking for. (RTP Nov '23)

Answer 19

The following controls may be considered by auditor in areas of credit appraisals and credit monitoring for ensuring that internal control over advances is effective and the system is capable of not only preventing and reducing the risk of NPAs at the sanction stage itself but also sending out timely signals to the bank subsequently.

(i) Use of third-party data sources in the bank for comprehensive due diligence at the sanction stage itself to mitigate risk on account of misrepresentation and fraud.

(ii) Classification of accounts as special mentioned accounts (SMA) for early recognition of signs of incipient stress resulting in default in timely servicing of debt obligations. It can enable banks to initiate timely remedial actions to prevent potential slippages into NPAs.

(iii) Institution of comprehensive, automated Early Warning Systems (EWS) in banks with EWS triggers to detect stress and reduce slippage into NPAs

(iv) Reporting of repayment behaviour of borrowers in their loan accounts to credit information companies and inclusion of this information in the credit appraisal and decision-making process for further sanctioning of loans to borrowers.

Question 20

In the course of audit of Skip Bank Ltd., you found that the Bank had sold certain of its non-performing assets. Draft the points of audit check that are very relevant to this area of checking. (PYP4 Marks, May '18, New SM)

Answer 20

Sale of Non-Performing Assets: In case of Sale of NPA by Bank, the auditor should examine:

- the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers.
- that only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.
- the assets have been sold/ purchased "without recourse' only.
- subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.
- the NPA has been sold at cash basis only.
- the bank has not purchased an NPA which it had originally sold.
- that on the sale of the NPA, the same has been removed from the books of the account.
- that the short fall in the net book value has been charged to the profit and loss account.
- that where the sale is for a value higher than the NBV, no profit is recognized and the excess provision has not been reversed but retained to meet the shortfall/ loss because sale of other nonperforming financial assets.

Question 21

Banks, because of certain characteristics, are distinguished from other commercial enterprises and hence it needs special audit consideration. As an auditor of a bank, specify the various peculiarities which may necessitate special audit consideration to be taken care by you. (PYP 4 Marks, May '19, Old & New SM)

Answer 21

Special audit considerations arise in the audit of banks because of:

(i) the particular nature of risks associated with the transactions undertaken;

(ii) the scale of banking operations and the resultant significant exposures which can arise within short period of time;

(iii) the extensive dependence on IT to process transactions;

(iv) the effect of the statutory and regulatory requirements;

(v) the continuing development of new products and services and banking practices which may not be matched by the concurrent development of accounting principles and auditing practices;

(vi) Evolution of technology and providing services through Net Banking and Mobiles has exposed banks to huge operational and financial risk.

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

The auditor should consider the effect of the above factors in designing his audit approach. It is imperative for Branch Auditor and SCAs to have detailed knowledge of the products offered and risks associated with them, and appropriately address them in their audit plan to the extent they give rise to the risk of material misstatements in the financial statements. In today's environment, the banks use different applications to carry out different transactions which may include data flow from one application to other application; the auditor while designing his plans should also understand interface controls between the various applications.

Question 22

In the course of statutory Branch audit of KS Bank Ltd, you observe that some borrower accounts have been regularized before Balance sheet date by payment of overdue amount. Narrate the audit procedures to be carried out with special focus on the Classification of advances and Provisioning for Non-Performing assets of the Branch. (PYP 5 Marks, Nov '20)

Answer 22

The Audit procedures that need to be carried out with special focus on classification of advances and provisioning for NPAs of KS Bank Ltd, in which the auditor has observed that some borrower accounts have been regularized before balance sheet date by payment of overdue amount shall be carried out as under:

(i) As per the Reserve Bank guidelines, if an account has been regularized before the balance sheet date by payment of overdue amount through genuine sources, the account need not be treated as NPA.

(ii) Where subsequent to repayment by the borrower (which makes the account regular), the branch has provided further funds to the borrower (including by way of subscription to its debentures or in other accounts of the borrower), the auditor should carefully assess whether the repayment was out of genuine sources or not.

(iii) Where the account indicates inherent weakness based in the data available, the account shall be deemed as a NPA.

Classification and Provision

a. Examine whether the classification made by the branch is appropriate. Particularly, examine the classification of advances where there are threats to recovery.

b. Examine whether the secured and the unsecured portions of advances have been segregated correctly and provisions have been calculated properly.

c. It is to be ensured that the classification is made as per the position as on date and hence classification of all standard accounts be reviewed as on balance sheet date.

d. The date of NPA is significant to determine the classification and hence specific care be taken in this regard.

e. NPA should be recognized only based on concept of Past Due/ Overdue concept, and not based on the Balance Sheet date.

Question 23

You have been appointed as Concurrent auditor of one of the branches of Coin Bank Ltd. This branch is dealing mainly in foreign exchange. State the suggested audit procedures to be covered by you to check the foreign exchange transactions of this branch while doing Concurrent audit. (PYP 5 Marks Dec '21, PYP 4 Marks, Nov '18, New SM)

Answer 23

Suggested audit procedure to be covered by the Concurrent Auditor to check the foreign exchange transactions of one of the branches of Coin Bank Ltd is given hereunder:

- Check foreign bills negotiated under letters of credit.
- Check FCNR and other non-resident accounts whether the debits and credits are permissible under rules.
- Check whether inward/outward remittance have been properly accounted for.
- Examine extension and cancellation of forward contracts for purchase and sale of foreign currency.

  Ensure that they are duly authorized and necessary charges have been recovered.
- Ensure that balances in Nostro accounts in different foreign currencies are within the limit as prescribed by the bank.
- Ensure that the overbought/oversold position maintained in different currencies is reasonable, considering the foreign exchange operations.
- Ensure adherence to the guidelines issued by RBI/HO of the bank about dealing room operations.
- Ensure verification/reconciliation of Nostro and Vostro account transactions/ balances.

Question 24

Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank for the financial year 2021-22. During the course of audit your audit team observed that a lump sum amount has been disclosed as Contingent Liability collectively though the components are correctly identified. In respect of contingent liabilities, the auditor is primarily, concerned with seeking reasonable assurance that all the contingent liabilities are identified and properly valued and the audit firm intends to obtain a representation from the 'management. Highlight the points/checklists that are to be covered in the management representation. (PYP 5 Marks May '22, RTP Nov'19)

Answer 24

Contingent Liabilities: In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. The auditor should obtain representation from management that: -

(i) all off-balance sheet transactions have been accounted in the books of accounts as and when such transaction has taken place;

(ii) all off balance sheet transactions have been entered into after following due procedure laid down;

(iii) all off balance sheet transactions are supported by the underlying documents;

(iv) all year end contingent liabilities have been disclosed;

(v) the disclosed contingent liabilities do not include any crystallised liabilities which are of the nature of loss/ expense and which, therefore, require creation of a provision/adjustment in the financial statements;

(vi) the estimated amounts of financial effect of the contingent liabilities are based on the best estimates in terms of Accounting Standard 29, including consideration of the possibility of any reimbursement;

(vii) in case of guarantees issued on behalf of the bank's directors, the bank has taken appropriate steps to ensure that adequate and effective arrangements have been made so that the commitments would be met out of the party's own resources and that the bank will not be called upon to grant any loan or advances to meet the liability consequent upon the invocation of the said guarantee(s) and that no violation of section 20 of the Banking Regulation Act, 1949 has arisen on account of such guarantee; and

(viii) such contingent liabilities which have not been disclosed on account of the fact that the possibility of their outcome is remote include the management's justification for reaching such a decision in respect of those contingent liabilities.

Note: Students may be given due credit for any other relevant point quoted.

Question 25

You have been appointed as an Auditor of LOC Bank, a nationalized bank. LOC Bank also deals in providing credit card facilities to its account holders. The bank is aware of the fact that there should be strict control over the storage and issuance of credit cards. How will you evaluate the internal control system in the area of credit card operations of the Bank? (PYP 5 Marks Nov 22, PYP 5 Marks, Nov '19, Old & New SM, MTP 6 Marks, Oct 20, RTP May'22)

Answer 25

Credit Card Operations System of Internal Control in Banks: The auditor should evaluate the internal control in the area of credit card operations of LOC Bank as under:

- There should be effective screening of applications with reasonably good credit assessments.
- There should be strict control over storage and issue of cards.
- There should be a system whereby a merchant confirms the status of unutilized limit of a credit-

card holder from the bank before accepting the settlement, in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.

- There should be a system of prompt reporting by the merchants of all settlements accepted by them through credit cards.
- Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.
- All the reimbursement (gross of commission) should be immediately charged to the customer's account.
- There should be a system to ensure that statements are sent regularly and promptly to the customer.
- There should be a system to monitor and follow-up customers' payments.
- Payments overdue beyond a reasonable period should be identified and attended to carefully. For defaulting customers, credit should be stopped by informing the merchants through periodic bulletins, as early as possible, to avoid increased losses.
- There should be a system of periodic review of credit card holders' accounts. On this basis, the limits of customers may be revised, if necessary. The review should also include determination of doubtful amounts and the provisioning in respect thereof.

Question 26

M/s GH & Associates have been appointed as Central Statutory Auditors of BNB Bank, a nationalized bank, headquartered in New Delhi for the F.Y 2020 -2021. Bank functions in automated environment using "FLC Software". While preparing audit report, one of the partner highlighted that some matters covered by Companies Act, 2013 and the requirements of Companies (Auditor's Report), Order, 2016 reporting:

You are required to answer the following:

(i) To which authority auditors should submit their audit report?

(ii) List the matters covered under Companies Act, 2013 and

(iii) Reporting under Companies (Auditor's Report), Order, 2016. (PYP 5 Marks July 21)

Answer 26

(i) Authority to whom Auditors to submit their Audit Report -

In the case of a nationalised bank, the auditor is required to make a report to the Central Government. So, GH & Associates, Central Statutory Auditors of BNB Bank- a nationalized bank, would be required to submit their report to Central Govt.

(ii) The auditor of a banking company is also required to state in the report the matters covered by Section 143 of the Companies Act, 2013.

1. Report on adequacy and operating effectiveness of Internal Controls over Financial Reporting in case of banks which are registered as companies under the Companies Act in terms of Section 143(3)(i) of the Companies Act, 2013 which is normally to be given as an Annexure to the main audit report as per the Guidance Note on Audit of Internal Financial Controls over Financial Reporting issued by the ICAI.

2. Report on whether any serious irregularity was noticed in the working of the bank which requires immediate attention (in accordance with sec 143(12) of the Companies Act, 2013.)

3. As per reporting requirements cast through Rule 11 of the Companies (Audit and Auditors) Rules, 2014 the auditor's report shall also include their views and comments on the following matters, namely:

(a) Whether the bank has disclosed the impact, if any, of the pending litigations on its financial position in its financial statements.

(b) Whether the bank has made provision, as required under the law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts.

(c) Whether there has been any delay in transferring amounts, required to be transferred to the Investor Education and Protection Fund by the bank.

(iii) Reporting requirements relating to the Companies (Auditor's Report) Order, 2016 are not applicable to a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949.

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

Multiple Choice Questions (MCQs)

Question 1

PFS Bank was engaged in the business of providing Portfolio Management Services to its customers, for which it took prior approval from RBI. Your firm has been appointed as the statutory auditors of the Bank's financial statements for the year 2018-19. Your senior has instructed you to verify the transactions of Portfolio Management Services (PMS). While verifying the transactions you noticed that the bank has not prepared separate record for PMS transactions from the Bank's own investments. As a statutory auditor what will be your decision for verification of PMS transactions?

(a) It is not necessary to maintain separate records for PMS clients from Bank's own investments, so the auditor can verify the PMS transactions as part of investment verification for Bank's financial statements and submit the audit report accordingly.

(b) As per RBI guidelines PMS investments need to be audited separately by the external auditors and the auditors are required to give a certificate separately for the same. So, in the above case the auditor should not verify the PMS transactions till the Bank segregates the transactions from its own investments.

(c) The auditor can give a qualified opinion in his audit report on the financial statements of the Bank and report the matter in special purpose certificate.

(d) Auditor should verify that PMS funds are not utilized for lending, inter-bank deposits or deposits to corporate bodies and bills re-discounting only. So, whether the PMS transactions are recorded separately or not will not matter for the auditor. (MTP 1 Marks, Oct 19)

Answer 1 : (b)

Question 2

The Chanakya Bank Ltd. was having 150 branches all over India by the year ending 31 st March, 2019. Ten branches of the bank were already covered for concurrent audit and the Bank's Audit Committee decided to include the below mentioned branches for concurrent audit from the year 2019 -20.

1. Allahabad branch which started foreign exchange business from February 2019.
2. Rae Bareilly branch whose aggregate deposits were more than 35% of the aggregate deposits of the bank.

Whether the decision of audit committee to include both the branches mentioned in above paragraph for concurrent audit is as per RBI Guidelines?

(a) The decision of audit committee is valid as according to RBI Guidelines, both the branches fulfil the criteria for compulsory concurrent audit.

(b) Allahabad branch falls under the compulsory audit criteria as per RBI Guidelines, however Rae Bareilly branch whose aggregate deposits are less than 50% of the aggregate deposits of the Bank is not required to be compulsorily covered for concurrent audit.

(c) Allahabad and Rae Bareilly branch are compulsorily not required to be covered under concurrent audit as per RBI Guidelines.

(d) Allahabad branch has started foreign exchange business in February 2019 and as per RBI Guidelines only the branches dealing in Foreign exchange business from more than three years are covered under concurrent audit. Therefore, Allahabad branch is not covered under compulsory concurrent audit criteria as per RBI Guidelines but the Rae Bareilly branch is covered under compulsory concurrent audit criteria. (MTP 2 Marks, Oct 19)

Answer 2 : (b)

Question 3

The MEA Bank Ltd. has sanctioned overdraft limit of Rs.34 crore to Bharat Ltd. on the working capital of the company as on 31st March 2017. As per bank norms the drawing power in the overdraft account need to be reviewed on quarterly basis as per the audited stock statement of the company. As a central statutory auditor for the year 2018-19, while verifying the advances for the year ending 31st March 2019, you noticed that the bank has not obtained the stock statement of Bharat Ltd. for the two quarters ending 31st December 2018 and 31st March 2019 and no provision of NPA has been made for this account in the financial statements for the year 2018-19. What will be your decision as a central statutory auditor?

(a) Classify the borrower's account as NPA as the borrower's financial position cannot be determined due to non-submission of stock statement.

(b) Instruct the bank to obtain the audited stock statement for both the quarters and review the credit limit accordingly.

(c) As per bank norms the drawing power need to be determined on the basis of stock statement and it was more than three months old as on 31st March 2019, so the outstanding in the account will be deemed as irregular.

(d) You should give a qualificatory note in the audit report as per SA 700. (MTP 1 Marks, May' 20 & March '23, RTP May'19)

Answer 3 (c)

Question 4

A bank has some non-interest-bearing staff advances. In the Balance Sheet these should be presented under:

(a) 'Term loans' under 'Advances'.

(b) 'Cash Credits, Overdrafts and Loans Repayable on Demand' under 'Advances'.

(c) 'Advances in India – Others' under 'Advances' Schedule.

(d) 'Others' under 'Other assets. (MTP 1 Marks, March' 21)

Answer 4 : (d).

Question 5

Your firm has been appointed statutory auditor by a Nationalized Bank for the year 2017-18. Your senior advised you to check all the standard assets shown in the balance sheet as on 31 st March 2018. While verification you observed that one of the accounts was regularised on 28th March 2018, for which the interest and instalment amount was overdue from the quarter ending 30th September 2017. The account was regularized after the repayment of overdue interest and instalment amounts was done on 26 th March 2018. Only the last day of the financial year was reckoned as the date of account becoming NPA by the Bank. As a statutory auditor will you agree with the Bank's policy?

(a) As the interest charged in the account was overdue for more than 90 days from the end of quarter, it should be classified as NPA and should be considered as sub-standard asset for the balance sheet as on 31st March 2018.

(b) As the overdue interest and instalment amount was paid before the balance sheet date there is no reason to classify the account as NPA.

(c) The auditor should not agree with the Bank's policy to regularise the account before balance sheet date as overdue interest indicates more than normal risk attached to the business.

(d) Bank can regularize the account before balance sheet date but should ensure that the amount has been paid through genuine resources and not by sanction of additional facilities, and the account remains in order subsequently. (MTP 1 Marks, April 19)

Answer 5 (d)

Question 6

While examining the computation of Demand and Time liabilities which of the following is to be included in liabilities:

(a) Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.

(b) Amounts received in Indian Currency against import bills and held in sundry deposits pending receipts of final rates.

(c) Net credit balance in branch adjustment accounts including these relating to foreign branches.

(d) Margins held and kept in sundry deposits for funded facilities. (MTP 1 Marks, April 21, Apr'22)

Answer 6 : (c)

Question 7

Which of the following statements is correct regarding submission of Statutory branch audit report and LFAR of branch signed by the branch Auditor CA. Mahaveer?

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

(a) Statutory branch audit report is to be submitted to Statutory Central auditors and LFAR is to be submitted to head office of bank directly.

(b) Statutory branch audit report is to be submitted to Statutory Central auditors and LFAR is to be submitted to RBI directly.

(c) Statutory branch audit report as well as LFAR are to be submitted to Statutory Central auditors.

(d) Statutory branch audit report as well as LFAR are to be submitted to head office directly as appointment was made by Head office. (MTP 1 Mark Oct 22)

Answer 7 : (c)

Question 8

You are the internal auditor of Fair Bank Limited for the year 2022-23 and the bank maintains all the data on computer. You are instructed by your senior to verify the loan against fixed deposits of the Agra branch. As per the scope of audit, you need to ensure that proper lien has been marked on all the fixed deposits against which loan has been issued. Which of the following procedure you will follow for the same:

(a) Ensure that all the fixed deposit receipts, against which the loan has been sanctioned, are discharged in favour of bank and check that the lien is marked in the computer software .

(b) Ensure that all the fixed deposit receipts are attached along with the approved loan documents.

(c) Discuss the process followed for lien marking with the branch manager.

(d) Ensure that all the fixed deposit receipts, against which the loan has been sanctioned, are discharged in favour of bank, check that the lien is marked in the computer software and the fixed deposit should be kept separately with the branch manager. (MTP 1 Mark April '23)

Answer 8 : (a)

Question 9

PARAS bank had an NPA account of M/s SUPARAS showing recoverable amount of ` 35 lakh in the books. It sold the NPA for ` 37 lakh. Please select as to which of the following options is the correct accounting:

(a) Let the amount remain in SUPARAS account.

(b) Credit the excess of ` 2 lakh to profit on sale of assets.

(c) Credit the excess of ` 2 lakh to Provision for loss on sale of NPAs.

(d) Return ` 2 lakh to the party purchasing the NPA. (RTP May '23)

Answer 9 : (c)

Question 10

Siddha and Associates, Chartered Accountants has been appointed as the branch statutory auditor of CRR Bank. Auditor identified cases of Advances where primary security is not adequate to cover the margin as stipulated by the Loan covenants. Further no documentation exists to confirm that the collateral security is unencumbered. For the advances not having adequate security, the auditor should:

(a) Mention the cases in the Long Form Audit report only.

(b) Not mention the cases in the Long Form Audit report.

(c) Document the cases and discuss with branch management.

(d) Consider to downgrade the asset as per RBI prudential norms. (MTP 1 Mark Oct 21)

Answer 10 : (d)

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

Question 1

You are appointed as the auditor of a NBFC which is an Investment company registered with RBI. What shall be the special points to be covered for the audit of NBFC in case of Investment companies? (MTP 6 Marks, April 19, MTP 6 Marks Oct'19, RTP Nov'18, RTP Nov'19)

OR

Shivam & Co LLP are the auditors of NBFC (Investment and Credit Company). Some of the team members of the audit team who audited BFC have left the firm and the new team members are in discussion with the previous team members who are still continuing with the firm regarding the verification procedures to be performed. In this context, please explain what verification procedures should be performed in relation to audit o NBFC- Investment and Credit Company (NBF-CICC). (New SM)

Answer 1

Some points that may be covered in the audit of NBFC - Investment and Credit Company (NBFC-ICC):

i. Physically verify all the shares and securities held by a NBFC. Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.

ii. Verify whether the NBFC has not advanced any loans against the security of its own shares.

iii. Verify that dividend income wherever declared by a company, has been duly received by an NBFC and interest wherever due [except in case of NPAs] has been duly accounted for. NBFC Prudential Norms directions require dividend income on shares of companies and units of mutual funds to be recognised on cash basis. However, the NBFC has an option to account for dividend income on accrual basis, if the same has been declared by the body corporate in its Annual General Meeting and its right to receive the payment has been established. Income from bonds/debentures of corporate bodies is to be accounted on accrual basis only if the interest rate on these instruments is predetermined and interest is serviced regularly and not in arrears.

iv. Test check bills/contract notes received from brokers with reference to the prices vis-à-vis the stock market quotations on the respective dates.

v. Verify the Board Minutes for purchase and sale of investments. Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long Term Investments.

vi. Check whether the investments have been valued in accordance with the NBFC Prudential Norms Directions and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions.

vii. Obtain a list of subsidiary/group companies from the management and verify the investments made in subsidiary/group companies during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares.

viii. Check whether investments in unquoted debentures/bonds have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.

ix. An auditor will have to ascertain whether the requirements of AS 13 "Accounting for Investments" or other accounting standard, as applicable, (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.

x. In respect of shares/securities held through a depository, obtain a confirmation from the depository regarding the shares/securities held by it on behalf of the NBFC.

xi. Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified period together with all corporate benefits thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon).

xii. Verify charges received or paid in respect of securities lend/borrowed.

xiii. Obtain confirmation from the approved intermediary regarding securities deposited with/ borrowed from it as at the year end.

xiv. An auditor should examine whether each loan or advance has been properly sanctioned. He should verify the conditions attached to the sanction of each loan or advance i.e. limit on borrowings, nature of security, interest, terms of repayment, etc.

xv. An auditor should verify the security obtained and the agreements entered into, if any, with the concerned parties in respect of the advances given. He must ascertain the nature and value of security and the net worth of the borrower/guarantor to determine the extent to which an advance could be considered realisable.

xvi. Obtain balance confirmations from the concerned parties.

xvii. As regards bill discounting, verify that proper records/documents have been maintained for every bill discounted/rediscounted by the NBFC. Test check some transactions with reference to the documents maintained and ascertain whether the discounting charges, wherever, due, have been duly accounted for by the NBFC.

xviii. Check whether the NBFC has not lent/invested in excess of the specified limits to any single borrower or group of borrowers as per NBFC Prudential Norms Directions.

xix. An auditor should verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances. In addition, he may analyse the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.

xx. Check the classification of loans and advances (including bills purchased and discounted) made by a NBFC into Standard Assets, Sub-Standard Assets, Doubtful Assets and Loss Assets and the adequacy of provision for bad and doubtful debts as required by NBFC Prudential Norms Directions.

(Note: The above checklist is not exhaustive. It is only illustrative. There could be various other audit procedures which may be performed for audit of an NBFC.)

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

Question 2

Shreyansh & Co LLP, a firm of Chartered Accountants, was appointed as auditor of an NBFC. The audit work has been completed. The audit team which was involved in the fieldwork came across various observations during the course of audit of this NBFC and have also limited understanding about the exceptions which are required to be reported in the audit report. They would like to understand in detail regarding the obligations on the part of an auditor in respect of exceptions in his report so that they can conclude their work. Briefly explain. (MTP 6 Marks Sep 22), MTP 5 Marks Nov 21, MTP 6 Marks May 20, New SM)

Answer 2

Obligation of auditor to submit an exception report to the RBI:

(I) Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 above, is unfavorable or qualified, or in the opinion of the auditor the company has not complied with:

(a) the provisions of Chapter III B of RBI Act (Act 2 of 1934); or

(b) Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or

(c) Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

It shall be the obligation of the auditor to make a report containing the details of such unfavorable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the registered office of the company is located as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

(II) The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph

(1) and such report shall not contain any statement with respect to compliance of any of those provisions.

Question 3

RB & Co. are the statutory auditors of Legal Finance Ltd., an NBFC engaged in the business of accepting public deposits and giving loans. Auditors are concerned that the format of the financial statements should be prepared as per the notification issued by the Ministry of Corporate Affairs dated 11th October, 2018. While auditing there was a difference of opinion between CA R and CA B regarding the disclosure of "Other Income" in the financial statements.

CA R believes that there is no difference in the presentation requirements between Division II and Division III of Schedule III of the Companies Act, 2013. Is the contention of CA R correct? (PYP 5 Marks May '23, PYP 5 Marks Nov'19, MTP 6 Marks Apr'21)

Answer 3

Though presentation requirements under Division III for NBFCs are similar to Division II (Non NBFC) to a large extent however there are certain following differences in the same:

(a) An NBFC is required to separately disclose by way of a note any item of 'other income' or 'other expenditure' which exceeds 1 per cent of the total income. Division II, on the other hand, requires disclosure for any item of income or expenditure which exceeds 1 per cent of the revenue from operations or ₹ 10 lakhs, whichever is higher.

(b) NBFCs have been allowed to present the items of the balance sheet in order of their liquidity which is not allowed to companies required to follow Division II.

(c) NBFCs are required to separately disclose under 'receivables', the debts due from any Limited Liability Partnership (LLP) in which its director is a partner or member.

(d) NBFCs are also required to disclose items comprising 'revenue from operations' and 'other comprehensive income' on the face of the Statement of profit and loss instead of showing those only as part of the notes.

(e) Separate disclosure of trade receivable which have significant increase in credit risk & credit impaired.

(f) The conditions or restrictions for distribution attached to statutory reserves have to be separately disclose in the notes as stipulated by the relevant statute.

In view of the above, contention of CA R that there is no difference in the presentation requirement between Division II and Division III of the Companies Act, 2013 is not correct.

Question 4

Super Non-Bank Limited, a "Systemically Important Non-Deposit Taking Non-Banking Financial Company", was operating appropriately till the start of COVID-19 Pandemic. Due to unforeseen conditions during the Pandemic and after that, the operating revenue of the NBFC started decreasing. Following were the position of Net Owned Funds of the company during the last 4 financial years:

Financial Year	Net Owned Funds
FY19-20	₹ 15 Crore
FY20-21	₹ 6 Crore
FY21-22	₹ 4 Crore
FY22-23	₹ 1.5 Crore

Super Non-Bank Limited appointed Mr Shyam as their statutory auditor for the FY 22-23. Mr Shyam identified that the Net Owned Funds of the company have been less than ₹ 2 Crore since June 2022. Kindly guide Mr Shyam with respect to his reporting requirements as per relevant NBFC provisions. (MTP 5 Marks Sep '23)

Answer 4

In exercise of the powers conferred under clause (b) of sub-section (1) of section 45–IA of the RBI Act and all the powers enabling it in that behalf, the Bank hereby specifies two hundred lakh rupees as the Net Owned Fund (NOF) required for a non-banking financial company to commence or carry on the business of non-banking financial institution, except wherever otherwise a specific requirement as to NOF is prescribed by the Bank.

It will be incumbent upon such NBFCs, the NOF of which currently falls below ₹200 lakh, to submit a statutory auditor's certificate certifying compliance with the prescribed levels by the end of the period as given above.

NBFCs failing to achieve the prescribed level within the stipulated period shall not be eligible to hold the CoR as NBFCs. Every non-banking financial company shall submit a certificate from its Statutory Auditor that it is engaged in the business of a non-banking financial institution requiring it to hold a Certificate of Registration under Section 45-IA of the RBI Act and is eligible to hold it. A certificate from the Statutory Auditor in this regard with reference to the position of the company as at end of the financial year ended March 31 may be submitted to the Regional Office of the Department of Non- Banking Supervision under whose jurisdiction the non-banking financial company is registered, within one month from the date of finalization of the balance sheet and in any case not later than December 30th of that year. The format of the Statutory Auditor's Certificate (SAC) to be submitted by NBFCs has been issued vide DNBS. PPD.02/66.15.001/2016 -17 Master Direction- Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016.

Hence, in the current case, it is the responsibility of the Statutory Auditor, i.e., Mr. Shyam, to report where NOF has fallen below ₹ 200 Lakhs.

Question 5

GYAN & Co. is the statutory auditor of KUNTHU NBFC Ltd. While planning the audit procedures to be done during the audit of entity, there was a difference of opinion between CA. Matigyan and his partner CA. Shrutgyan. CA. Shrutgyan is of the opinion that evaluation of internal control system and verification of registration with RBI should not be the part of audit procedure, as it is the part of internal audit only. Is the contention of CA. Shrutgyan correct? Also state what broad areas should mandatorily become part of the audit procedure of GYAN & Co. for conducting the audit of KUNTHU NBFC Ltd.? (MTP 6 Marks Oct '22 & April 22)

Answer 5

Following are broad areas that should be mandatorily part of the audit procedure for conducting the audit of NBFC:

(1) **Ascertaining the Business of the Company -** The first step in carrying out the audit of a NBFC is to scan through the Memorandum and Articles of Association of the company, so as to acquaint oneself with the type of business that the company is engaged into.

The task of ascertaining the principal business activity of any NBFC is of paramount importance since the very classification of a company as a NBFC and its further classification would all depend upon its principal business activity. Based on the classification of a company, it will be required to comply with the provisions relating to limits on acceptance of public deposits as contained in the NBFC Public Deposit Directions.

(2) **Evaluation of Internal Control System -** An auditor should gain an understanding of the accounting system and related internal controls adopted by the NBFC to determine the nature, timing and extent of his audit procedures. An auditor should also ascertain whether the internal controls put in place by the NBFC are adequate and are being effectively followed.

In particular, an auditor should review the effectiveness of the system of recovery prevalent at the NBFC. He should ascertain whether the NBFC has an effective system of periodical review of advances in place which would facilitate effective monitoring and follow up. The absence of a periodical review system could result in non-detection of sticky advances at their very inception which may ultimately result in the NBFC having an alarmingly high level of NPAs.

(3) **Registration with the RBI -** Section 45-IA of the RBI Act, 1934, has made it incumbent on the part of all NBFCs to comply with registration requirements and have minimum net owned funds. An auditor should obtain a copy of the certificate of registration granted by the RBI or in case the certificate of registration has not been granted, a copy of the application form filed with the RBI for registration. It may particularly be noted that NBFCs incorporated af ter 9th January, 1997 are not entitled to commence business without first obtaining a registration certificate from the RBI. An auditor should, therefore, verify whether the dual conditions relating to registration with the RBI and maintenance of minimum net owned funds have been duly complied with by the concerned NBFC. The auditor should ascertain whether investment in prescribed liquid assets have been made and whether quarterly returns as mentioned above have been regularly filed with the RBI by the concerned NBFC.

(4) The auditors must ascertain whether the company properly classified as per the requirements of various regulations. In case, the NBFC has not been classified by the RBI, the classification of a company will have to be determined after a careful consideration of various factors such as particulars of earlier registration granted, if any, particulars furnished in the application form for registration, company's Memorandum of Association and its financial results.

(5) **NBFC Prudential Norms Directions -** Check compliance with prudential norms encompassing income recognition, income from investments, accounting standards, accounting for investments, asset classification, provisioning for bad and doubtful debts, capital adequacy norms, prohibition on granting of loans by a NBFC against its own shares, prohibition on loans and investments for failure to repay public deposits and norms for concentration of credit/investments.

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

In the given situation, GYAN & Co., is the statutory auditor of KUNTHU NBFC Ltd. While planning the audit procedures to be done during the audit of entity, there was difference of opinion between Matigyan and his partner Shrutgyan regarding evaluation of internal control and verification of registration with RBI.

As discussed above NBFCs are not entitled to commence business without first obtaining a registration certificate from the RBI. An auditor should, therefore, verify whether the dual conditions relating to registration with the RBI and maintenance of minimum net owned funds have been duly complied with by the concerned NBFC. Further, auditor should gain an understanding of the accounting system and related internal controls adopted by the NBFC to determine the nature, timing and extent of his audit procedures. An auditor should also ascertain whether the internal controls put in place by the NBFC are adequate and are being effectively followed.

Accordingly, contention of Mr. Shrutgyan regarding evaluation of internal control system and verification of registration with RBI should not be part of the audit procedure as it is part of internal audits only, is not correct.

Question 6

CA Sheetal is conducting the statutory audit of Kunthu Ltd., a non-banking financial company. It has branches in various parts of India. The company with a focus on housing finance, has outstanding nonconvertible debentures worth ₹ 170 crore. The company reportedly missed interest payments of ₹ 17 crore on its debts because of inadequate liquidity. As a result, Kunthu Ltd. faced a series of downgrades by rating agencies on its debts over the past two months. Rating was cut to D from A4 implying that the company was in default or expected to be in default soon. What aspects CA Sheetal should look into in relation to the activity of mobilization of public deposits (particularly in relation to downgrading of credit facilities) by Kunthu Ltd? (MTP 5 Marks March 22 & April '23, PYP 5 Marks ,Nov '20)

Answer 6

CA Sheetal has to ascertain whether the company has complied with the following aspects in relation to the activity of mobilization of public deposits:-

i. The ceiling on quantum of public deposits has been linked to its credit rating as given by an approved credit rating agency. In the event of a upgrading/downgrading of credit rating, the auditor should bear in mind that the NBFC will have to increase/reduce its public deposits in accordance with the revised credit rating assigned to it within a specified time frame and should ensure that the NBFC has informed about the same to the RBI inwriting.

ii. In the event of downgrading of credit rating below the minimum specified investment grade, a non-banking financial company, being an investment and credit company or a factor, shall regularise the excess deposit as provided hereunder:

a. with immediate effect, stop accepting fresh public deposits and renewing existing deposits;

b. all existing deposits shall run off to maturity; and

c. report the position within 15 working days, to the concerned Regional Office of the RBI where the NBFC is registered.

d. No matured public deposit shall be renewed without the express and voluntary consent of the depositor.

Question 7

In the case of companies carrying on the business of a non-banking financial institution, the auditor needs to report under CARO, 2016 whether the registration has been obtained under section 45-IA of the Reserve Bank of India Act, 1934, if required.

You are required to state in brief the audit procedure to be followed while reporting under above mentioned circumstances. (RTP May 18)

Answer 7

Reporting under CARO, 2020 for Registration under RBI Act, 1934: As per Clause (xvi) of paragraph 3 of the CARO, 2020, the auditor is required to report whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934. If so, whether the registration has been obtained.

Audit Procedures and Reporting-

(i) The auditor should examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.

(ii) The financial statements should be examined to ascertain whether company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.

(iii) Whether the company has net owned funds as required for the registration as NBFC.

(iv) Whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.

Question 8

What is a Core Investment Company (CIC) under the Reserve Bank of India regulations? What are the specific reporting requirements to be considered by an auditor in respect of CIC under CARO 2020? (PYP 5 Marks Nov 22)

Answer 8

Core Investment Companies: As per RBI Master Direction – Core Investment Companies (Reserve Bank) Directions, 2016, (Reference may be made to aforesaid Master Direction), these directions shall apply to every Core Investment Company (CIC), that is to say, a non- banking financial company

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

carrying on the business of acquisition of shares and securities and which satisfies the following conditions as on the date of the last audited balance sheet:-

(i) it holds not less than 90% of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies;

(ii) its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies and units of Infrastructure Investment Trust only as sponsor constitute not less than 60% of its net assets as mentioned in clause (i) above;

Provided; that the exposure of such CICs towards InvITs shall be limited to their holdings as sponsors and shall not, at any point in time, exceed the minimum holding of units and tenor prescribed in this regard by SEBI (Infrastructure Investment Trusts) Regulations, 2014, as amended from time to time.

(iii) it does not trade in its investments in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment;

(iv) it does not carry on any other financial activity referred to in Section 45I(c) and 45I(f) of the Reserve Bank of India Act, 1934 except a. investment in

(i) bank deposits,

(ii) money market instruments, including money market mutual funds and liquid mutual funds

(iii) government securities, and

(iv) bonds or debentures issued by group companies,

b. granting of loans to group companies and

c. Issuing guarantees on behalf of group companies.

As per CARO 2020, the auditor is required to report that –

(i) Whether the company is a Core Investment Company (CIC) as defined in the regulations made by the Reserve Bank of India, if so, whether it continues to fulfil the criteria of a CIC, and in case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria; [Paragraph 3(xvi) (c)]

(ii) Whether the Group has more than one CIC as part of the Group, if yes, indicate the number of CICs which are part of the Group; [Paragraph 3(xvi) (d)]

Question 9

ABC Ltd. is a company registered under the Companies Act, 2013. The company is engaged in the business of loans and advances, acquisition of shares / stocks / bonds / debentures/securities issued by Government or local authorities. For the year ended 31st March, 2021 following are some extracts from the financial statements:

(i) Paid-up share capital	₹ 40.53 Cr.
(ii) Non-Current Assets - Loans & Advances	₹ 55.90 Cr.
(iii) Current Assets - Loans and advances	₹ 344.47 Cr.
(iv) Total assets of the company	₹ 530 Cr.
(v) Intangible assets	₹ 3 Cr.
(vi) Profit for the Year	₹ 7.25 Cr.
(vii) Income from interest and dividends	₹ 52 Cr.
(viii) Gross income	₹ 102.57 Cr.

Directors intend to apply for registration as Non-Banking Financial Company (NBFC) under Section 45-IA of the Reserve Bank of India (Amendment) Act, 1997. Advise. (RTP Nov'22, PYP 4 Marks Dec '21)

Answer 9

In order to identify a particular company as Non-Banking Financial Company (NBFC), it will consider both assets and income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. The company will be treated as NBFC when a company's

(i) Financial assets constitute more than 50 per cent of the total assets (netted off by intangible assets) and

(ii) Income from financial assets constitute more than 50 per cent of the gross income.

A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by RBI.

In the given case of ABC Ltd, its Financial Assets are	= ₹ 55.90 + ₹ 344.47= ₹ 400.37 Cr Total
Assets (netted off by intangible assets)	= ₹ 527 Cr
Income from financial assets	= ₹ 52 Cr
Gross Income	= ₹ 102.57 Cr

From the above, it is clear that ABC Ltd.'s financial assets constitute more than 50 per cent of the total assets (netted off by intangible assets) and income from financial assets constitutes more than 50 per cent of the gross income. Hence, ABC Ltd. fulfills both these criteria to qualify as an NBFC.

Thus ABC Ltd. can apply for registration under Section 45-IA of Reserve Bank of India (Amendment) Act, 1997 in prescribed form along with the necessary documents.

Question 10

Classification of Frauds by NBFC (RTP May 19, RTP Nov'20)

Answer 10

Classification of Frauds by NBFC: In order to have uniformity in reporting, frauds have been classified as under based mainly on the provisions of the Indian Penal Code:

(i) Misappropriation and criminal breach of trust.

(ii) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.

(iii) Unauthorised credit facilities extended for reward or for illegal gratification.

(iv) Negligence and cash shortages.

(v) Cheating and forgery.

(vi) Irregularities in foreign exchange transactions Any other type of fraud not coming under the specific heads as above.

(vii) Any other type of fraud not coming under the specific heads as above.

Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' referred to in items (d) and (f) above are to be reported as fraud if the intention to cheat/ defraud is suspected/ proved. However, the following cases where fraudulent intention is not suspected/ proved, at the time of detection, will be treated as fraud and reported accordingly:

(I) cases of cash shortages more than ₹ 10,000/- and

(II) cases of cash shortages more than ₹ 5000/- if detected by management/ auditor/ inspecting officer and not reported on the occurrence by the persons handling cash.

Question 11

Differences between Division II (Ind- AS- Other than NBFCs) and Division III (Ind- AS- NBFCs) of Schedule III. (RTP May 21)

Answer 11

Differences between Division II (Ind- AS- Other than NBFCs) and Division III (Ind- AS- NBFCs) of Schedule III: The presentation requirements under Division III for NBFCs are similar to Division II (Non NBFC) to a large extent except for the following:

(i) NBFCs have been allowed to present the items of the balance sheet in order of their liquidity which is not allowed to companies required to follow Division II. Additionally, NBFCs are required to classify items of the balance sheet into financial and non-financial whereas other companies are required to classify the items into current and non-current.

(ii) An NBFC is required to separately disclose by way of a note any item of 'other income' or 'other expenditure' which exceeds 1 per cent of the total income. Division II, on the other hand, requires disclosure for any item of income or expenditure which exceeds 1 per cent of the revenue from operations or ₹ 10 lakh, whichever is higher.

(iii) NBFCs are required to separately disclose under 'receivables', the debts due from any Limited Liability Partnership (LLP) in which its director is a partner or member.

(iv) NBFCs are also required to disclose items comprising 'revenue from operations' and 'other comprehensive income' on the face of the Statement of profit and loss instead of showing those only as part of the notes.

(v) Separate disclosure of trade receivable which have significant increase in credit risk & credit impaired.

(vi) The conditions or restrictions for distribution attached to statutory reserves have to be separately disclose in the notes as stipulated by the relevant statute.

Question 12

Write a short note on the following: Categorisation of NBFCs carrying out specific activity. (RTP May '23)

Answer 12

Categorisation of NBFCs carrying out specific activity: As the regulatory structure envisages scale based as well as activity-based regulation, the following prescriptions shall apply in respect of the NBFCs

(i) NBFC-P2P, NBFC-AA, NOFHC and NBFCs without public funds and customer interface will always remain in the Base Layer of the regulatory structure.

(ii) NBFC-D, CIC, IFC and HFC will be included in Middle Layer or the Upper Layer (and not in the Base layer), as the case may be. SPD and IDF-NBFC will always remain in the Middle Layer.

(iii) The remaining NBFCs, viz., Investment and Credit Companies (NBFC-ICC), Micro Finance Institution (NBFC-MFI), NBFC-Factors and Mortgage Guarantee Companies (NBFC-MGC) could lie in any of the layers of the regulatory structure depending on the parameters of the scale based regulatory framework.

(iv) Government owned NBFCs shall be placed in the Base Layer or Middle Layer, as the case may be.

They will not be placed in the Upper Layer till further notice.

Multiple Choice Questions (MCQs)

Question 1

Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation (DICGC) is :

(a) Not available to depositors of NBFCs

(b) Available to depositors of NBFCs

(c) Available to depositors of Banks

(d) Not available to depositors of both NBFCs and banks (MTP 1 Mark , Mar 19)

Answer 1 : (a)

Question 2

CER Ltd is a non-banking financial company and has been operating for the last 10 years. The company is duly registered as per the requirements of the Reserve Bank of India. The company's assets base has been very strong over the years due to its efficient management function. The company is also planning to get listed for which required work is going on.

For the financial year ended 31 March 2019, the company has closed its books of accounts and prepared the financial statements for the purpose of statutory audit in a timely manner. The auditors of the company have started their fieldwork. It has been observed by the auditors that the company's various term loans which have been given to various parties have become overdue in terms of instalment including interest for a period of 5 months. As per the auditors these terms loans should be considered by the company for making provision at the rate of 20% of total outstanding amount, however, the management has considered. Please advise the auditors and the management regarding this matter considering that "Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016" are applicable to this NBFC.

(a) Provision should be made at 10%.

(b) Provision should be made 0.30%

(c) Provision should be made at 20%.

(d) Provision should be made at 0.40% (MTP 1 Marks, Oct 19)

Answer 2 : (a)

Question 3

50:50 test determination is popularly used in

(a) Banking Company

(b) Insurance Company

(c) NBFC Company

(d) Stock Trading Company (MTP 1 Marks, Oct 19, Nov'21, Oct'22, Sep'23)

Answer 3 : (c)

Question 4

Yuvraj Ltd. is a non-banking financial company other than Nidhi company and is covered under "Master Direction - Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2016". The NBFC has been in existence for the last 11 years and its operations are considerable in size having a net worth of ₹ 299 crores.

The NBFC has new statutory auditors for the financial year ended 31 March 2019. The audit report (including CARO) of the NBFC was clean for the financial year ended 31 March 2018. The company had a planning discussion with the auditors of the company for the financial year ended 31 March 2019 who raised a point regarding the applicability of new set of accounting standards, Indian Accounting Standards (Ind AS), on the NBFC for the financial year ended 31 March 2019 and have asked the management to ensure that its financial statements should be according to that. This comes as a big surprise to the management who had assessed that Ind AS would not be applicable to this NBFC because of the fact that CARO is applicable on this NBFC. There is a big disconnect on this matter between the auditor and the management. Please help by resolving this matter.

(a) Both the management and statutory auditors are not correct because Ind AS is not applicable to any NBFC covered under "Master Direction - Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2016".

(b) Management is correct because Ind AS is only applicable to NBFC which are also a Nidhi company. In this case, CARO being applicable Ind AS cannot apply to this NBFC.

(c) If the management does not agree with the view of statutory auditors then they should give adverse opinion in their report and also report this to RBI.

(d) Ind AS would not be applicable for financial year ended 31 March 2019 and hence the view of statutory auditors is not correct. (RTP Nov 19)

Answer 4 (d)

Question 5

CA Z is appointed as a Statutory Auditor of JB Finance Limited (a Non- Banking Financial Company covered under Non-Banking Financial Company — Systematically important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016) for the year 2021-22. Following information is available with CA Z with respect to JB Finance Limited as at 31st March, 2022:

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

Particulars	₹ (in Lakh)
Standard Assets	700.00
Sub-standard Assets	200.00
Doubtful Assets (Secured and up-to one year)	10.00
Doubtful Assets (Secured and more than three years)	50.00

What will be the total provision required to be made in the books of JB Finance Limited for the year ended 31st March, 2022 for the above stated Assets?

(a) ₹ 49.8 Lakh

(b) ₹ 47 Lakh

(c) ₹ 34.8 Lakh

(d) ₹ 52.8 Lakh .(RTP Nov'22)

Answer 5 (a)

Question 1

Your firm has been appointed as Central Statutory Auditors of a Nationalized Bank. The Bank follows financial year as accounting year. Your Audit Manager informed that the bank has recognized on accrual basis income from dividends on securities and Units of Mutual Funds held by it as at the end of financial year. The dividends on securities and Units of Mutual Funds were declared after the end of financial year. comment.

Answer 1

Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its annual general meeting and the owner's right to receive payment is established. This is also in accordance with AS 9. In this case the dividends have been declared after the financial year end. Therefore, the recognition of income by the bank on accrual basis is not in order.

In respect of income from government securities and bonds and debentures of corporate bodies, where interest rates on these instruments are pre-determined, income could be booked on accrual basis, provided interest is serviced regularly and as such is not in arrears. It was further, however, clarified that banks may book income on accrual basis on securities of corporate bodies/public sector undertakings in respect of which the payment of interest and repayment of principal have been guaranteed by the central government or a State government.

Question 2

As statutory central auditors of a Nationalized bank, what special points are to be borne in mind in the audit of compliance with "Statutory Liquidity Ratio" (SLR) requirements?

Answer 2

(i) Statutory Liquidity Ratio (SLR) Requirement–s SLR is the requirement that every scheduled commercial bank in India is required to maintain in the form of certain liquid assets such as gold, cash and government approved securities before providing credit to the customers. The Reserve Bank of India requires statutory central auditors of banks to verify the compliance with SLR requirements of 12 odd dates in different months of a fiscal year not being Fridays. The objective of maintaining SLR is to have an amount in the form of liquid assets which can be used to handle a sudden increase in demand for the amount from the depositors. The resultant report is to be sent to the top management of the bank and to the Reserve Bank.

Area of Focus	Suggested Audit Procedures
Compliance with CRR and SLR requirements	• Obtain an understanding of the relevant circulars/ instructions of the RBI, particularly regarding composition of items of DTL. • Request the branch auditors to send their weekly trial balance as on Friday and these are consolidated at the head office. Based on this consolidation, the DTL position is determined for every reporting Friday. The statutory central auditor should request the branch auditors to verify the correctness of the trial balances relevant to the dates selected by him/her. The branch auditors should also be specifically requested to examine the cash balance at the branch on the selected dates.
	• Examine, on a test basis, the consolidations regarding DTL position prepared by the bank with reference to the related returns received from branches. The auditor should examine whether the valuation of securities done by the bank is in accordance with the guidelines prescribed by the RBI.
	• While examining the computation of DTL, specifically examine that items have been excluded from liabilities as per RBI guidelines. Some of these items are:-
	• Paid up capital, reserve, any credit balance in profit & loss account of bank, amount of loan taken from RBI and amount of refinance taken from EXIM bank, NHB, SIDBI and NABARD
	• Part amounts of recoveries from the borrowers in respect of debts considered bad and doubtful of recovery.
	• Amounts received in Indian currency against import bills and held in sundry deposits pending receipts of final rates.

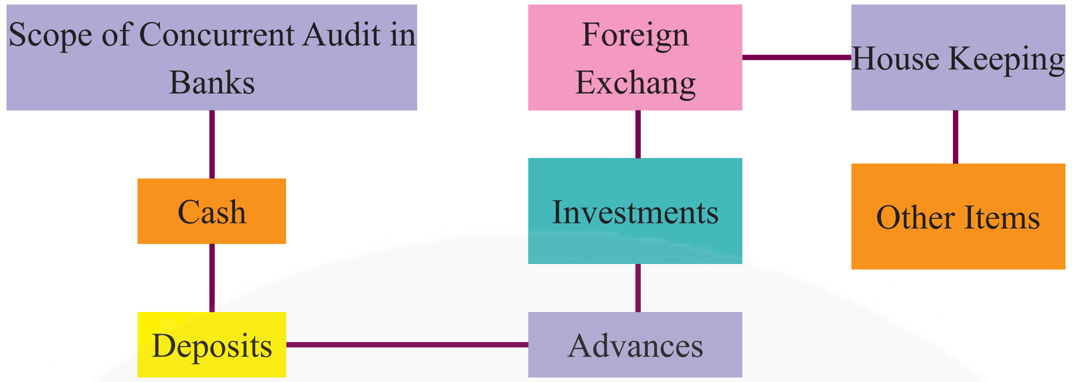
Question 3

Explain the scope of concurrent audit of a bank with reference to Reserve Bank of India guidelines.

Answer 3

The detailed scope of the concurrent audit should be clearly and uniformly determined for the Bank as a whole by the Bank's Central Inspection and Audit Department in consultation with the Bank's Audit Committee of the Board of Directors (ACB). In determining the scope, importance should be given to checking high-risk transactions having large financial implications as opposed to transactions involving lesser amounts. The detailed scope of the concurrent audit may be determined and approved by the ACB.

Further, the guidelines issued by the RBI cover all the key areas of activities of the branch which is under concurrent audit. Most banks have prepared an Audit Manual for this purpose. Broadly stated, the following areas are covered by these guidelines:



Question 4

In course of audit of Good Samaritan Bank as at 31st March,23 you observed the following.

a) In a particular account there was no recovery in the past 18 months. The bank has not applied the NPA norms as well as income recognition norms to this particular account. When queried the bank management replied that this account was guaranteed by the central government and hence these norms were not applicable. The bank has not invoked the guarantee. Please respond. Would your answer be different if the advance is guaranteed by a State Government?

b) The bank's advance portfolio comprised of significant loans against Life Insurance Policies. Write suitable audit program to verify these advances.

Answer 4

a) Government Guaranteed Advance: - A government guaranteed advance becomes NPA, then for the purpose of income recognition, interest on such advance should not to be taken to income unless interest is realized.

However, for purpose of asset classification, credit facility backed by Central Government Guarantee, though overdue, can be treated as NPA only when the Central Government repudiates its guarantee, when invoked.

Since the bank has not invoked the guarantee, the question of repudiation does not arise. Hence the bank is correct to the extent of not applying the NPA norms for provisioning purpose. But this exemption is not available in respect of income recognition norms. Hence the income to the extent not recovered should be reversed.

The situation would be different if the advance is guaranteed by State Government because this exception is not applicable for State Government Guaranteed advances, where advance is to be considered NPA if it remains overdue for more than 90 days.

In case the bank has not invoked the Central Government Guarantee though the amount is overdue for long, the reasoning for the same should be taken and duly reported in LFAR.

b) The Audit Programme to Verify Advances against Life Insurance Policies is as under-

(i) The auditor should inspect the policies and see whether they are assigned to the bank and whether such assignment has been registered with the insurer.

(ii) The auditor should also examine whether premium has been paid on the policies and whether they are in force.

(iii) Certificate regarding surrender value obtained from the insurer should be examined.

(iv) The auditor should particularly see that if such surrender value is subject to payment of certain premium, the amount of such premium has been deducted from the surrender value.

Question 5

Your firm has been appointed as Central Statutory Auditors of a Nationalized Bank is a consortium member of Cash Credit Facilities of 50 crores to X Ltd. Bank's own share is ₹ 10 crores only. During the last two quarters against a debit of ₹1.75 crores towards interest the credits in X Ltd's account are to the tune of 1.25 crores only. Based on the certificate of lead bank, the bank has classified the account of X Ltd as performing. The Bank follows financial year as accounting year. vise your views on the issue which were brought to your notice by your Audit Manager.

Answer 5

The bank is a consortium member of cash credit facilities of ₹ 50 crores to X Ltd. Bank's own share is ₹ 10 crores only. During the last two quarters against a debit of ₹ 1.75 crores towards interest, the credits in X Ltd.'s account are to the tune of ₹ 1.25 crores only. Sometimes, several banks form a group (the 'consortium') under the leadership of a 'lead bank' to make advance to a large customer on same conditions and security with proportionate rights. In such cases, each bank may classify the advance given by it according to its own experience of recovery and other factors. Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as non-performing asset.

Question 6

You have been appointed as an auditor of LCO Bank, a nationalized bank. LCO Bank also deals in providing credit card facilities to its account holder. The bank is aware of the fact that there should be strict control over storage and issue of credit cards. How will you evaluate the Internal Control System in the area of Credit Card operations of a Bank?

Answer 6

- There should be effective screening of applications with reasonably good credit assessments.
- There should be strict control over storage and issue of cards.
- There should be a system whereby a merchant confirms the status of unutilised limit of a credit-card holder from the bank before accepting the settlement, in case the amount to be settled exceeds a specified percentage of the total limit of the card holder.

- There should be a system of prompt reporting by the merchants of all settlements accepted by them through credit cards.
- Reimbursement to merchants should be made only after verification of the validity of merchant's acceptance of cards.
- All the reimbursement (gross of commission) should be immediately charged to the customer's account.
- There should be a system to ensure that statements are sent regularly and promptly to the customer.

Question 7

You have been appointed as Concurrent Auditor of a nationalized bank branch. The main business at the branch is dealing in foreign exchange. Suggest the main areas of coverage with regard to foreign exchange transactions of the said branch under concurrent audit.

Answer 7

- Check foreign bills negotiated under letters of credit.
- Check FCNR and other non-resident accounts whether the debits and credits are permissible under rules.
- Check whether inward/outward remittance have been properly accounted for.
- Examine extension and cancellation of forward contracts for purchase and sale of foreign currency.

  Ensure that they are duly authorized and necessary charges have been recovered.
- Ensure that balances in Nostro accounts in different foreign currencies are within the limit as prescribed by the bank.
- Ensure that the overbought/oversold position maintained in different currencies is reasonable, considering the foreign exchange operations.
- Ensure adherence to the guidelines issued by RBI/HO of the bank about dealing room operations.
- Ensure verification/reconciliation of Nostro and Vostro account transactions/balances.

Question 8

While auditing FAIR Bank, you observed that a lump sum amount has been disclosed as contingent liability collectively. You are, therefore, requested by the management to guide them about the disclosure requirement of Contingent Liabilities for Banks. Kindly guide.

Answer 8

(b) Contingent Liabilities for Banks: The Third Schedule to the Banking Regulation Act, 1949, requires the disclosure of the following as a footnote to the balance sheet-

(A) Contingent liabilities

(i) Claims against the bank not acknowledged as debts.

(ii) Liability for partly paid investments.

(iii) Liability on account of outstanding forward exchange contracts.

(iv) Guarantees given on behalf of constituents-

(1) In India.

(2) Outside India.

(v) Acceptances, endorsements and other obligations.

(vi) Other items for which the bank is contingently liable.

(B) Bills for collection.

Question 9

ABC Chartered Accountants have been appointed as concurrent auditors for the branches of Effective Bank Ltd. for the year 2202-23. You are part of the audit team for Agra branch of the bank and have been instructed by your senior to verify the advances of the audit period. You are required to guide your assistant about the areas to be taken care while doing verification during the concurrent audit.

Answer 9

(a) Verification of Advances as a Concurrent Auditor:

(i) Ensure that loans and advances have been sanctioned properly (i.e. after due scrutiny and at the appropriate level).

(ii) Verify whether the sanctions are in accordance with delegated authority.

(iii) Ensure that securities and documents have been received and properly charged/ registered.

(iv) Ensure that post disbursement supervision and follow-up is proper, such as receipt of stock statements, instalments, renewal of limits, etc.

(v) Verify whether there is any mis utilisation of the loans and whether there are instances indicative of diversion of funds.

(vi) Check whether the letters of credit issued by the branch are within the delegated power and ensure that they are for genuine trade transactions.

(vii) Check the bank guarantees issued, whether they have been properly worded and recorded in the register of the bank. Whether they have been promptly renewed on the due dates.

(viii) Ensure proper follow-up of overdue bills of exchange.

(ix) Verify whether the classification of advances has been done as per RBI guidelines.

(x) Verify whether the submission of claims to DICGC and ECGC is in time.

(xi) Verify that instances of exceeding delegated powers have been promptly reported to controlling/ Head Office by the branch and have been got confirmed or ratified at the required level.

(xii) Verify the frequency and genuineness of such exercise of authority beyond the delegated powers by the concerned officials.

Question 10

In the course of audit of Skip Bank Ltd., you found that the Bank had sold certain of its non-performing assets. Draft the points of audit check that are very relevant to this area of checking.

Answer 10

In case of Sale/Purchase of NPA by Bank, the auditor sho examine:

- the policy laid down by the Board of Directors in this regard relating to procedures, valuation and delegation of powers including non performing financial assets that may be purchased/sold, norms or such purchase/sale, valuation procedure and accounting policy.
- only such NPA has been sold which has remained NPA in the books of the bank for at least 2 years.
- the assets have been sold/ purchased "without recourse' only i.e the entire credit risk associated with the non-performing asset should be transferred to the purchasing bank.
- subsequent to the sale of the NPA, the bank does not assume any legal, operational or any other type of risk relating to the sold NPAs.
- the NPA has been sold at cash basis only. Under no circumstances, NPA can be sold to another bank at a contingent price .The entire sale consideration has to be received on upfront basis.
- the bank has not purchased an NPA which it had originally sold.

In case of sale of an NPA, the auditor should also ensure that:

- on the sale of the NPA, the same has been removed from the books of the account of selling bank on transfer;
- If the sale is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year.
- If the sale is for a value higher than the NBV, the excess provision shall not be reversed but will be utilised to meet the shortfall/ loss on account of sale of other non-performing financial assets.
- Similarly, in case of purchase of NPAs, the auditor should ver that:
- the NPA purchased has been subjected to the provisioning requirements appropriate to the classification status in the books of the purchasing bank.
- any recovery in respect of an NPA purchased from other banks is first adjusted against its acquisition cost and only the recovered amount in excess of the acquisition cost has been recognised as profit.
- for the purpose of capital adequacy, banks have assigned 100% risk weights to the NPAs purchased from other banks.

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

Question 11

Banks, because of certain characteristics, are distinguished from other commercial enterprises and hence it needs special audit consideration. As an auditor of a bank, specify the various peculiarities which may necessitate special audit consideration to be taken care by you?

Answer 11

Special audit considerations arise in the audit of banks because of:

- the particular nature of risks associated with the transactions undertaken;
- the scale of banking operations and the resultant significant exposures which can arise within short period of time;
- the extensive dependence on IT to process transactions;
- the effect of the statutory and regulatory requirements;
- the continuing development of new products and services and banking practices which may not be matched by the concurrent development of accounting principles and auditing practices.

Evolution of technology and providing services through Net Banking and Mobiles has exposed banks to huge operational and financial risk.

The auditor should consider the effect of the above factors in designing his audit approach. It is imperative for Branch Auditors and SCAs (Statutory Central Auditors) to have detailed knowledge of the products offered and risks associated with them, and appropriately address them in their audit plan to the extent they give rise to the risk of material misstatements in the financial statements.

In today's environment, the banks use different applications to carry out different transactions which may include data flow from one application to other application; the auditor while designing his plans should also understand interface controls between the various applications.

Question 12

ABC Bank had sanctioned credit limits of₹ 100 lakh to M/s Volkart Ltd on 1st September 2021. The renewal of limits was due ons1t September 2022. While doing the statutory branch audit for the year ended 31st March 2023, you find that the renewal has not been done even though180 days are over. The bank says that the renewal process has been initiated on time and most of the document are received. The account is operated regularly and is in order; balance is maintained within drawing power. It also shows a letter from Volkat stating that due to a sudden death of their auditor, a new auditor had to be appointed. Procedure for appointment took some time and the new auditor was doing the audit all over again. The limit was not renewed till 31/3/202.3However, the audited financials are received on 10th April 2023 and the renewal letter was issued immediately. Your assistant is insisting that the account must be classified as NPA since the limit was not renewed as on 31/3/2023. what is your opinion?

Answer 12

As per Guidelines of Reserve Bank of India the account should be classified as NPA if renewal is not done in 180 days. However, in the present case, operations in the account are excellent. The bank has shown a letter from that company that due to certain reasons the audited financial statements are delayed. Further, the limit has been renewed before signing the audit report.

Thus, even if the sanction was issued after the balance sheet date, it relates to the position as on the balance sheet date. Therefore, it is an adjusting event under AS 4, Contingencies and Events Occurring After the Balance Sheet Date. It is also a matter of substance over form.

The auditor would consider classifying the account as a standard asset.

Question 13

You are auditing a small bank branch with staff strength of the manager, cashier and three other staff S1,S2 and S3. Among allocation of work for other areas, S1 who is a also opens all the mail and forwards it to the concerned person. He does not have a signature book so as to check the signatures on important communications. S2 has possession of all bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheque, foreign currency cards etc.) He maintains a record meticulously which you have test checked also. However, no one among staff regularly checks that. You are informed that being a small branch with shortage of manpower, it is not possible to always check the work and records. Give your comments.

Answer 13

Banks are required to implement and maintain a system of internal controls for mitigating risks, maintain good governance and to meet the regulatory requirements. Given below are examples of internal controls that are violated in the given situation:

In the instant case, S1 who is a peon opens all the mail and forwards it to the concerned person. Further, he does not have a signature book so as to check the signatures on important communications is not in accordance with implementation and maintenance of general internal control. As the mail should be opened by a responsible officer. Signatures on all the letters and advices received from other branches of the bank or its correspondence should be checked by an officer with the signature book.

All bank forms (e.g. Cheque books, demand draft/pay order books, travelers' cheque, foreign currency cards etc.) should be kept in the possession of an officer, and another responsible officer should verify the issuance and stock of such stationery. In the given case, S2 has possession of all bank forms (e.g. cheque books, demand draft/pay order books, travelers' cheque, foreign currency cards etc.). He maintains a record meticulously which were also verified on test check basis.

Further, contention of bank that being a small branch with shortage of manpower they are not able to check the work and records on regular basis, is not tenable as such lapses in internal control pose risk of fraud.

The auditor should report the same in his report accordingly.

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

Question 14

CA. Harshit is conducting statutory audit of branch of a public sector bank. On examining 20 large advances of the branch, he finds that in 5 examined cases, loan applications have been filled up scantily with important details left out. In these cases, it is also noticed that cash credit limits to the borrowers were enhanced during the year but there are no records pertaining to assessment of enhanced working capital requirements in respective borrower files. The branch is unable to show such assessments/workings in system either.

However, all the five accounts are operating satisfactorily. These accounts have been classified as standard assets by branch. Would above information prompt auditor to suggest change in asset classification of above accounts? What does depicted situation reflect?

Answer 14

An account becomes NPA when it ceases to generate income for bank. In the given situation, all the examined five accounts are operating satisfactorily. There is no reason for suggesting changes in their classification.

The matter of scantily filling up loan applications and lack for record for assessment of enhanced working capital requirements shows that internal control over advances in branch is not proper. The above said situation shows deficiencies in "credit appraisal" at branch level. Such deficiencies need to be highlighted by auditor in LFAR.

Question 15

You are conducting concurrent audit of branch of a public sector bank. It is a large branch having advances of about ₹ 500 crores including export advances of ₹ 300 crores. Some borrowers also get LCs issued from branch for importing raw diamonds from diamond hubs of Belgium. You want to be sure that there is no revenue leakage in branch. For the time being, you are focusing upon advances. Discuss any five areas pertaining to advances of the branch which you would verify to ensure no revenue leakage.

Answer 15

(i) Interest rates fed in the system need to be verified with respect to corresponding sanction letters. It would help ensure that correct rate of interest is fed into the system and interest is applied properly at stipulated intervals on advances.

(ii) Processing fees in respect of freshly sanctioned advances and renewed limits need to be levied in accordance with bank guidelines and these need to be verified. Any revision in processing fees from time to time has to be given effect to in accordance with circulars/manual of bank.

(iii) Sanction of cash credit limits is generally accompanied with stipulation to submit stock statements. Non submission of stock statements can involve levying of penal interest. Verification of this aspect is required.

(iv) Verification of overdue interest on export bills purchased and packing credit facilities for overdue period.

(v) Verification of charges/commission in respect of letters of credit issued in accordance with Bank's circulars/manual.

Question 16

CA. Seema is appointed as stock auditor of Bhawani Rice Mills Pvt. Ltd. availing credit facilities from R.K.

Puram Branch, Near Tamil Educational Society, New Delhi.

The borrower is enjoying cash credit limit of ₹ 12 crore from branch against security of paid stocks and debtors up to 90 days against margin of 25%. She proceeds to visit premises of Bhawani Rice Mills Pvt. Ltd. located on outskirts of Delhi. She verifies books of accounts and stock records of the company and also test checks quantity of paddy and rice of 20000 quintals and 8000 bags lying in premises of the company.

Drawing power of ₹ 12.05 crore is computed in stock audit report and report stands submitted to bank. After about a week, regular internal inspector appointed by Inspection department of bank also happened to visit premises of the borrower and found that rice contained in about 5000 bags included in stocks having approx. value of ₹ 1.50 crore was fungus ridden. The company was holding this stock for last 15 months.

How do you view the above situation? Discuss

Answer 16

The above situation reflects that professional work of stock audit was not performed diligently by stock auditor. It is one of the important responsibilities of stock auditor to verify condition of stocks. The auditor's role is not limited to verify physical quantities only.

In given case, she should have got opened rice bags on test check basis. In the process, she could have come to know about fungus ridden condition of rice. Value of such rice should have been excluded while arriving at value of stocks for purpose of computation of drawing power. It shows that she has failed to perform her work diligently and drawing power calculated in the report submitted to bank is not proper.

Integrated Case Scenario

CA. Madhusudan is conducting concurrent audit of a branch of a nationalized bank. It is a large branch having deposits of ` 350 crore and advances of ` 600 crore respectively. The deposits of branch consist of term deposits apart from CASA deposits. It is an old branch in operation since late 70s. Therefore, there are many dormant deposit savings, current and term deposit accounts at the branch.

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

Of late, the top management of the bank has been pushing for aggressive targets in opening of CASA deposits. He wants to ensure that CASA deposit accounts opened by the branch during his term comply with KYC norms.

During the course of concurrent audit of a particular month, he finds that temporary over limits are granted to few borrowers availing cash credit facilities up to 10% of their respective sanctioned limits. Granting of such over limits falls within the powers of Chief Manager of the said branch. It is also noticed by him that temporary overdrafts are allowed to few customers in their current accounts. However, granting of these temporary overdrafts also falls in Chief Manager's delegated powers. Temporary over limits and overdrafts as discussed above have been adjusted and paid before the end of the month.

It is further noticed by him during the same month that branch has sanctioned 5 fresh advances falling within Chief Manager's powers and conforming to bank norms aggregating to ` 10 crore. All these sanctioned advances pertain to same industry i.e., jute mills manufacturing jute sacks. He feels that branch's approach is not proper and sanction of 5 advances to the same industry lacks diversity and lending decision of branch is not proper.

He further notices that during the month, one borrower of branch falling under definition of "small enterprise" in MSME sector has shifted its credit facilities from the branch to a bank in private sector. The branch has levied foreclosure charges on outstanding credit facilities pertaining to borrower by disregarding "Code of Bank's Commitment to Micro and Small Enterprises. The borrower is still having current account with branch. Reversal of such charges would lead to revenue loss for branch. He is in a fix as far as reporting is concerned.

Keeping in view above, answer the following questions: -

1. As regards dormant deposit accounts in the branch, which of the following is not part of duty of concurrent auditor?

a) Verifying that dormant accounts are revived with appropriate authority

b) Examining authorization for withdrawals

c) Following up with account holders to ensure status of accounts remains active

d) Verifying that dormant accounts at the branches ageing more than 10 years have been transferred to Deposit Education and Awareness Fund (DEAF)

Ans: (c)

2. The concurrent auditor wants to ensure that fresh CASA accounts opened in the branch are KYC compliant. Which of the following best sums up scope of KYC guidelines prescribed by RBI?

a) The basic purpose of such guidelines is to weed out duplicate customers at the same branch.

b) Such guidelines contain detailed requirements for banks to enable them to draw a 360- degree credit profile of the customers by monitoring of transactions. Its primary purpose is assisting banks in making prudent credit decisions.

c) Such guidelines have a basic objective of ensuring credit of Direct benefit transfers (DBT) in accounts of deserving account holders.

d) Such guidelines contain detailed requirements in respect of customer acceptance policy, customer identification procedures, monitoring of transactions and risk management.

Ans: (d)

3. Which of the following statements is most appropriate as regards reporting of matters relating to temporary over limits in cash credit accounts and temporary overdrafts in current accounts?

a) The said instances cannot be reported as these fall in powers of Chief Manager.

b) The said instances can be reported in monthly concurrent audit report. No discussion is necessary with Chief Manager in this respect to ensure sanctity of report.

c) The said instances can be reported in monthly concurrent audit report. However, a discussion is necessary with Chief Manager in this respect.

d) The said instances cannot be reported as these fall in powers of Chief Manager and have been adjusted and paid before the end of the month

Ans: (c)

4. Which of the following statements is most appropriate regarding sanction of fresh advances to borrowers in the same industry in a month from concurrent auditor's perspective?

a) Such a lending lacks diversity and needs to be reported without fail.

b) Such a lending increases credit risk for branch and needs immediate attention of higher authorities of bank.

c) Lending has been made within Chief Manager's powers. It does not fall in concurrent auditor's domain to question wisdom of lending decision conforming to bank norms.

d) Although lending has been made within Chief Manager's powers, branch should have reported to higher authorities flagging sanction of fresh advances to same industry. Only this aspect should be reported in concurrent auditor's report.

Ans: (c)

5. As regards matter of levying of foreclosure charges described in case scenario, what is appropriate course of action for concurrent auditor?

a) The matter should be reported even though it would lead to revenue loss for branch.

b) The matter should not be reported as it is part of duties of concurrent auditor to safeguard branch's revenue interests.

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

c) The matter should be reported only for its disregard of Code without highlighting revenue impact.

d) The matter concerns branch management's decision. It does not fall in purview of concurrent audit.

Ans: (a)

Question 1

Define NBFC. Also give a brief description about types of NBFCs covering any five NBFCs.

Answer 1

Definition of NBFC:45 I(f) of Reserve Bank of India (Amendment) Act, 1997 define non-banking financial company as:

(i) A financial institution which is a company;

(ii) A non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

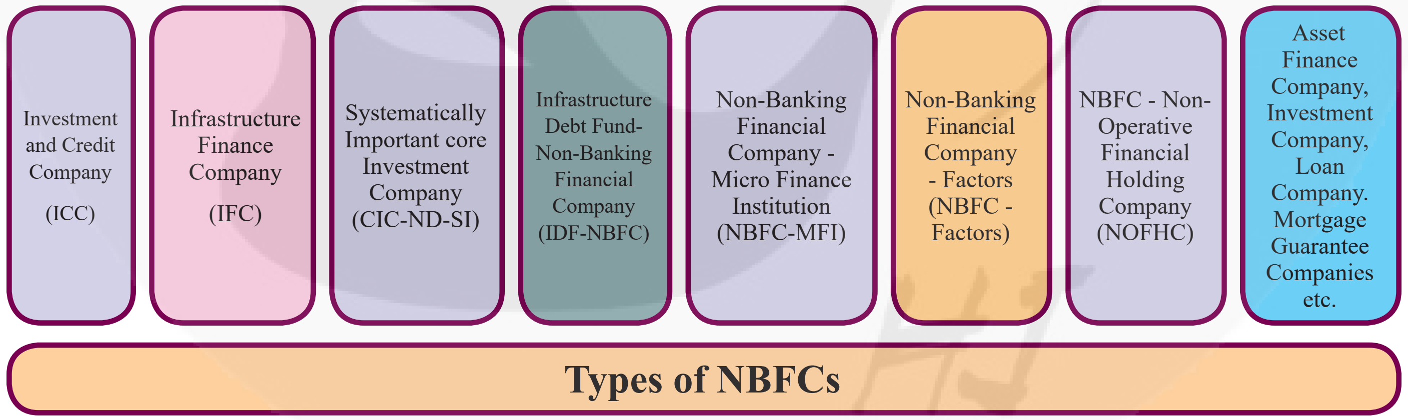
(iii) Such other non-banking institution or class of such institutions, as the Bank may, with the previous approval of the Central Government and by notification in the Official Gazette, specify;" NBFCs mandated to register under RBI NBFCs registered with RBI are categordizaes follows:

(a) in terms deposit acceptance or otherwise into Deposit and Non-Deposit accepting NBFCs;

(b) non deposit taking NBFCs by their size into systemically important and non-systemically important (NBFC-NDSI and NBFC-ND); and

(c) by the kind of activities, they conduct.

Within the categorization mentioned in (c) above, (i.e. by the kind of activity they conduct) the different types of NBFCs are as follows:



All NBFCs are either deposit taking or non-deposit taking. If they are non-deposit taking, ND is suffixed to their name (NBFC-ND).

Companies exempted from registration under RBI

Companies that do financial business but are regulated by other regulators are given specific exemption by the Reserve Bank from its regulatory requirements for avoiding duality of regulation. Following NBFCs have been exempted from the requirement of registration under Section 45-IA of the RBI Act, 1934 subject to certain conditions.

Question 2

Shubham & Associates are going to start the audit of NBFCs. They have not performed much work for the NBFCs in the past years. You are required to explain the requirements related to registration and regulation of NBFCs which an auditor needs to keep his in mind while planning the audit of NBFC which would help this firm.

Answer 2

An auditor should know following points regarding registration and regulation of NBFCs: Under Section 45–IA of the RBI Act, 1934, no NBFC shall commence or carry on the business of a non-banking financial institution without

- obtaining a certificate of registration issued by the RBI; and
- having a net owned fund (NOF) of ₹ 25 lakhs (₹ Two crore since April 1999) not exceeding two hundred lakhs rupees, as the RBI may, by notification in the Official Gazette, specify.

(The RBI (Amendment) Act (1997) provided an entry point norm of ₹ 25 lakh as the minimum NOF which was revised upwards to ` 2 crore for new NBFCs seeking grant of certificate of registration (CoR) on or after 21 April 1999).

A company incorporated under the Companies Act and desirous of commencing business of non-banking financial institution as defined under Section 45–IA of the RBI Act, 1934 can apply to the RBI in prescribed form along with necessary documents for registration. The RBI issues CoR after satisfying itself that the conditions as enumerated in Section 45-IA of the RBI Act, 1934 are satisfied.

However, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/ Merchant Banking companies/Stock Broking Companies registered with SEBI, Insurance Company holding a valid CoR issued by IRDA, Nidhi Companies as notified under Section 406 of the Companies Act, 2013, Chit Companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982 or Housing Finance Companies regulated by National Housing Bank.

The RBI has issued directions to NBFCs on acceptance of public deposits, prudential norms like capital adequacy, income recognition, asset classification, provision for bad and doubtful debts, risk exposure norms and other measures to monitor the financial solvency and reporting by NBFCs.

Directions were also issued to auditors to report non-compliance with the RBI Act and regulations to the Reserve Bank, Board of Directors and shareholders.

Question 3

Satyam Pvt Ltd is a company engaged in trading activities, it also has made investments in shares of other Companies and advanced loans to group companies amounting to more than 50% of its total assets.

However, trading income constitutes majority of its total income. Whether the Company is an NBFC?

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

Answer 3

In order to identify a particular company as Non-Banking Financial Company (NBFC), it will consider both assets and income pattern as evidenced from the last audited balance sheet of the company to decide its principal business. The company will be treated as NBFC when a company's financial assets constitute more than 50 per cent of the total assets (netted off by intangible assets) and income from financial assets constitute more than 50 per cent of the gross income. A company which fulfils both these criteria shall qualify as an NBFC and would require to be registered as NBFC by Reserve Bank of India.

In the given case, though Satyam Pvt Ltd is fulfilling the criteria on the asset side, but however is not fulfilling the criteria on the income side, the company cannot be classified as a deemed NBFC.

Question 4

Shivam & Co LLP are the auditors of NBFC (Investment and Credit Company). Some of the team members of the audit team who audited BFC have left the firm and the new team members are in discussion with the previous team members who are still continuing with the firm regarding the verification procedures to be performed. In this context, please explain what verification procedures should be performed in relation to audit o NBFC- Investment and Credit Company (NBF-CICC).

Answer 4

i. Physically verify all the shares and securities held by a NBFC. Where any security is lodged with an institution or a bank, a certificate from the bank/institution to that effect must be verified.

ii. Verify whether the NBFC has not advanced any loans against the security of its own shares.

iii. Verify that dividend income wherever declared by a company, has been duly received by an NBFC and interest wherever due [except in case of NPAs] has been duly accounted for. NBFC Prudential Norms require dividend income on shares of companies and units of mutual funds to be recognised on cash basis.

   However, the NBFC has an option to account for dividend income on accrual basis, if the same has been declared by the body corporate in its Annual General Meeting and its right to receive the payment has been established. Income from bonds/debentures of corporate bodies is to be accounted on accrual basis only if the interest rate on these instruments is predetermined and interest is serviced regularly and not in arrears.

iv. Test check bills/contract notes received from brokers with reference to the prices vis-à-vis the stock market quotations on the respective dates.

v. Verify the Board Minutes for purchase and sale of investments. Ascertain from the Board resolution or obtain a management certificate to the effect that the investments so acquired are current investments or Long-Term Investments.

vi. Check whether the investments have been valued in accordance with the NBFC Prudential

Norms and adequate provision for fall in the market value of securities, wherever applicable, have been made there against, as required by the Directions.

vii. Obtain a list of subsidiary/group companies from the management and verify the investments made in subsidiary/group companies during the year. Ascertain the basis for arriving at the price paid for the acquisition of such shares and whether the Valuation is as per Prudential norms.

viii. Check whether investments in unquoted debentures/bonds have not been treated as investments but as term loans or other credit facilities for the purposes of income recognition and asset classification.

ix. An auditor will have to ascertain whether the requirements of AS 13 "Accounting for Investments" or other accounting standard, as applicable, (to the extent they are not inconsistent with the Directions) have been duly complied with by the NBFC.

x. In respect of shares/securities held through a depository, obtain a confirmation from the depository regarding the shares/securities held by it on behalf of the NBFC.

xi. Verify that securities of the same type or class are received back by the lender/paid by the borrower at the end of the specified period together with all corporate benefits thereof (i.e. dividends, rights, bonus, interest or any other rights or benefit accruing thereon).

xii. Verify charges received or paid in respect of securities lend/borrowed.

xiii. Obtain a confirmation from the approved intermediary regarding securities deposited with/ borrowed from it as at the year end.

xiv. An auditor should examine whether each loan or advance has been properly sanctioned. He should verify the conditions attached to the sanction of each loan or advance i.e. limit on borrowings, nature of security, interest, terms of repayment, etc.

xv. An auditor should verify the security obtained and the agreements entered into, if any, with the concerned parties in respect of the advances given. He must ascertain the nature and value of security and the net worth of the borrower/guarantor to determine the extent to which an advance could be considered realisable.

xvi. Obtain balance confirmations from the concerned parties.

xvii. As regards bill discounting, verify that proper records/documents have been maintained for every bill discounted/rediscounted by the NBFC. Test check some transactions with reference to the documents maintained and ascertain whether the discounting charges, wherever, due, have been duly accounted for by the NBFC.

xviii. Check whether the NBFC has not lent/invested in excess of the specified limits to any single borrower or group of borrowers as per NBFC Prudential Norms.

xix. An auditor should verify whether the NBFC has an adequate system of proper appraisal and follow up of loans and advances. In addition, he may analyse the trend of its recovery performance to ascertain that the NBFC does not have an unduly high level of NPAs.

xx. Check the classification of loans and advances (including bills purchased and discounted) made by a NBFC into Standard Assets, Sub-Standard Assets, Doubtful Assets and Loss Assets and the adequacy of provision for bad and doubtful debts as required by NBFC Prudential Norms.

Question 5

You are appointed as the auditor of a NBFC registered with the RBI and which is accepting and holding public deposits. You are considering your reporting requirement addition to your report made under Section 143 of the Companies Act, 2013 on the accounts of this NBFC as per the prescribed Directions.

Please explain what points are required to be known in respect of separate report to be given by you to the Board of Directors of this NBFC.

Answer 5

Material to be included in the Auditor's report to the Board Doirfectors:

The auditor's report on the accounts of a non-banking financial company shall include a statement on the following matters, namely

(A) In the case of a non-banking financial companies accepting/holding public deposits

Apart from the matters enumerated in (A) above, the auditor shall include a statement on the following matters, namely-

(i) Whether the public deposits accepted by the company together with other borrowings indicated below viz.

(a) from public by issue of unsecured non-convertible debentures/bonds;

(b) from its shareholders (if it is a public limited company); and

(c) from entities which are not excluded from the definition of 'public deposit' in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016, are within the limits admissible to the company as per the provisions of the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(ii) Whether the public deposits held by the company in excess of the quantum of such deposits permissible to it under the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 are regularised in the manner provided in the said Directions;

(iii) Whether the non-banking financial company is accepting "public deposit" without minimum investment grade credit rating from an approved credit rating agency as per the provisions of Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(iv) Whether the capital adequacy ratio as disclosed in the return submitted to the Bank in terms of the Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016 has been correctly determined and whether such ratio is in compliance with the minimum CRAR prescribed therein;

(v) In respect of non-banking financial companies referred to in clause (iii) above,

(a) whether the credit rating, for each of the fixed deposits schemes that has been assigned by one of the Credit Rating Agencies listed in Non- Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016 is in force; and

(b) whether the aggregate amount of deposits outstanding as at any point during the year has exceeded the limit specified by the such Credit Rating Agency;

(vi) Whether the company has violated any restriction on acceptance of public deposit as provided in Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016;

(vii) Whether the company has defaulted in paying to its depositors the interest and/or principal amount of the deposits after such interest and/or principal became due;

(viii) Whether the company has complied with the prudential norms on income recognition, accounting standards, asset classification, provisioning for bad and doubtful debts, and concentration of credit/investments as specified in the Directions issued by the Bank in terms of the Master Direction -Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016;

(ix) Whether the company has complied with the liquid assets requirement as prescribed by the Bank in exercise of powers under section 45-IB of the RBI Act and whether the details of the designated bank in which the approved securities are held is communicated to the office concerned of the RBI in terms of NBS 3; Non-Banking Financial Company Returns (Reserve Bank) Directions, 2016;

(x) Whether the company has furnished to the RBI within the stipulated period the return on deposits as specified in the NBS 1 to – Non- Banking Financial Company Returns (Reserve Bank) Directions, 2016;

(xi) Whether the company has furnished to the RBI within the stipulated period the quarterly return on prudential norms as specified in the Non-Banking Financial Company Returns (Reserve Bank) Directions,2016;

(xii) Whether, in the case of opening of new branches or offices to collect deposits or in the case of closure of existing branches/offices or in the case of appointment of agent, the company has complied with the requirements contained in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

Reasons to be stated for unfavorable or qualified statements: Where, in the auditor's report, the statement regarding any of the items referred to in paragraph 3 above is unfavorable or qualified, the auditor's report shall also state the reasons for such unfavorable or qualified statement, as the case may be. Where the auditor is unable to express any opinion on any of the items referred to in paragraph 3 above, his report shall indicate such fact together with reasons therefor.

Question 6

Kamna & Co LLP, a firm of Chartered Accountants, was appointed as auditor of an NBFC. The audit work has been completed. The audit team which was involved in the fieldwork came across various observations during the course of audit of this FNCB and have also limited understanding about the exceptions which are required to be reported in the audit report. They would like to understand in detail regarding the obligations on the part of an auditor in respect of exceptions in his reports that they can conclude their work. Please explain.

Answer 6

Obligation of auditor to submit an exception report to RBI

Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 above, is unfavorable or qualified, or in the opinion of the auditor the company has not complied with:

(a) the provisions of Chapter III B of RBI Act (Act 2 of 1934); or

(b) Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or

(c) Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

It shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the registered office of the company is located as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions.

Question 7

The Statutory Auditor of the NBFC company is required to give a report to the Board of Directors. What shall be the content of the Auditor's Report to the Board.

Answer 7

The statutory auditor of Karma Pvt Ltd, being a Non-Deposit Taking Non-Systemically Important NBFC is required to submit separate report to the Board of Directors on the matters as specified as below:

1. Conducting Non-Banking Financial Activity without a valid Certificate of Registration (CoR) granted by the RBI is an offence under chapter V of the RBI Act, 1934. Therefore, if the company

is engaged in the business of non-banking financial institution as defined in section 45-I (a) of the RBI Act and meeting the Principal Business Criteria (Financial asset/income pattern) as laid down vide the RBI's press release dated April 08, 1999, and directions issued by DNBR, auditor shall examine whether the company has obtained a Certificate of Registration (CoR) from the RBI.

2. In case of a company holding CoR issued by the RBI, whether that company is entitled to continue to hold such CoR in terms of its Principal Business Criteria (Financial asset/income pattern) as on March 31 of the applicable year.
3. Whether the non-banking financial company is meeting the required net owned fund requirement as laid down in Master Direction - Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Master Direction - Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Apart from the aspects enumerated above, the auditor shall include a statement on the following matters, namely: -

(i) Whether the Board of Directors has passed a resolution for non- acceptance of any public deposits;

(ii) Whether the company has accepted any public deposits during the relevant period/year;

(iii) Whether the company has complied with the prudential norms relating to income recognition, accounting standards, asset classification and provisioning for bad and doubtful debts as applicable to it in terms of Non-Banking Financial Company – Non- Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016;

Where, in the auditor's report, the statement regarding any of the items referred to matters specified above is unfavorable or qualified, the auditor's report shall also state the reasons for such unfavorable or qualified statement, as the case may be. Where the auditor is unable to express any opinion on any of the items referred above, his report shall indicate such fact together with reasons there of.

Question 8

Krishna Pvt Ltd is primarily into the business of selling computer parts. However, the company is fulfilling the Principal Business Criteria as at the balance sheet date i.e. Financial Assets are more than 50 % of total assets and Financial Income is more than 50% of Gross Income. What shall be the obligation of the Statutory Auditor in such a scenario?

Answer 8

In the given case, Krishna Pvt Ltd is fulfilling the Principal Business Criteria i.e. Financial Assets are more than 50 % of total assets and Financial Income is more than 50 % of Gross Income. The company which fulfils both these criteria shall qualify as an NBFC and hence is required to obtain Certificate of Registration (CoR) with Reserve Bank of India. In such a scenario, the statutory auditor has an obligation to submit exception report to the RBI on the following matters:

1. Where, in the case of a non-banking financial company, the statement regarding any of the items referred to in paragraph 3 of the Non-Banking Financial Companies Auditor's Report (Reserve Bank) Directions, 2016, is unfavourable or qualified, or in the opinion of the auditor the company has not complied with:

a) the provisions of Chapter III B of RBI Act (Act 2 of 1934); or

b) Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016; or

c) Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016 and Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

It shall be the obligation of the auditor to make a report containing the details of such unfavourable or qualified statements and/or about the non-compliance, as the case may be, in respect of the company to the concerned Regional Office of the Department of Non-Banking Supervision of the RBI under whose jurisdiction the registered office of the company is located as per first Schedule to the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016.

2. The duty of the Auditor under sub-paragraph (I) shall be to report only the contraventions of the provisions of RBI Act, 1934, and Directions, Guidelines, instructions referred to in sub-paragraph (1) and such report shall not contain any statement with respect to compliance of any of those provisions.

Question 9

Mr. G. has been appointed as an auditor of LMP Ltd., a NBFC company registered with RBI. Mr. G is concerned about whether the format of financial statements prepared by LMP Ltd. is as per notification issued by the Ministry of Corporate Affairs (MCA) dated October 11, 2018. The notification prescribed the format in Division III under Schedule III of the Companies Act, 2013 applicable to NBFCs complying with Ind- AS. Mr. G wants to know the differences in the presentation requirements between Division II and Division III of Schedule of the Companies Act, 2013. Help Mr. G.

Answer 9

The presentation requirements under Division III for NBFCs are similar to Division II (Non NBFC) to a large extent except for the following:

(a) NBFCs have been allowed to present the items of the balance sheet in order of their liquidity which is not allowed to companies required to follow Division II.

(b) An NBFC is required to separately disclose by way of a note any item of 'other income' or 'other expenditure' which exceeds 1 per cent of the total income. Division II, on the other hand, requires disclosure for any item of income or expenditure which exceeds 1 per cent of the revenue from operations o`r10 lakhs, whichever is higher.

(c) NBFCs are required to separately disclose under 'receivables', the debts due from any Limited Liability Partnership (LLP) in which its director is a partner or member.

(d) NBFCs are also required to disclose items comprising 'revenue from operations' and 'other comprehensive income' on the face of the Statement of profit and loss instead of showing those only as part of the notes.

(e) Separate disclosure of trade receivable which have significant increase in credit risk & credit impaired

(f) The conditions or restrictions for distribution attached to statutory reserves have to be separately disclose in the notes as stipulated by the relevant statute.

Question 10

Abhimanyu Finance Ltd. is a Non-Banking Finance Company and was in the business of accepting public deposits and giving loan since 2015. The company was having net owned funds of ` 1,50,00,000/(-one crore fifty lakhs) and was not having registration certificate from RBI and applied for it on 30 th March 2023. The company appointed Mr. Kabra as its statutory auditors for the year 2022-2.3Advise the auditor with reference to auditor procedures to be taken and reporting requirements on the same in view of CARO 2020?

Answer 10

As per Clause (xvi) of Paragraph 3 of CARO 2020, the auditor is required to report that "whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained."

The auditor is required to examine whether the company is engaged in the business which attract the requirements of the registration. The registration is required where the financing activity is a principal business of the company. The RBI restrict companies from carrying on the business of a non-banking financial institution without obtaining the certificate of registration.

Audit Procedures and Reporting:

1. The auditor should examine the transactions of the company with relation to the activities covered under the RBI Act and directions related to the Non-Banking Financial Companies.
2. The financial statements should be examined to ascertain whether company's financial assets constitute more than 50 per cent of the total assets and income from financial assets constitute more than 50 per cent of the gross income.
3. Whether the company has net owned funds as required for the registration as NBFC.
4. Whether the company has obtained the registration as NBFC, if not, the reasons should be sought from the management and documented.
5. The auditor should report incorporating the following: -

(i) Whether the registration is required under section 45-IA of the RBI Act, 1934.

(ii) If so, whether it has obtained the registration.

(iii) If the registration not obtained, reasons thereof.

In the instant case Abhimanyu Finance Ltd. is a Non-Banking Finance Company and was in the business of accepting public deposits and giving loans since 2015. The company was having net owned funds of ` 1,50,00,000/-(one crore fifty lakhs) which is less in comparison to the prescribed limit i.e. 2 crore rupees and was also not having registration certificate from RBI (though applied for it on 30th March 2021). The auditor is required to report on the same as per Clause (xvi) of Paragraph 3 of CARO 2020.

Question 11

"Fin crazy" is a P2P online platform owned by Future Technologies Pvt Limited which is registered with RBI as NBFC. Peer to Peer Platform (P2P) means an intermediary providing the services of loan facilitation via online medium or otherwise to the participants.

Participants have to enter into an arrangement with NBFC-P2P to lend on its platform or avail loan facilitation services provided by it. It provides only as a medium connecting lenders and borrowers. It also carries out the credit assessment and risk profiling of the participants on the platform. It also provides services relating to loan documentation and loan recovery. The company falls outside purview of upper layer.

Where does such NBFC fit into in accordance with scale-based regulations? Suggest few audit procedures for above NBFC-P2P.

Answer 11

NBFC-P2P falls in base layer in accordance with scale-based regulations of RBI. Few audit procedures for NBFCP2P are as under: -

- Gaining an understanding of business conducted by NBFC-P2P. It should be verified that company undertakes only permissible activities applicable to such type of NBFCs like providing online marketplace to participants for lending and borrowing. It should not be engaged in business of lending funds on its own.
- Verifying certificate of registration obtained from RBI for carrying business of P2P platform.
- Verifying Board approved policy setting out eligibility criteria for participants i.e. lenders and borrowers.
- Verifying board approved policy for pricing of services provided by P2P platform
- Verification of adherence to lending and borrowing guidelines prescribed by RBI
- Verifying appropriate arrangements have been entered into among participants and NBFC-P2P.
- Compliance with reporting requirements of RBI
- Verifying board approved policy for grievance redressal and complaints

Question 12

Sugam Housing Finance Limited is in the business of housing finance activities having asset size of ₹ 800 crores. Its principal business is of providing finances for housing mainly to individuals. It is not identified by RBI in upper layer. Under scale-based regulations introduced by RBI, what should be appropriate classification for such a company?

Is there any specific reporting requirement under CARO, 2020 for statutory auditor of a company engaged in housing finance activities?

Answer 12

The said company is not identified in upper layer by RBI. Under scale based regulations introduced by RBI, NBFCs undertaking housing finance activities constitute "middle layer". The asset size is not relevant in such a case. All housing finance companies not identified in upper layer would constitute middle layer due to nature of such activities undertaken by them.

There is specific reporting requirement under CARO, 2020 under clause 3 (xvi)(b) which requires auditor to report whether the company has conducted any non-Banking financial or housing finance activities without a valid Certificate of Registration (CoR) from the Reserve Bank of India as per the Reserve Bank of India Act, 1934.

Question 13

You are auditor of a deposit taking NBFC (NBFC-D). The NBFC is identified by RBI in its upper layer and its financial statements are required to prepared in accordance with requirements of Ind AS. The following is extract of statement of profit and loss for year ending 31St March, 2023 in accordance with Division III of Schedule III of Companies Act, 2013. Previous year figures are ignored.

Ongoing through details of head "other expenditure" in expenses side of statement of profit and loss, it is noticed that there is an expenditure relating to manpower outsourcing cost amounting to ₹99.50 crores included under "other expenditure"

Does it meet the requirements of Division III of Schedule III of Companies Act, 2013?

Answer 13

An NBFC is preparing financial statements in accordance with requirements of Division III of Schedule III of Companies Act, 2013 has to separately disclose by way of note any item of "other expenditure" exceeding 1% of total income.

The said expenditure of ₹99.50 crore does not exceed 1% of total income. Hence, it meets requirements of Division III of Schedule III of Companies Act, 2013.

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

Integrated Case Scenario

CA. Parampara is statutory auditor of "Lohit Finance Limited" a , Micro finance institution, working predominantly in states popularly described as "seven sisters of North East", West Bengal, Odisha and Andhra Pradesh. It is a non-deposit taking NBFC catering to credit requirements of rural and semi-urban households and provides small ticket loans. She has performed audit procedures for year 2022-23 and following further information is given as under: -

(A) The Board of Directors of the company has passed a resolution in its meeting held on 1.5.22 for nonacceptance of public deposits during year ended 31st March, 2023.

(B) The company has obtained certificate of registration dated 15th March, 2012 from RBI in pursuance of section 45-IA of RBI Act, 1934 and it is entitled to hold such certificate of registration in terms of its financial assets/income pattern for year ended 31st March, 2023.

(C) The company has identified instances of cash embezzlement by the employees during the year. Such instances relate to employees fleeing after collection of instalments from customers at some centres.

The total amount involved is `15 lacs and ` 5 lacs have been recovered subsequently. The matter has also been reported in note 35 of financial statements.

(D) It falls in middle layer of scale-based regulations and regulations for a systemically important nondeposit taking NBFC are applicable to it. Its capital adequacy ratio is stated in note 36 of financial statements.

(E) Audit procedures performed by her included testing design and operating effectiveness of controls relating to allowances for loan losses using Expected credit loss model (ECL) in accordance with Ind AS 109. Tests of details performed by her included verifying assumptions affecting ECL calculations.

Keeping in view above information, answer the following questions: -

1. The Board of Directors has passed a resolution for non- acceptance of public deposits during year 2022-23. Which of the following statements is most appropriate in this regard as regards reporting obligations of auditor are concerned?

a) Passing of board resolution for non-acceptance of public deposits, being an internal governance matter, is not required to be reported by auditor.

b) Matter of passing of board resolution for non-acceptance of public deposits is a specific reporting requirement for auditor under CARO, 2020.

c) Matter of passing of board resolution for non-acceptance of public deposits is a specific reporting requirement in auditor's additional report to the Board of Directors of the company.

d) Matter of passing of board resolution for non-acceptance of public deposits is a specific reporting requirement in auditor's additional report to the Board of Directors of the company as well as under CARO, 2020.

Ans: (c)

2. Which of the following statements is most appropriate in respect of reporting requirements relating to certificate of registration of the company obtained from RBI as described in para [B] of the case?

a) It is the duty of auditor to report whether company has obtained certificate of registration as required under section 45-IA of RBI Act, 1934 in auditor's additional report to the Board of Directors of the company.

b) It is the duty of auditor to report whether company has obtained certificate of registration as required under section 45-IA of RBI Act, 1934 in auditor's additional report to the Board of Directors of the company as well as under CARO,2020.

c) It is the duty of auditor to report whether company has obtained certificate of registration as required under section 45-IA of RBI Act, 1934 under CARO,2020.

d) It is the duty of auditor to report whether company has obtained certificate of registration as required under section 45-IA of RBI Act, 1934 in auditor's additional report to the Board of Directors of the company as well as under CARO,2020. Further, it is also required to be reported in auditor's additional report to Board of Directors whether company is entitled to hold such certificate in terms of its financial assets/income pattern.

Ans: (d)

3. Regarding instances of cash embezzlement identified by the company during the year, which of the following statements best fits into reporting requirements of an auditor?

a) Such instances are required to be reported under CARO, 2020 under relevant clause.

b) Cash embezzled amount is less than `1 crore. No reporting under CARO, 2020 is required of such instances.

c) Such instances are required to be reported under CARO, 2020 as well as in auditor's additional report to Board of Directors of company.

d) Such instances are to be specifically reported in auditor's report under Section 143(3) of Companies Act,2013.

Ans: (a)

4. As regards description of capital adequacy ratio as described in para [D] of case, which of the following statements meets regulatory reporting requirements?

a) Auditor has to ascertain and verify whether such ratio has been disclosed in financial statements in notes to accounts.

b) Auditor has to ascertain and verify whether such ratio as disclosed in NBS-7 has been correctly arrived at.

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

c) Auditor has to ascertain and verify whether such ratio as disclosed in NBS-7 has been correctly arrived at and whether such ratio is in compliance with minimum CRAR prescribed by RBI.

d) Auditor has to ascertain and verify whether such ratio has been disclosed in financial statements in notes to accounts and has been correctly arrived at and is in compliance with minimum CRAR prescribed by RBI.

Ans: (c)

5. The auditor has performed audit procedures relating to allowances for loan losses using ECL in accordance with Ind AS 109. As these allowances involve significant judgment and estimates, she wants to state how it was addressed by her. How she can do that?

a) By stating it in Auditor's additional report to Board of Directors.

b) By stating it in matters as required under Section 143(3) of Companies Act.

c) By incorporating Emphasis of Matter Paragraph in Independent auditor's report.

d) By identifying it as Key audit matter in Independent auditor's report.

Ans: (d)

SPECIAL FEATURES OF AUDIT OF BANKS & NON-BANKING FINANCIAL COMPANIES

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15
CHAPTER

AUDIT OF PUBLIC SECTOR UNDERTAKINGS

Question 1

The Comptroller and Auditor General assists the legislature in reviewing the performance of public undertakings. He conducts an efficiency-cum-performance audit other than the field which has already been covered either by the internal audit of the individual concerns or by the professional auditors. He locates the area of weakness for managements' information. Explain stating clearly the issues examined in comprehensive audit (MTP 4 Marks, Oct 19)

OR

Solar Limited is a public sector undertaking engaged in production of electricity from solar power. It has started a new project near Puducherry with a new technology for a cost of Rs. 9,750 crore. Though there is delay in commencement of project and accordingly, there has been overrun in the cost. State the matters C&AG while conducting Comprehensive Audit may cover in reporting on the performance and efficiency of this project. (MTP 4 Marks, Oct 20, MTP 5 Marks Apr'21, PYP 4 Marks Nov'18, MTP 5 Marks Sep'22, Old & New SM)

OR

Bahubali & Co., a CA. firm was appointed by C&AG to conduct comprehensive audit of Brahmi Ltd., a public sector undertaking. C&AG advised Bahubali & Co. to cover areas such as investment decisions, project formulation, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, materials management, sales and credit control, budgetary and internal control systems, etc.

Discuss stating the issues examined in comprehensive audit. (MTP 5 Marks March 22,RTP May 20)

Answer 1

The Comptroller and Auditor General assist the legislature in reviewing the performance of public undertakings. He conducts an efficiency-cum-performance audit other than the field which has already been covered either by the internal audit of the individual concerns or by the professional auditors. He locates the area of weakness and extravagance for managements' information.

The areas covered in comprehensive audit naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations. However, in general, the covered areas are those of investment decisions, project formulation, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, materials management, sales and credit control, budgetary and internal control systems, etc.

Some of the issues examined in comprehensive audit are:

(i) How does the overall capital cost of the project compare with the approved planned costs? Were there any substantial increases and, if so, what are these and whether there is evidence of extravagance or unnecessary expenditure?

(ii) Have the accepted production or operational outputs been achieved? Has there been underutilization of installed capacity or shortfall in performance and, if so, what has caused it?

(iii) Has the planned rate of return been achieved?

(iv) Are the systems of project formulation and execution sound? Are there inadequacies? What has been the effect on the gestation period and capital cost?

(v) Are cost control measures adequate and are there inefficiencies, wastages in raw materials consumption, etc.?

(vi) Are the purchase policies adequate? Or have they led to piling up of inventory resulting in redundancy in stores and spares?

(vii) Does the enterprise have research and development programmes? What has been the performance in adopting new processes, technologies, improving profits and in reducing costs through technological progress?

(viii) If the enterprise has an adequate system of repairs and maintenance?

(ix) Are procedures effective and economical?

(x) Is there any poor or insufficient or inefficient project planning?

The efficiency and effectiveness audit of public enterprises is conducted on the basis of certain standards and criteria. Profit is not the key criterion on performance; management's performance in the economical and efficient use of public funds and in the achievement of objectives is more relevant. Public enterprises have been set up with certain socio-economic purposes and for fulfillment of certain objectives. The objectives vary from enterprise to enterprise. Audit appraisal analyses the performance of an enterprise to bring out the extent to which the objectives for which the enterprise was set up have been served.

Question 2

Tee & Co., a firm of Chartered Accountants had been appointed by C & AG to conduct statutory audit of M/s Rare Airlines Limited, a Public Sector Company. They would like to check certain mandatory propriety points as required under section143(1) of the Companies Act, 2013. List the areas of check to meet these requirements. (MTP 4 Marks, April 19)(PYP 4 Marks May 18)

Answer 2

Mandatory Propriety Points under section 143 (1) of the Companies Act, 2013: The requirement of the provisions of section 143(1) is essentially propriety-oriented as much as some specific dubious

practices are required to be looked into by the auditor. Areas of propriety audit under the provisions of Section 143(1) may be following:

(i) Whether the terms on which secured loans and secured advances have been made are prejudicial to the interests of the company or its members": It may be appreciated that the terms of loans include such matters as security, interest, repayment period and other business considerations. The auditor has to inquire whether the terms are such that they can be adjudged as prejudicial to the legitimate interest of the company or of its shareholders. This is a process of judging a situation by reference to certain objective standards or reasonableness whether the terms entered into are prejudicial or not, not only to the company but also to the shareholders.

(ii) Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company: This proposition has got to be inquired into by reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards. It is also possible that some transactions may not adversely affect the interests of the company. The auditor has to judiciously consider what does and does not constitute the interest of the company.

(iii) Whether investment of companies, other than a banking or an investment company, in the form of shares, debentures and other securities have been sold at a price lower than the cost: Apparently, this is a matter of verification by the auditor. The intention, however, is not known whether loss has occurred due to the sale. The auditor is required to inquire into circumstances of sale of investments that resulted in loss. Obviously, the duty cast on him is propriety based, i.e., reasonableness of the decision to sell at a loss. It involves exercise of judgment having regard to the circumstances in which the company was placed at the time of making the sale.

(iv) Whether loans and advances made by the company have been shown as deposits. Again, considering the propriety element, rationalizing the proper disclosure of loans and advance given by company is made:

(v) Whether personal expenses have been charged to revenue: It is an accepted principle that expenses which are not business expenses should not be charged to revenue. The effect of charging personal expenses to the business is to distort the profitability of the company and to secure a personal gain at the cost of the company. Obviously, propriety is involved in this; charging personal expenses to business account is highly improper and abusive hence this provision.

(vi) In case it is stated in the books and papers of the company that shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash actually received, whether the position in books of account and balance sheet so stated is correct, regular and not misleading: A control has been set up to verify the receipt of cash in case of allotment of shares for cash. Further, if cash is not received, the books of accounts and statement of affairs shows the true picture.

Question 3

ABG & Co., a Chartered Accountant firm has been appointed by C & AG for performance audit of a Sugar Industry. List out the factors to be considered generally by ABG & Co., while planning a performance audit of Sugar Industry? (MTP 4 Marks, March 18)

Answer 3

Factors to be considered while planning the Performance Audit: While planning a performance audit of Sugar Industry, the auditors should take care of certain factors which are listed below:

(i) to consider significance and the needs of potential users of the audit report.

(ii) to obtain an understanding of the program to be audited.

(iii) to consider legal and regulatory requirements.

(iv) to consider management controls.

(v) to identify criteria needed to evaluate matters subject to audit.

(vi) to identify significant findings and recommendations from previous audits that could affect the current audit objectives. Auditors should determine if management has corrected the conditions causing those findings and implemented those recommendations.

(vii) to identify potential sources of data that could be used as audit evidence and consider the validity and reliability of these data, including data collected by the audited entity, data generated by the auditors, or data provided by third parties.

(viii) to consider whether the work of other auditors and experts may be used to satisfy some of the auditors' objectives.

(ix) to provide sufficient staff and other resources to do the audit.

(x) to prepare a written audit plan.

Question 4

The Comptroller & Auditor General of India plays a key role in the functioning of the financial committees of Parliament and the State Legislatures. He has come to be recognized as a 'friend, philosopher and guide' of the Committees. In view of above, you are required to list down any four role. (4 Marks, Oct 18)

OR

The Comptroller & Auditor General of India plays a key role in functioning of financial committees of Parliament and state legislatures. Therefore, he has come to be recognized as a friend, philosopher and guide of committees. Discuss how such a role is ensured in practice. Also, briefly discuss the functions of "Estimates Committee" of Parliament. (MTP 5 Marks Oct '23)

Answer 4

The Comptroller & Auditor General of India plays a key role in the functioning of the financial committees of Parliament and the State Legislatures. He has come to be recognized as a 'friend, philosopher and guide' of the Committees. It is ensured as follows: -

(i) His reports generally form the basis of the Committees' working, although they are not precluded from examining issues not brought out in his reports

(ii) He scrutinizes the notes which the Ministries submit to the Committees and helps the Committees to check the correctness of submissions to the Committees and facts and figures in their draft reports

(iii) The financial Committees present their report to the Parliament/ State Legislature with their observations and recommendations.

The various Ministries / Department of the Government are required to inform the Committees of the action taken by them on the recommendations of the Committees (which are generally accepted) and the Committees present Action Taken Reports to Parliament / Legislature

(iv) In respect of those audit reports, which could not be discussed in detail by the committees', written answers are obtained from the Department / Ministry concerned and are sometimes incorporated in the Reports presented to the Parliament / State Legislature.

This ensures that the audit reports are not taken lightly by the Government, even if the entire report is not deliberated upon by the Committee.

The functions of "Estimates Committee" are: -

(i) to report what economies, improvements in organization, efficiency or administrative reform, consistent with the policy underlying the estimates may be effected

(ii) to suggest alternative policies

(iii) to examine whether the money is well laid out within the limit and

(iv) to suggest the form in which the estimates shall be presented to Parliament.

Question 5

The Comptroller and Auditor General of India has appointed a chartered accountant firm to conduct the comprehensive audit of Tram Company Limited (a listed government company) which is handling the Metro project of the metropolitan city for the period ending 31-03-2021. The work to be conducted under Project 'D' handled by the Tram Company Limited was of laying down railway line of 124 kilometers. [The chartered accountant firm reviewed the internal audit report and observed the shortcoming reported about the performance of Project 'D' regarding the understatement of the Current liabilities and Capital work in progress by ` 95.39 crore.] Explain some of the matters to be undertaken by the chartered accountant firm while conducting the comprehensive audit of Tram Company Limited. (MTP 5 Marks April 22)

AUDIT OF PUBLIC SECTOR UNDERTAKINGS

OR

The Comptroller and Auditor General of India has appointed a chartered accountant firm to conduct the comprehensive audit of Metro Company Limited (a listed government company) which is handling the Metro project of the metropolitan city for the period end ing 31-03-2020. The work to be conducted under Project A handled by the Metro Company Limited was of laying down railway line of 124 kilometers. [The chartered accountant firm reviewed the internal audit report and observed the shortcoming reported about the performance of Project A regarding the understatement of the Current liabilities and Capital work in progress by ~ 84.68 crore.] Explain some of the matters to be undertaken by the chartered accountant firm while conducting the comprehensive audit of Metro Company Limited. (PYP 5 Marks, Jan '21)

Answer 5

A CA Firm has been appointed to conduct comprehensive audit of Tram Company Limited, which is a listed Govt Company handling the Metro project. CA firm has observed the shortcomings as stated in internal audit report regarding understatement of Current liabilities and CWIP by ` 95.39 crore.

Matters to be undertaken by the CA Firm while conducting the comprehensive audit of Tram Company Limited are:

(i) How does the overall capital cost of the project compare with the approved planned costs? Were there any substantial increases and, if so, what are these and whether there is evidence of extravagance or unnecessary expenditure?

(ii) Have the accepted production or operational outputs been achieved? Has there been underutilisation of installed capacity or shortfall in performance and, if so, what has caused it?

(iii) Has the planned rate of return been achieved?

(iv) Are the systems of project formulation and execution sound? Are there inadequacies? What has been the effect on the gestation period and capital cost?

(v) Are cost control measures adequate and are there inefficiencies, wastages in raw materials consumption, etc.?

(vi) Are the purchase policies adequate? Or have they led to piling up of inventory resulting in redundancy in stores and spares?

(vii) Does the enterprise have research and development programmes? What has been the performance in adopting new processes, technologies, improving profits and in reducing costs through technological progress?

(viii) If the enterprise has an adequate system of repairs and maintenance?

(ix) Are procedures effective and economical?

(x) Is there any poor or insufficient or inefficient project planning?

Question 6

"The C & AG may direct the appointed auditor about the manner in which the accounts of the Government Company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India". What are the relevant sections of the Companies Act, 2013 and steps involved in the audit of Government Companies?(MTP 5 Marks March '23, RTP May 18, Old SM)

Answer 6

The following steps are involved in the audit of government companies:

(i) Appointment of Auditors under Section 139(5) and 139(7) read with section 143(5) of the Companies Act, 2013 - Statutory auditors of Government Companies are appointed or re-appointed by the C&AG. There is thus, a departure from the practice in vogue in the case of private sector companies where appointment or re-appointment of the auditors and their remuneration are decided by the members at the annual general meetings. In the case of government companies, though the appointment of statutory auditors is done by the C&AG, the remuneration is left to the individual companies to decide based on certain guidelines given by the C&AG in this regard.

(ii) The C&AG may direct the appointed auditor on the manner in which the accounts of the Government company are required to be audited and the auditor so appointed has to submit a copy of the audit report to the Comptroller and Auditor-General of India. The report, among other things, includes the directions, if any, issued by the C&AG, the action taken thereon and its impact on the accounts and financial statement of the company.

The report under section 143(5) is in addition to the reports issued by the Statutory Auditors under various other clauses of section 143.

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

(iv) Comment upon or supplement such Audit Report under section 143(6)(b) of the Companies Act, 2013 - Any comments given by the C&AG upon, or in supplement to, the audit report issued by the statutory auditors shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 of the said Act i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

(v) **Test audit under section 143(7) of the Companies Act, 2013 -**Without prejudice to the provisions relating to audit and auditor, the C&AG may, in case of any company covered under sub-section (5) or sub-section (7) of section 139 of the said Act, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

Question 7

C & AG appointed a chartered accountant firm to conduct Performance audit of OM Ltd., a PSU of Govt. of India. The firm conducted the audit with a view to check all the expenses of the unit are in conformity with the public interest and publicly accepted customs. The audit report submitted by audit firm was rejected by C&AG. Give your opinion on the action of C&AG. (MTP 5 Marks April '23, RTP Nov'22, Old & New SM)

Answer 7

In the given scenario, C&AG appointed a chartered accountant firm to conduct Performance Audit of OM Ltd., a PSU of Government of India. The firm conducted audit with a view to check all the expenses of the unit are in conformity to the public interest and publicly accepted customs which is not Performance Audit.

A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.

Performance audit in PSUs is conducted by the C&AG (Supreme Audit Institutions) through various subordinate offices of Indian Audit and Accounts Department (IAAD). In conducting performance audit, the subordinate offices are guided by manual and auditing standards prescribed by C&AG.

Therefore, the objectives of performance auditing are evaluation of economy, efficiency, and effectiveness of policy, programmes, organization and management. It also promotes accountability by assisting those charged with governance and oversight responsibilities to improve performance; and transparency by affording taxpayers, those targeted by government policies and other stakeholders an insight into the management and outcomes of different government activities.

Performance auditing focuses on areas in which it can add value which have the greatest potential for development. It provides constructive incentives for the responsible parties to take appropriate action. Regulations on Audit and Accounts issued by C&AG lay down that the responsibility for the development of measurable objectives and performance indicators as also the systems of measurement rests with the Government departments or Heads of entities. They are also required to define intermediate and final outputs and outcomes in measurable and monitorable terms, standardise the unit cost of delivery and benchmark quality of outputs and outcomes.

AUDIT OF PUBLIC SECTOR UNDERTAKINGS

Thus, rejection of audit report (submitted by audit firm) by C&AG is in order as audit with a view to mere check all the expenses of the unit are in conformity to the public interest and publicly accepted customs done by audit firm is not performance audit in all aspects.

Question 8

"A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action." Briefly discuss the issues addressed by Performance Audits conducted in accordance with the guidelines issued by C&AG. (RTP Nov 18, RTP May 20, Old & New SM)

Answer 8

According to the guidelines issued by the C&AG, Performance Audits usually address the issues of:

(i) **Economy-** It is minimising the cost of resources used for an activity, having regard to appropriate quantity, quality and at the best price.

Judging economy implies forming an opinion on the resources (e.g. human, financial and material) deployed. This requires assessing whether the given resources have been used economically and acquired in due time, in appropriate quantity and quality at the best price.

(ii) **Efficiency-** It is the input-output ratio. In the case of public spending, efficiency is achieved when the output is maximised at the minimum of inputs, or input is minimised for any given quantity and quality of output.

Auditing efficiency embraces aspects such as whether:

(a) sound procurement practices are followed;

(b) resources are properly protected and maintained;

(c) human, financial and other resources are efficiently used;

(d) optimum amount of resources (staff, equipment, and facilities) are used in producing or delivering the appropriate quantity and quality of goods or services in a timely manner;

(e) public sector programmes, entities and activities are efficiently managed, regulated, organized and executed;

(f) efficient operating procedures are used; and

(g) the objectives of public sector programmes are met cost-effectively.

(iii) **Effectiveness-** It is the extent to which objectives are achieved and the relationship between the intended impact and the actual impact of an activity.

In auditing effectiveness, performance audit may, for instance:

(a) assess whether the objectives of and the means provided (legal, financial, etc.) for a new or ongoing public sector programme are proper, consistent, suitable or relevant to the policy;

(b) determine the extent to which a program achieves a desired level of program results;

(c) assess and establish with evidence whether the observed direct or indirect social and economic impacts of a policy are due to the policy or to other causes;

(d) identify factors inhibiting satisfactory performance or goal-fulfilment;

(e) assess whether the programme complements, duplicates, overlaps or counteracts other related programmes;

(f) assess the effectiveness of the program and/or of individual program components;

(g) determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;

(h) assess the adequacy of the management control system for measuring, monitoring and reporting a programme's effectiveness;

(i) assess compliance with laws and regulations applicable to the program; and identify ways of making programmes work more effectively.

Question 9

The objectives of audit in connection with a State Electricity Distribution Company were to ascertain whether the:

(i) total cost of providing electricity is being recovered by timely submissions to the State Electricity Regulatory Commission;

(ii) tariff orders, sales circulars and sales instructions were issued timely, without any ambiguity. They were implemented in time;

(iii) metering, billing and collection was managed efficiently and effectively;

(iv) monitoring and internal controls were efficient.

What kind of audit is referred in the above scenario? Also briefly discuss the steps suggested to the auditors for planning such an audit. (RTP May 22, New SM)

OR

ABG & Co., a Chartered Accountant firm has been appointed by C & AG for performance audit of a Sugar Industry. What factors should be considered by ABG & Co., while planning a performance audit of Sugar Industry? (Old SM)

Answer 9

In the given scenario, in view of the objectives discussed, performance audit is being referred. The following steps are suggested to the auditors for planning while conducting the performance audit:

(A) Understanding the Entity/Programme - It is the starting point for planning individual performance audit.

The auditor may use the following sources for understanding the entity:

(i) Documents of the entity: Documents on administration and functions of the entity, policy files, annual reports, budget documents, accounts, minutes of meetings, information on the website, internal audit reports, electronic databases and MIS reports, RTI material etc.

(ii) Legislative documents: Legislation, parliamentary questions and debates, reports of the Public Accounts Committee, the Committee on Public Undertakings, the Estimates Committee, and letters from Members of Parliament.

(iii) Policy documents: Documents of Planning Commission, Ministry of Finance etc.

(iv) Academic or special research: Independent evaluations on the entity, academic research and similar work done by other governments and other SAIs.

(v) Past audits: Past financial and performance audits of the entity provide a major source of information and understanding.

(vi) Media coverage: Print and electronic media - their systematic documentation on regular basis in a transparent manner.

(vii) Special focus groups: Audit Advisory Committee concerns, annual and special reports of World Bank, Reserve Bank of India, reports by special interest groups, NGOs, etc.

(B) Defining the Objectives and the Scope of Audit - The audit objectives should be defined in a succinct manner as they will impact the nature of the audit, govern its conduct and affect audit conclusions. Setting audit objectives ensures good quality performance audits. It facilitates clarity, demonstrates the consistent quality of audit and serves as a measure of quality assurance of the audit. Defining the scope constricts the audit to significant issues that relate to the audit objectives. It mainly focuses on the extent, timing and nature of the audit.

(C) Determining Audit Criteria - Audit criteria are the standards used to determine whether a program meets or exceeds expectations. It provides a context for understanding the results of the audit.

Audit criteria are reasonable and attainable standards of performance against which economy, efficiency and effectiveness of programmes and activities can be assessed. The audit criteria may be sought to be obtained from the following sources:

(i) procedure manuals of the entity.

(ii) policies, standards, directives, and guidelines.

(iii) criteria used by the same entity or other entities in similar activities or programmes.

(iv) independent expert opinion and know how.

(v) new or established scientific knowledge and other reliable information.

(vi) general management and subject matter literature and research papers.

(D) Deciding Audit Approach - There is no uniform audit approach prescribed that can be applicable to all types of subjects of performance audits. The selection of approach also determines methods and means used for conducting the audit.

Some of the methods which could be used in conducting performance audits include:

(i) **Analysis of procedures:** It involves review of the systems in place for planning, conducting, checking and monitoring the activity. This would consist of examination of documents such as financial reports, budgets, programme guidelines, procedure manuals, etc.

(ii) **Case studies:** A case study is a descriptive analysis of an entity, scheme or programme. It involves analysis of a particular issue within the context of the whole area under review.

(iii) **Use of existing data:** The audit staff should investigate the data held by entity management and by other relevant sources. Audit conclusions based on testing of available data for correctness and completeness enhances the assurance level.

(iv) **Surveys:** Survey is a method of collecting information from members of a population to assess the interrelation of events and conditions. Surveys on predetermined parameters can supplement the audit findings and conclusions adding value to the performance audits.

(v) **Analysis of results:** It requires the auditor to carry out actual output-input analysis to determine the efficiency of the programme.

(vi) **Quantitative analysis:** It involves an examination of available data relating to financials like earnings, revenue, or data relating to programme implementation like details of beneficiaries etc. However, it may not be possible for the auditor to work with complete data due to its high volume. In such cases, sampling techniques are required to be used.

(E) Developing Audit Questions - Subsequent to designing of audit objectives and determination of audit criteria, the audit team is required to prepare a list of questions to which they would seek answers. The questions should be framed in a comprehensive manner involving a detailed hierarchy of questions.

(F) Assessing Audit Team Skills and whether Outside Expertise required - It is essential that the performance auditors possess special aptitude and knowledge. The Auditing Standards of C&AG of India provide that the audit institution should develop and train the auditors to enable them to perform their tasks effectively & efficiently and should prepare manuals & other written guidance notes & instructions concerning the conduct of audits.

Given the diverse range of subjects of performance auditing, the audit team needs to develop a sound understanding of the programme or entity proposed to be audited.

The audit team needs to decide at the planning stage on which aspect of expertise is required.

Though the Accountant General may use the work of an expert, he retains full responsibility for the expression of opinion in the auditor's report.

(G) Preparing Audit Design Matrix (ADM) - Having determined the audit objective, audit criteria, audit approach, data collection etc., the audit team should prepare an Audit Design Matrix. It is a structured and highly focused approach to designing a performance audit study.

The ADM highlights the data collection and analysis method as well as the type and sources of evidence required to support audit opinion/findings.

A specimen of ADM is given as under:

Audit Objective (1)	Audit Questions (2)	Audit Criteria (3)	Evidence (4)	Data Collection and Analysis Method (5)

An ADM is prepared on the basis of information and knowledge obtained during the planning stage. A well-designed ADM leads to effective audits thus providing the highest assurances to the auditing entities. It is desirable to prepare ADM for each of the audit objectives.

(H) Establishing Time-Table and Resources - It is significant to determine the timetable and desirable resources. Selection of an appropriate audit team is the most vital component in planning an audit. Considerations for the selection of an appropriate audit team should be recorded along with the proposed timelines for various activities to be undertaken as a part of the audit process. The progress should also be monitored against these timelines. The Accountant General would be liable for ensuring that the performance audit is completed on time. The variations between the required and actual time spent should be compared and approved from the competent authority.

The team should build time for translation, approval and possible delays in their own schedule in order to meet the targets.

(I) Intimation of Audit Programme to Audit Entities - Audited entities must be intimated about the intention of taking up planned performance audit with the scope and extent of audit including the constitution of an audit team and the tentative time schedule, well before the commencement of Audit. Acknowledgement of this may be requested and placed on record.

It may be required to refine an audit's objectives as the audit progresses for gathering the requisite information to fulfil the audit. The reasons for such changes in the objectives should also be recorded and approved by the competent authority. The audit programme should be flexible and reviewed from time to time as it is not possible to anticipate all the contingencies at the early stage. The Accountant General should share all significant refinements in the approach and additional tests and findings, concurrently with other audit teams when different persons conduct the audit at different locations. The system of sharing of the significant field audit experience should be documented and reviewed.

Question 10

Siddha Ltd., a company wholly owned by central government was disinvested during the previous year, resulting in 40% 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.

Mahavir, the FM 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. (RTP May '23, Old & New SM)

Answer 10

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.

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.

In the given situation, Siddha Ltd is a company wholly owned by central government was disinvested during the previous year, resulting in 40% of the shares being held by public. The shares were also listed on the BSE. The listing of company's shares on a stock exchange is irrelevant for this purpose and hence, Mahavir's opinion is not correct.

Question 11

On receipt of statutory audit report on 30-03-2018 of M/s Sunlight Ltd., a government company, C&AG on 25-05-2018 appointed M/s Veeru & Associates to conduct supplementary audit u/s 143(6)(a) of the Companies Act, 2013. They submitted their report to C&AG as per their scope of work. The Company held its AGM on 01-09-2018 but directors did not think it necessary to discuss supplementary auditor's report and comment of the C&AG. Is the approach of the directors of Sunlight Ltd. correct? Guide the company with the provisions related to supplementary audit. (PYP 5 Marks, May '19)

Answer 11

The Comptroller and Auditor-General of India shall within 60 days from the date of receipt of the audit report have a right to,

(i) conduct a supplementary audit under section 143(6)(a), of the financial statement of the company by such person or persons as he may authorize in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorized, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and

(ii) comment upon or supplement such audit report under section 143(6)(b): It may be noted that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub-section (1) of section 136 i.e. every member of the company, to every trustee for the debenture-holder of any debentures issued by the company, and to all persons other than such member or trustee, being the person so entitled and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

In view of above provisions, the approach of directors of Sunlight Ltd. is not correct. They are required to mandatory send the Supplementary Audit Report and comments of C&AG to every member of the company etc. as prescribed and also be placed before the annual general meeting of the company in the same manner as in case of audit report. Since in the given case neither the report has been distributed nor discussed in the Annual General Meeting, the directors of the company will be liable for contravention of aforesaid sections..

Question 12

The reports of the Comptroller and Auditor General of India on the audit of PSUs are presented to the Parliament and to various state legislatures to facilitate a proper consideration. Enumerate the contents of Audit Report presented by C & AG. (PYP 5 Marks Dec '21, New SM)

Answer 12

To facilitate a proper consideration, the reports of the C&AG on the audit of PSUs are presented to the Parliament in several parts consisting of the following:

(i) Introduction containing a general review of the working results of Government companies, deemed Government companies and corporations;

(ii) Results of comprehensive appraisals of selected undertakings conducted by the Audit Board;

(iii) Resume of the company auditors' reports submitted by them under the directions issued by the C&AG and that of comments on the accounts of the Government companies; and

(iv) Significant results of audit of the undertakings not taken up for appraisal by the Audit Board. For certain specified states, the C&AG submits a separate audit report (commercial) to the legislature, while for other States/Union Territories with legislature, there is a commercial chapter in the main audit report. The State audit reports, contains both the results of audit appraisal of performance of selected companies/corporations as well as important individual instances of financial irregularities, wasteful expenditure, system deficiencies noticed by the statutory auditors, and a general review of the working results of Government companies and corporations.

Multiple Choice Questions (MCQs)

Question 1

In Case of PSU, Direct Reporting Engagement does not include

(a) Performance audits

(b) compliance audits

(c) Financial audits

(d) Comprehensive Audit (MTP 1 Mark ,Mar 19, MTP 1 Mark Apr'21)

Answer 1 : (c)

Question 2

You have been given an assignment of audit of IT department of a PSU. A checklist was handed over to you which contained many questions such as,

- Are separate usernames and passwords assigned to individual users?
- Are periodical changes of passwords ensured?
- Are external (offsite) data backups maintained at a place outside the premises? The type of audit being conducted is likely to be:

(a) Comprehensive audit.

(b) Propriety audit.

(c) Compliance audit.

(d) Financial audit. (MTP 1 Mark Sep '23, Oct'22, RTP May'23)

Answer 2 : (d)

Question 3

NOP Ltd. is a joint venture of Central Government and a private company and is engaged in the business of distribution of electricity in Chennai. The Central Government holds 51% shares of the company. The company is acknowledged for its consumer-friendly practices. Initially it was completely owned by the Government and was running into significant losses but after the joint venture, the aggregate technical and commercial losses of the company showed a record decline. The operations of the company have improved significantly as claimed by the management of the company. The C&AG wants to conduct the performance audit of one of the departments of the company through a subordinate office of Indian Audit and Accounts Department. For this purpose, the audit programme has also been finalized and the Accountant General has intimated the company that the audit would start within a day's time. The company is concerned because the programme which has been received from the Accountant General is quite detailed and would involve significant time. Further the management of the company is quite surprised as to why this audit should be conducted as this is not a company subject to such types of audits as per law. The management of the company would like to have your inputs in respect of this matter. Please guide.

(a) The notice for such type of audit should give reasonable time to the management to prepare themselves. Further it should not be a detailed audit requiring significant time of the company.

(b) The C&AG may conduct such type of audits in respect of NOP Ltd. which would get covered in this criteria, however, the notice for conducting such type of audit should give reasonable time to the management to prepare themselves.

(c) In case of a joint venture such type of audit cannot be performed as per the Companies Act, 2013. The company should write to the Registrar of Companies in respect of this matter and till that time no audit can be started.

(d) In case of a joint venture such type of audit cannot be performed as per the Companies Act, 2013. Further wherever this is applicable that is only for a small period of time. The company should write to the Ministry of Corporate Affairs in respect of this matter. (MTP 1 Mark Oct '23)

Answer 3 : (b)

Question 4

With respect to audit of public sector undertaking, which among the below is related to propriety audit?

(a) This audit is carried out by assessing whether activities, financial transactions and information comply in all material aspects, with the regulatory and other authorities which govern the audited entity.

(b) This auditing focuses on the areas in which it can add value which have the greatest potential for development. It provides constructive incentives for the responsible parties to take appropriate action.

(c) It is an audit under which the C&AG does not really cover again the field which has already been covered. He conducts an appraisal or an efficiency cum performance audit.

(d) It stands for verification of transactions on the tests of public interest, commonly accepted customs and standards of conduct. This audit is directed towards an examination of managements decisions in sales, purchases, contracts, etc. (RTP Nov'22)

Answer 4 (a)

Question 1

The reports of the Comptroller and Auditor General of India on the audit of PSUs are presented to the Parliament and to various state legislatures to facilitate a proper consideration. Enumerate the contents of Audit Report presented by C & AG.

Answer 1

To facilitate a proper consideration, the reports of the C&AG on the audit of PSUs are presented to the Parliament in several parts consisting of the following :

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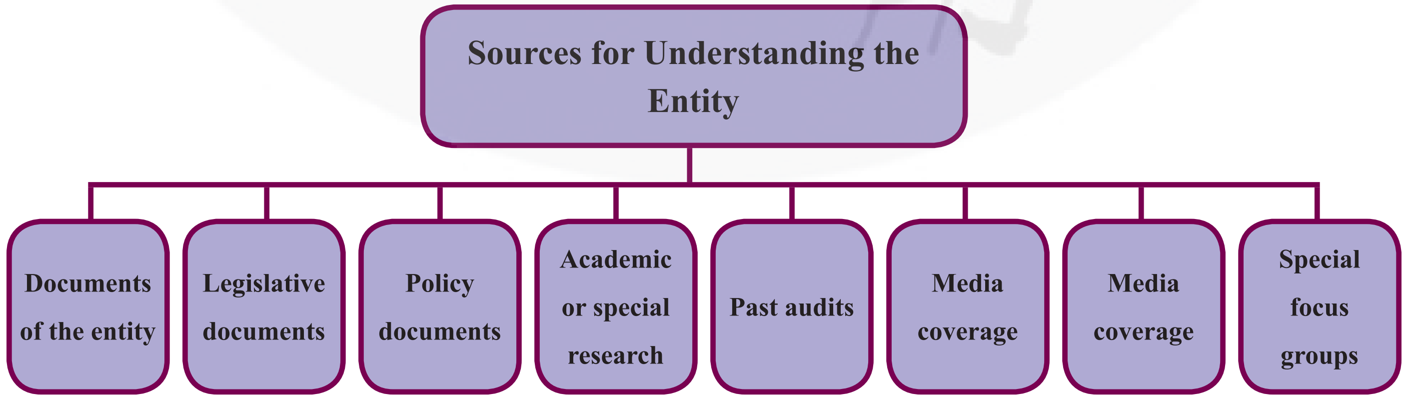
Question 2

ABG & Co., a Chartered Accountant firm has been appointed by C & AG for performance audit of a Sugar Industry. What factors should be considered by ABG & Co., while planning a performance audit of Sugar Industry?

Answer 2

The following steps are suggested to the auditors for planning while conducting the performance audit:

(A) Understanding the Entity/Programme - It is the starting point for planning individual performance audit.



The auditor may use the following sources for understanding the entity:

(i) Documents of the entity: Documents on administration and functions of the entity, policy files, annual reports, budget documents, accounts, minutes of meetings, information on the website, internal audit reports, electronic databases and MIS reports, RTI material etc.

(ii) Legislative documents: Legislation, parliamentary questions and debates, reports of the Public Accounts Committee, the Committee on Public Undertakings, the Estimates Committee and letters from Members of Parliament.

(iii) Policy documents: Documents of Planning Commission, Ministry of Finance etc.

(iv) Academic or special research: Independent evaluations on the entity, academic research and similar work done by other governments and other SAIs.

(v) Past audits: Past financial and performance audits of the entity provide a major source of information and understanding.

(vi) Media coverage: Print and electronic media - their systematic documentation on regular basis in a transparent manner.

(vii) Special focus groups: Audit Advisory Committee concerns, annual and special reports of World Bank, Reserve Bank of India, reports by special interest groups, NGOs, etc.

(B) Defining the Objectives and the Scope of Audit - The audit objectives should be defined in a crisp & clear manner as they will impact the nature of the audit, govern its conduct and affect audit conclusions. Setting audit objectives ensures good quality performance audits. It facilitates clarity, demonstrates consistent quality of audit and serves as a measure of quality assurance of the audit.

Defining the scope constricts the audit to significant issues that relate to the audit objectives. It mainly focuses on the extent, timing and nature of the audit.

(C) Determining Audit Criteria - Audit criteria are the standards used to determine whether a program meets or exceeds expectations. It provides a context for understanding the results of the audit. Audit criteria are reasonable and attainable standards of performance against which economy, efficiency and effectiveness of programmes and activities can be assessed.

The audit criteria may be sought to be obtained from the following sources:

(i) procedure manuals of the entity.

(ii) policies, standards, directives and guidelines.

(iii) criteria used by the same entity or other entities in similar activities or programmes.

(iv) independent expert opinion and know how.

(v) new or established scientific knowledge and other reliable information.

(vi) general management and subject matter literature and research papers.

(D) Deciding Audit Approach - There is no uniform audit approach prescribed that can be applicable to all types of subjects of performance audits. Selection of approach also determine methods and means used for conducting the audit.

Some of the methods which could be used in conducting performance audits include:

Analysis of procedures	Case studies	Use of existing data
Surveys	Analysis of results	Quantitative analysis

(i) **Analysis of procedures:** It involves review of the systems in place for planning, conducting, checking and monitoring the activity. This would consist of examination of documents such as financial reports, budgets, programme guidelines, procedure manuals, etc.

(ii) **Case studies:** A case study is a descriptive analysis of an entity, scheme or a programme. It involves analysis of a particular issue within the context of the whole area under review.

(iii) **Use of existing data:** The audit staff should investigate the data held by entity management and by other relevant sources. Audit conclusions based on testing of available data for correctness and completeness enhances the assurance level.

(iv) **Surveys:** Survey is a method of collecting information from members of a population to assess the interrelation of events and conditions. Surveys on predetermined parameters can supplement the audit findings and conclusions adding value to the performance audits.

(v) **Analysis of results:** It requires the auditor to carry out actual output-input analysis to determine the efficiency of the programme.

(vi) **Quantitative analysis:** It involves examination of available data relating to financials like earnings, revenue, or data relating to programme implementation like details of beneficiaries etc. However, it may not be possible for the auditor to work with complete data due to its high volume. In such cases, sampling techniques are required to be used.

(E) **Developing Audit Questions -** Subsequent to designing of audit objectives and determination of audit criteria, the audit team is required to prepare a list of questions to which they would seek answers. The questions should be framed in comprehensive manner involving detailed hierarchy of questions.

(F) **Assessing Audit Team Skills and whether Outside Expertise required -** It is essential that the performance auditors possess special aptitude and knowledge. The Auditing Standards of C&AG of India provide that the audit institution should develop and train the auditors to enable them to perform their tasks effectively & efficiently and should prepare manuals & other written guidance notes & instructions concerning conduct of audits.

AUDIT OF PUBLIC SECTOR UNDERTAKINGS

Given the diverse range of subjects of performance auditing, the audit team needs to develop sound understanding of the programme or entity proposed to be audited.

The audit team needs to decide at the planning stage on which aspect expertise is required. Though, the Accountant General may use the work of an expert, he retains full responsibility for the expression of opinion in the auditor's report.

(G) **Preparing Audit Design Matrix (ADM) -** Having determined the audit objective, audit criteria, audit approach, data collection etc., audit team should prepare an Audit Design Matrix. It is a structured and highly focused approach to designing a performance audit study.

The ADM highlights the data collection and analysis method as well as the type and sources of evidence required to support audit opinion/findings.

(H) **Establishing Time Table and Resources -** It is significant to determine the timetable and desirable resources. Selection of appropriate audit team is the most vital component in planning an audit. Considerations for selection of an appropriate audit team should be recorded along with the proposed timelines for various activities to be undertaken as a part of audit process. The progress should also be monitored against these timelines. The Accountant General would be liable for ensuring that the performance audit is completed on time. The variations between the required and actual time spent should be compared and approved from the competent authority.

The team should build time for translation, approval and possible delays in their own schedule in order to meet the targets.

(I) **Intimation of Audit Programme to Audit Entities -** Audited entities must be intimated about the intention of taking up planned performance audit with the scope and extent of audit including the constitution of audit team and the tentative time schedule, well before the commencement of Audit. Acknowledgement of this may be requested and placed on record.

It may be required to refine an audit's objectives as the audit progresses for gathering the requisite information to fulfill the audit. The reasons for such changes in the objectives should also be recorded and approved from the competent authority.

The audit programme should be flexible and reviewed from time to time as it is not possible to anticipate all the contingencies at the early stage.

The Accountant General should share all significant refinements in the approach and additional tests and findings, concurrently with other audit teams when different persons conduct the audit at different locations. The system of sharing of the significant field audit experience should be documented and reviewed.

Question 3

Sunlight Limited is a public sector undertaking engaged in production of electricity from solar power. It had commissioned a new project near Goa with a new technology for a cost of ₹ 5,750 crore. The project had seen delay in commencement and cost overrun. State the matters that a

AUDIT OF PUBLIC SECTOR UNDERTAKINGS

Comprehensive Audit by C&AG may cover in reporting on the performance and efficiency of this project.

Answer 3

Propriety requires the transactions, and more particularly expenditure, to conform to certain general principles. These principles are:

(i) that the expenditure is not prima facie more than the occasion demands and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence would exercise in respect of his own money;

(ii) that the authority exercises its power of sanctioning expenditure to pass an order which will not directly or indirectly accrue to its own advantage;

(iii) that funds are not utilised for the benefit of a particular person or group of persons and

(iv) that, apart from the agreed remuneration or reward, no other avenue is kept open to indirectly benefit the management personnel, employees and others.

It may be stated that it is the responsibility of the executive departments to enforce economy in public expenditure. The function of audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper, avoidable and infructuous expenditure.

The functions of Auditor in the context of Propriety Audit may be specified as under as to:

- see that all expenditure incurred are properly planned.
- see that the size and channels of expenditure are rightful and expected to give maximum results.
- appraise whether those expenditure are likely to give optimum result.
- see that any substitute plan of action can bring about an improvement on current operation and as well as return from capital expenditure.
- examine the actions and decisions of the management to see that they are conductive to public interests and that they meet the standards of conduct.

Question 4

"A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action." Briefly discuss the issues addressed by Performance Audits conducted in accordance with the guidelines issued by C&AG.

Answer 4

According to the guidelines issued by the C&AG, Performance Audits usually address the issues of:

(i) Economy- It is minimising the cost of resources used for an activity, having regard to appropriate quantity, quality and at the best price.

(ii) Efficiency- It is the input-output ratio. In the case of public spending, efficiency is achieved when the output is maximised at the minimum of inputs, or input is minimised for any given quantity and quality of output. When the audit objective of efficiency considers outputs, focus is usually on processes by which an organisation transforms inputs into outputs.

Auditing efficiency embraces aspects such as whether:

(a) sound procurement practices are followed;

(b) resources are properly protected and maintained;

(c) human, financial and other resources are efficiently used;

(d) optimum amount of resources (staff, equipment, and facilities) are used in producing or delivering the appropriate quantity and quality of goods or services in a timely manner;

(e) public sector programmes, entities and activities are efficiently managed, regulated, organised and executed;

(f) efficient operating procedures are used; and

(g) the objectives of public sector programmes are met cost-effectively.

(iii) Effectiveness- It is the extent to which objectives are achieved and the relationship between the intended impact and the actual impact of an activity.

In auditing effectiveness, performance audit may, for instance:

(h) assess whether the objectives of and the means provided (legal, financial, etc.) for a new or ongoing public sector programme are proper, consistent, suitable or relevant to the policy;

(i) determine the extent to which a program achieves a desired level of program results;

(j) assess and establish with evidence whether the observed direct or indirect social and economic impacts of a policy are due to implementation of the policy or to other causes;

(k) identify factors inhibiting satisfactory performance or goal-fulfilment;

(l) assess whether the programme complements, duplicates, overlaps or counteracts other related programmes;

(m) assess the effectiveness of the program and/or of individual program components;

(n) determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;

(o) assess the adequacy of the management control system for measuring, monitoring and reporting a programme's effectiveness;

(p) assess compliance with laws and regulations applicable to the program; and

(q) identify ways of making programmes work more effectively.

Question 5

BT Ltd , a company wholly owned by central government was disinvested during the previous year, resulting in 40% 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.

Sam, the FM 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.

Answer 5

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. 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. The listing of company's shares on a stock exchange is irrelevant for this purpose and hence Sam's opinion is not correct.

Question 6

You have been appointed as auditor of a AKY Ltd. After having determined the audit objectives, now you have been requested to draft audit criteria. What are the sources that you will use while doing the task?

Answer 6

The audit criteria may be sought to be obtained from the following sources:

(i) procedure manuals of the entity.

(ii) policies, standards, directives and guidelines.

(iii) criteria used by the same entity or other entities in similar activities or programmes.

(iv) independent expert opinion and know how.

(v) new or established scientific knowledge and other reliable information.

(vi) general management and subject matter literature and research papers.

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Question 7

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

Answer 7

In the given scenario, C&AG appointed Verma & Associates, a chartered accountant firm, to conduct Performance Audit of MAP Ltd., a PSU of Government of India. The firm conducted audit with a view to check all the expenses of the unit are in conformity to the public interest and publicly accepted customs which is not Performance Audit.

A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action.

Performance audit in PSUs is conducted by the C&AG (Supreme Audit Institutions) through various subordinate offices of Indian Audit and Accounts Department (IAAD). In conducting performance audit, the subordinate offices are guided by manual and auditing standards prescribed by C&AG.

Therefore, the objectives of performance auditing are evaluation of economy, efficiency, and effectiveness of policy, Programmes, organization and management. It also promotes accountability by assisting those charged with governance and oversight responsibilities to improve performance; and transparency by affording taxpayers, those targeted by government policies and other stakeholders an insight into the management and outcomes of different government activities.

Performance auditing focuses on areas in which it can add value which have the greatest potential for development. It provides constructive incentives for the responsible parties to take appropriate action. Regulations on Audit and Accounts issued by C&AG lay down that the responsibility for the development of measurable objectives and performance indicators as also the systems of measurement rests with the Government departments or Heads of entities. They are also required to define intermediate and final outputs and outcomes in measurable and monitor able terms, standardize the unit cost of delivery and benchmark quality of outputs and outcomes.

Thus, rejection of audit report (submitted by audit firm) by C&AG is in order as audit with a view to mere check all the expenses of the unit are in conformity to the public interest and publicly accepted customs done by audit firm is not performance audit in all aspects.

Question 8

The objectives of audit in connection with a State Electricity Distribution Company were to ascertain whether the:

(i) total cost of providing electricity is being recovered by timely submissions to the State Electricity Regulatory Commission;

(ii) tariff orders, sales circulars and sales instructions were issued timely, without any ambiguity. They were implemented in time;

(iii) metering, billing and collection was managed efficiently and effectively;

(iv)monitoring and internal controls were efficient.

What kind of audit is referred in the above scenario? Also briefly discuss the steps suggested to the auditors for planning such an audit.

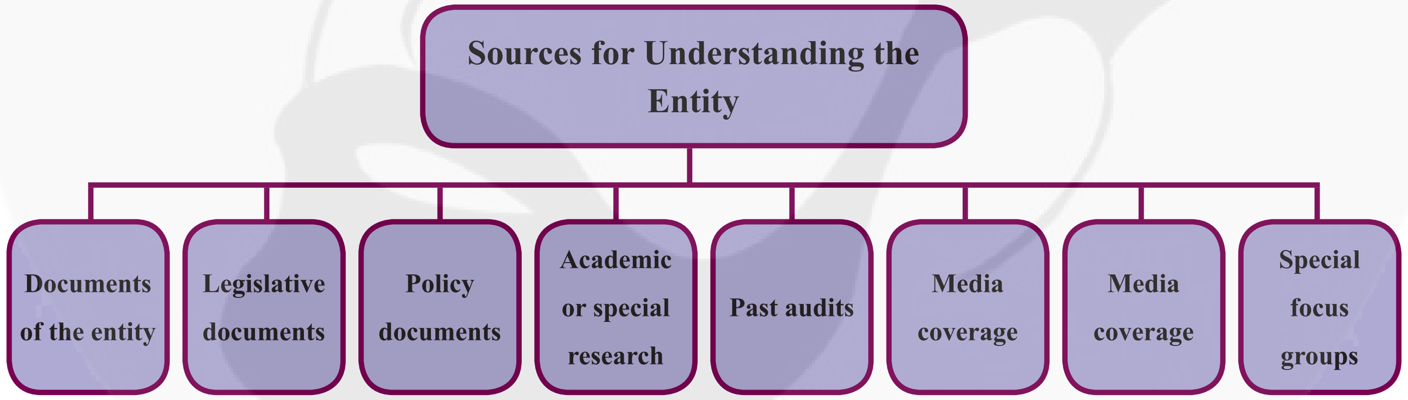
Answer 8

In the given scenario, in view of the objectives discussed, performance audit is being referred.

The following steps are suggested to the auditors for planning while conducting the performance audit:

A) Understanding the Entity/Programme - It is the starting point for planning individual performance audit.

The auditor may use the following sources for understanding the entity:



i) **Documents of the entity:** Documents on administration and functions of the entity, policy files, annual reports, budget documents, accounts, minutes of meetings, information on the website, internal audit reports, electronic databases and MIS reports, RTI material etc.

ii) **Legislative documents:** Legislation, parliamentary questions and debates, reports of the Public Accounts Committee, the Committee on Public Undertakings, the Estimates Committee and letters from Members of Parliament.

iii) **Policy documents:** Documents of Planning Commission, Ministry of Finance etc.

iv) **Academic or special research:** Independent evaluations on the entity, academic research and similar work done by other governments and other SAIs.

v) **Past audits:** Past financial and performance audits of the entity provide a major source of information and understanding.

vi) **Media coverage:** Print and electronic media - their systematic documentation on regular basis in a transparent manner.

vii) **Special focus groups:** Audit Advisory Committee concerns, annual and special reports of World Bank, Reserve Bank of India, reports by special interest groups, NGOs, etc.

B) **Defining the Objectives and the Scope of Audit -** The audit objectives should be defined in a crisp & clear manner as they will impact the nature of the audit, govern its conduct and affect audit conclusions. Setting audit objectives ensures good quality performance audits. It facilitates clarity, demonstrates consistent quality of audit and serves as a measure of quality assurance of the audit.

Defining the scope constricts the audit to significant issues that relate to the audit objectives. It mainly focuses on the extent, timing and nature of the audit.

C) **Determining Audit Criteria -** Audit criteria are the standards used to determine whether a program meets or exceeds expectations. It provides a context for understanding the results of the audit. Audit criteria are reasonable and attainable standards of performance against which economy, efficiency and effectiveness of programmers and activities can be assessed.

The audit criteria may be sought to be obtained from the following sources:

i) procedure manuals of the entity.

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iii) criteria used by the same entity or other entities in similar activities or programmes.

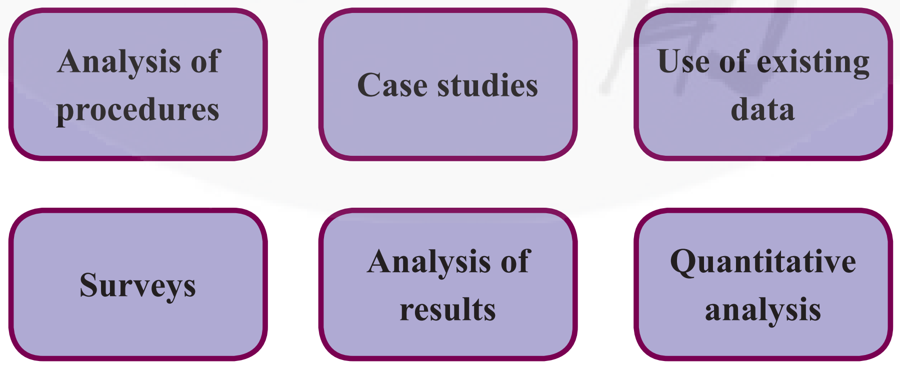
iv) independent expert opinion and know how.

v) new or established scientific knowledge and other reliable information.

vi) general management and subject matter literature and research papers.

D) **Deciding Audit Approach -** There is no uniform audit approach prescribed that can be applicable to all types of subjects of performance audits. Selection of approach also determine methods and means used for conducting the audit.

Some of the methods which could be used in conducting performance audits include:



i) **Analysis of procedures:** It involves review of the systems in place for planning, conducting, checking and monitoring the activity. This would consist of examination of documents such as financial reports, budgets, programme guidelines, procedure manuals, etc.

ii) **Case studies:** A case study is a descriptive analysis of an entity, scheme or a programme. It involves analysis of a particular issue within the context of the whole area under review.

iii) **Use of existing data:** The audit staff should investigate the data held by entity management and by other relevant sources. Audit conclusions based on testing of available data for correctness and completeness enhances the assurance level.

iv) **Surveys:** Survey is a method of collecting information from members of a population to assess the interrelation of events and conditions. Surveys on predetermined parameters can supplement the audit findings and conclusions adding value to the performance audits.

v) **Analysis of results:** It requires the auditor to carry out actual output-input analysis to determine the efficiency of the programme.

vi) **Quantitative analysis:** It involves examination of available data relating to financials like earnings, revenue, or data relating to programme implementation like details of beneficiaries etc. However, it may not be possible for the auditor to work with complete data due to its high volume. In such cases, sampling techniques are required to be used.

E) **Developing Audit Questions -** Subsequent to designing of audit objectives and determination of audit criteria, the audit team is required to prepare a list of questions to which they would seek answers. The questions should be framed in comprehensive manner involving detailed hierarchy of questions.

F) **Assessing Audit Team Skills and whether Outside Expertise required -** It is essential that the performance auditors possess special aptitude and knowledge. The Auditing Standards of C&AG of India provide that the audit institution should develop and train the auditors to enable them to perform their tasks effectively & efficiently and should prepare manuals & other written guidance notes & instructions concerning conduct of audits.

Given the diverse range of subjects of performance auditing, the audit team needs to develop sound understanding of the programme or entity proposed to be audited.

The audit team needs to decide at the planning stage on which aspect expertise is required. Though, the Accountant General may use the work of an expert, he retains full responsibility for the expression of opinion in the auditor's report.

G) **Preparing Audit Design Matrix (ADM) -** Having determined the audit objective, audit criteria, audit approach, data collection etc., audit team should prepare an Audit Design Matrix. It is a structured and highly focused approach to designing a performance audit study.

The ADM highlights the data collection and analysis method as well as the type and sources of evidence required to support audit opinion/findings.

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H) **Establishing Time Table and Resources -** It is significant to determine the timetable and desirable resources. Selection of appropriate audit team is the most vital component in planning an audit.

Considerations for selection of an appropriate audit team should be recorded along with the proposed timelines for various activities to be undertaken as a part of audit process. The progress should also be monitored against these timelines. The Accountant General would be liable for ensuring that the performance audit is completed on time. The variations between the required and actual time spent should be compared and approved from the competent authority.

The team should build time for translation, approval and possible delays in their own schedule in order to meet the targets.

I) **Intimation of Audit Programme to Audit Entities -** Audited entities must be intimated about the intention of taking up planned performance audit with the scope and extent of audit including the constitution of audit team and the tentative time schedule, well before the commencement of Audit. Acknowledgement of this may be requested and placed on record.

It may be required to refine an audit's objectives as the audit progresses for gathering the requisite information to fulfill the audit. The reasons for such changes in the objectives should also be recorded and approved from the competent authority.

The audit programme should be flexible and reviewed from time to time as it is not possible to anticipate all the contingencies at the early stage.

The Accountant General should share all significant refinements in the approach and additional tests and findings, concurrently with other audit teams when different persons conduct the audit at different locations. The system of sharing of the significant field audit experience should be documented and reviewed.

Question 9

PGC & Associates are statutory auditors of BNPC Limited, a PSU in power sector. It is engaged in building large sized thermal power stations to accelerate development of power sector in the country. One of the financial committees of Parliament has decided to examine its physical and financial performance. It has also examined audit findings of C&AG in respect of which action is yet to be taken by the said PSU. The committee also proposes to include in its report performance of the company in various operational matters.

Which financial committee of Parliament deals with such matters? Outline its main functions.

Answer 9

The said matters are dealt by Committee on Public Undertakings (COPU). The functions of the Committee are -

(i) to examine the reports and accounts of public undertakings.

(ii) to examine the reports of the C&AG on public undertakings.

(iii) to examine the autonomy and efficiency of public undertakings and to see whether they are being managed in accordance with sound business principles and prudent commercial practices.

(iv) to exercise such other functions vested in the PAC and the Estimates Committee as are not covered above and as may be allotted by the Speaker from time to time.

The examination of public enterprises by the Committee takes the form of comprehensive appraisal or evaluation of performance of the undertaking. It involves a thorough examination, including evaluation of the policies, Programmes and financial working of the undertaking.

Question 10

PS & Associates are statutory auditors of a Central government owned company for a particular year. The statutory auditors were required to examine the following areas mandatorily, provide their specific replies and also their impact on financial statements for that particular year in their audit report.

1) **Whether the company has system in place to process all the accounting transactions through IT system? If yes, the implications of processing of accounting transactions outside IT system on the integrity of the accounts along with the financial implications, if any, may be stated.**
2) **Whether there is any restructuring of an existing loan or cases of waiver / write off of debts / loans/ interest etc. made by a lender to the company due to the company's inability to repay the loan? If yes, the financial impact may be stated. Whether such cases are properly accounted for?**
3) **Whether funds (grants/subsidy etc.) received / receivable for specific schemes from Central government or its agencies were properly accounted for / utilized as per its term and conditions? List the cases of deviation.**

Can you gauge likely nature of such responsibility thrust upon auditors of above PSU?

Answer 10

The above areas for which statutory auditors of PSU were required to examine, report and indicate impact of these matters in financial statements are likely to relate to directions issued by C&AG to statutory auditors under section 143(5) of Companies Act, 2013.

In terms of section 143(5), in case of a government company, the C&AG has the power to direct the auditor the manners in which accounts of company are required to be audited and auditor shall submit audit report which among other things, include the directions, if any, issued by the C&AG the action taken thereon and its impact on the accounts and financial statements of the company.

Integrated Case Scenario

SRM & Associates are refreshing up their knowledge on functions of various Parliamentary financial committees and on the varied functions and duties of Comptroller & Auditor General of India in relation to audit of government institutions and government companies. They feel that unless they have understood scope of duties of C&AG, they would not be in a position to do justice to audits and professional work in this area.

In the process, they have gone through various materials both offline and online. The summarized information derived from some of such materials including website of C&AG are stated below:

A. **The C&AG report for a particular year contained results of the compliance audit of Department of Revenue-Direct Taxes of the Union Government dealing with "Assessments relating to Agricultural Income". It included certain observations relating to allowing of claim for exemption of agricultural income without supporting documents, use of this area by non-agriculturists as a conduit to avoid taxes etc., in scrutiny assessments performed by the Department.**

B. **The C&AG in one of its reports in respect of a state government owned industrial development corporation pointed out non-adherence of One-time settlement (OTS) guidelines of state government by the corporation resulting in acceptance of a below par OTS proposal thus foregoing recovery of loan amounting to ` 6.87 crores. The said corporation was providing loans to industrial units.**

C. **Annual report of a listed public sector company which is a "mini-ratna" PSU was also gone through. The said company is engaged in providing diversified services to Indian Railways.**

D. **A state government owned PSU was involved in setting up of a thermal power plant in the state. The C&AG, in its audit report, pointed out delay in completion of work due to failure to decide on the type of water treatment in the cooling plant on a timely basis. Besides, other reasons leading to delay like frequent changes in lay-out and re-testing of soil by the company were pointed out Answer the following questions based upon above information:**

1. Based on description provided at para [A] of case, which Parliamentary financial committee is likely to examine above report of C&AG and make its recommendations?

a) Estimates Committee.

b) Public Accounts Committee.

c) Committee on Public Undertakings.

d) Committee on Commerce.

Ans: (b)

2. Considering the description stated in para [B] of case, the above audit finding is likely to fall in which areas?

a) Compliance audit.

b) Performance audit.

c) Propriety audit.

d) Comprehensive audit

Ans: (a)

3. As regards listed PSU described in para [C] of case, which of the following statements is most appropriate?

a) The statutory audit of above PSU is to be conducted by a firm of auditors appointed by shareholders in AGM. C&AG cannot give directions to such firm of auditors. However, its office is empowered to conduct a supplementary audit.

b) The statutory audit of above PSU is to be conducted by C&AG.

c) The statutory audit of above PSU is to be conducted by a firm of auditors appointed by C&AG. Further, C&AG can give directions to the firm of auditors.

d) The statutory audit of above PSU is to be conducted by a firm of auditors appointed by shareholders in AGM. However, C&AG can give directions to the firm of auditors

Ans: (c)

4. Considering nature of audit finding described at para [D] of case concerning delay in completion of work of thermal power plant, the said audit finding is likely to fall in domain of:

a) Propriety audit.

b) Performance audit.

c) Financial audit.

d) Compliance audit.

Ans: (b)

5. PSU engagements are generally attestation engagements or direct reporting engagements. Which of the following statements is correct in this regard?

a) Performance audits and compliance audits are generally attestation engagements.

b) Performance audits and compliance audits are generally direct reporting engagements.

c) Performance audit is a direct reporting engagement whereas compliance audit is an attestation engagement.

d) Performance audit is an attestation engagement whereas compliance audit is a direct reporting engagement.

Ans: (b)

AUDIT OF PUBLIC SECTOR UNDERTAKINGS

16 CHAPTER INTERNAL AUDIT

Question 1

ABC Ltd. is engaged in manufacturing of Yarns and Towels. It sells its product in both domestic as well as in International Market. It has achieved turnover of 200 crores in the F.Y. 2016 -17. Directors of the company realized that they are not managing the company professionally and thereby request your firm of Internal Auditors for appraisal of its organizational structure to ascertain whether it is in harmony with the objectives of ABC (P) Ltd. Comment. (MTP 4 Marks, Aug '18, PYP 4 Marks , Nov '18)

Answer 1

Review of the Organization Structure - The internal auditor should conduct an appraisal of the organization structure to ascertain whether it is in harmony with the objectives of the enterprise and whether the assignment of responsibilities is in consonance therewith. For this purpose:

- He should review the manner in which the activities of the enterprise are grouped for managerial control. It is also important to review whether responsibility and authority are in harmony with the grouping pattern.
- The internal auditor should examine the organization chart to find out whether the structure is simple and economical and that no function enjoys an undue dominance over the others.
- He should particularly see that the responsibilities of managerial staff at headquarters do not overlap with those of chief executives at operating units. He should examine whether there is a satisfactory balance between authority and responsibility of important executives.
- The internal auditor should examine the reasonableness of the span of control of each executive (the number of sub-ordinates that an executive controls). He should examine whether there is a unity of command i.e., whether each person reports only to one superior.
- Where dual responsibilities cannot be avoided, the primary one should be specified and the specific responsibility to each senior fixed. This must be made known to all concerned.

Finally, he should evaluate the process of managerial development in the enterprise. This is a vital aspect in a fast growing enterprise

Question 2

You have been appointed as an internal auditor of a company RSM Ltd. The Managing Director Rakesh is worried about employee attrition in large number. Rakesh requests you to analyse the causes for high employee attrition rate in his company. What factors would you consider in such analysis? (MTP 4 Marks, May '20, Old SM)

OR

The Managing Director of X Ltd is concerned about high employee attrition rate in his company. As the internal auditor of the company he requests you to analyze the causes for the same. What factors would you consider in such analysis? (New SM)

Answer 2

The factors responsible for high employee attrition rate are as under:

a) Job Stress & work life imbalance;

b) Wrong policies of the Management;

c) Unbearable behavior of Senior Staff;

d) Safety factors;

e) Limited opportunities for promotion;

f) Low monetary benefits;

g) Lack of Labour welfare schemes;

h) Whether the organization has properly qualified and experienced personnel for the various levels of works?

i) Is the number of people employed at various work centers excessive or inadequate?

j) Does the organization provide facilities for staff training so that employees and workers keep themselves abreast of current techniques and practices?

Question 3

Munch Ltd. is a public company having Rs. 40 lacs paid up capital in previous financial year which raised to Rs. 60 lacs in current financial year under audit. The company had turnover of previous three consecutive financial years being Rs. 49 crores, Rs. 145 crores and Rs. 150 crores. During the previous year, Munch Ltd. borrowed a loan from a public financial institution of Rs. 110 crores but squared up Rs. 20 crores by the year end. The company does not have any internal audit system. In view of the management, internal audit system is not mandatory.

You are required to state the provisions related to applicability of internal audit as per the Companies Act, 2013 and comment upon the contention of the management of the company. (MTP 4 Marks, April 18, RTP May 22)

INTERNAL AUDIT

Answer 3

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, following class of companies (prescribed in Rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(A) every listed company;

(B) every unlisted public company having-

(1) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(2) turnover of two hundred crore rupees or more during the preceding financial year; or

(3) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(4) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(C) every private company having-

(1) turnover of two hundred crore rupees or more during the preceding financial year; or

(2) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

In the given case, Munch Ltd. is a public company. The company borrowed a loan from a public financial institution of Rs. 110 crores during the previous year. At the year end, the loan outstanding after being squared up is Rs. 90 crores (Rs. 110 crores - Rs. 20 crores) which is less than the minimum prescribed limit of Rs. 100 crores for applicability of internal audit. Although, the outstanding loan at previous year end is Rs. 90, it was Rs. 110 crores at some point of time which is the requirement of the section (refer Rule 13(B)(3) as mentioned above).

Hence, Munch Ltd. has the statutory liability to appoint an Internal Auditor and mandatorily conduct internal audit. Consequently, the contention of the management of the company is not tenable.

Question 4

XYZ Yarns Ltd. is a manufacturing company engaged in manufacturing of different types of yarns. Its annual turnover is Rs. 100 Crores and net profit Rs. 10 crores. It has two manufacturing units. Company is facing difficulties in maintaining adequate system of internal control. Company wants to appoint Internal Auditor who would help in the above task and also various other functions including compliance.

In view of above, you are required to explain the main responsibility of Internal Auditors. (MTP 4 Marks, Oct 18)

Answer 4

Main responsibility of internal auditor must be :

to maintain adequate system of internal control by a continuous examination of accounting procedures, receipts and disbursements and to provide adequate safeguards against misappropriation of assets.

to operate independently of the accounting staff and must not in any way divest himself of any of the responsibilities placed upon him.

Not to involve himself in the performance of executive functions in order that his objective outlook does not get obscured by the creation of vested interest.

to observe facts and situations and bring them to notice of authorities who would otherwise never know them; also, they critically appraise various policies of the management and draw its attention to any deficiencies, wherever these require to be corrected. to associate closely with management and his knowledge must be kept up to date by his being kept informed about all important occurrences and events affecting the business, as well as the changes that are made in business policies. He must enjoy an independent status.

In addition, the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

It may also be noted that the Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

Question 5

ABC Pvt Ltd was involved in the business of manufacturing pipes and holdings. For financial year 2020-21 the company had the following turnover from its various segments and product:

Segment Name	Turnover	Profit
Steel / Iron Pipe Manufacturing	140 Crore	10 Crore
Holdings and Civil Structure Accessories	25 Crore	50 Lakh
PVC / Yellow Pipe Manufacturing	65 Crore	8 Crore

During Financial Year 2021-22, the company's performance was considerably lower compared to FY 2020-21 due to competition and high prices. Turnover and Profit of the company for FY 2021-22 is given hereunder:

Segment Name	Turnover	Profit
Steel / Iron Pipe Manufacturing	60 Crore	2 Crore
Holdings and Civil Structure Accessories	15 Crore	35 Lakh
PVC / Yellow Pipe Manufacturing	35 Crore	3 Crore

INTERNAL AUDIT

The company was fully financed through its own capital during both years. Kindly assess whether the company was required to appoint internal auditor as per section 138 read with Rule 13 of the Companies (Accounts) Rules, 2014 for FY 2021-22. (MTP 4 Marks Oct '22)

Answer 5

As per section 138 of the Companies Act, 2013, such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company.

As per Rule 13 of the Companies (Accounts) Rules, 2014, the following class of companies shall be required to appoint an internal auditor which may be either an individual or a partnership firm or a body corporate, namely:

- every listed company.
- every unlisted public company having
  - o paid up share capital of fifty crore rupees or more during the preceding financial year; or
  - o turnover of two hundred crore rupees or more during the preceding financial year; or
  - o outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
  - o outstanding deposits of twenty-five crore rupees or more at any point of time during the preceding financial year; and
- every private company having
  - o turnover of two hundred crore rupees or more during the preceding financial year; or
  - o outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point time during the preceding financial year:

In the current scenario, the company is a private limited company with having turnover of ₹ 230 Crore in FY 2020-21 and ₹ 110 Crore in FY 2021-22. As per Rule 13, every private company with a turnover of two hundred crore rupees or more during the preceding financial year must appoint an internal auditor who may be either an individual, a partnership firm or a body corporate. Hence, ABC Pvt Ltd is required to appoint Internal Audit for FY 2021 -22.

Question 6

One of the independent directors sought information regarding the appointment of internal auditors for following Group Companies in accordance with the Companies Act, 2013 of which certain Financial Information are given below:

Figures are in ` crore and correspond to the previous year.

Name	Nature	Equity Share Capital	Turnover	Loan from Bank and PFI	Public Deposits
AADI Ltd.	Listed	100	190	50	24
AJIT Ltd.	Unlisted Public	60	190	50	24
NEMI Ltd.	Unlisted Private	60	190	50	-

You are required to evaluate the requirements of the Companies Act, 2013 regarding the appointment of internal Auditors for the Group Companies. Discuss. (MTP 4 Marks Sep '23)

Answer 6

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, following class of companies (prescribed in Rule 13 of Companies (Accounts) Rules, 2014) shall be required to appoint an internal auditor or a firm of internal auditors, namely:-

(A) every listed company;

(B) every unlisted public company having-

(1) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(2) turnover of two hundred crore rupees or more during the preceding financial year; or

(3) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(4) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(C) every private company having-

(1) turnover of two hundred crore rupees or more during the preceding financial year; or

(2) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

In the given case, AADI Ltd. is a listed company. As per section 138 of the Companies Act, 2013, every listed company is required to appoint an internal auditor or a firm of internal auditors. Thus, in view of the above, AADI Ltd. is required to appoint an internal auditor.

Further, AJIT Ltd. is unlisted public company. The company is having ` 60 crore as equity share capital which is exceeding the prescribed limit of rupees fifty crore as per section 138. Thus, AJIT Ltd. is required to appoint an internal auditor as per section 138 of the Companies Act, 2013.

NEMI Ltd. is unlisted private company and having ` 60 crore as equity share capital, ` 190 crore as turnover and ` 50 crore loan from Bank and PFI. In view of provisions of section 138 of the Companies Act, 2013 discussed above, all the limits are below the prescribed limit for a private company. Therefore, NEMI Ltd. is not required to appoint an internal auditor.

INTERNAL AUDIT

It can be concluded that AADI Ltd. and AJIT Ltd. is required to appoint the internal auditor as per the provisions of the Companies Act, 2013 whereas NEMI Ltd. is not required to do the same.

Question 7

Consider the following statement:

"The internal auditor of a company shall be free from any undue influences which force him to deviate from the truth. He shall be independent."

Is above statement proper? If so, how independence of internal auditor can be established? (MTP 4 Marks Oct'23)

Answer 7

The Internal Auditor shall be free from any undue influences which force him to deviate from the truth.

This independence shall be not only in mind but also in appearance. Also, the internal auditor shall resist any undue pressure or interference in establishing the scope of the assignments or the manner in which these are conducted and reported, in case these deviate from set objectives. The independence of the internal audit function and the Internal Auditor within the organization is a vital aspect of maintaining effective corporate governance. It is important to ensure that the internal audit function is free from any undue influence or pressure that may affect its ability to provide impartial and objective assessments of the organization's operations, risks, and controls.

Therefore, the given statement is proper.

To establish the independence of the Internal auditor, several factors need to be considered. Firstly, the overall organizational structure of key personnel plays a crucial role. The Internal auditor should be positioned in a way that allows them to operate independently and objectively. This includes having direct access to the Audit Committee, Board of Directors, and other senior executives. Secondly, the reporting line of the Chief Internal Auditor is an important consideration. The Chief Internal Auditor should report to the highest level of authority within the organization, such as the CEO or the Board of Directors. This ensures that the Internal auditor has the necessary authority and support to carry out their responsibilities effectively. Finally, the powers and authority derived from superiors further establish the independence of the Internal auditor. The Internal auditor should have the necessary resources, budget, and support to conduct their work without any undue influence or pressure from senior executives or other stakeholders.

Question 8

Mr. Anand is appointed as statutory auditor of XYZ Ltd. XYZ Ltd is required to appoint internal auditor as per statutory provisions given in the Companies Act, 2013 and appointed Mr. Bhola as its internal auditor.

The external auditor Mr. Anand asked internal auditor to provide direct assistance to him regarding evaluating significant accounting estimates by the management and assessing the risk of material misstatements.

(a) Discuss whether Mr. Anand, statutory auditor, can ask direct assistance from Mr. Bhola, internal auditor as stated above in view of Standards on Auditing. (MTP 4 Marks, April 21, RTP May 18)

(b) Will your answer be different, if Mr. Anand ask direct assistance from Mr. Bhola, internal auditor with respect to external confirmation requests and evaluation of the results of external confirmation procedures? (RTP May 20, Old & New SM)

Answer 8

(a) Direct Assistance from Internal Auditor: As per SA 610 "Using the Work of Internal Auditor", the external auditor shall not use internal auditors to provide direct assistance to perform procedures that Involve making significant judgments in the audit.

Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement.

Significant judgments include the following:

- Assessing the risks of material misstatement;
- Evaluating the sufficiency of tests performed;
- Evaluating the appropriateness of management's use of the going concern assumption;
- Evaluating significant accounting estimates; and
- Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.

In view of above, Mr. Anand cannot ask direct assistance from internal auditors regarding evaluating significant accounting estimates and assessing the risk of material misstatements.

(b) Direct Assistance from Internal Auditor in case of External Confirmation Procedures: SA 610 "Using the Work of Internal Auditor", provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors. In determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned. Further, in accordance with SA 505, "External Confirmation" the external auditor is required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, it would not be appropriate to assign these responsibilities to internal auditors.

However, internal auditors may assist in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.

INTERNAL AUDIT

Question 9

A professional accountant in public practice is always subject to various threats incompliance with fundamental principles of his profession and you, as a professional accountant, are worried about engagement specific threat in your audit assignment of M/s Soft Ltd. and want to implement some measures to eliminate and reduce the same. Enumerate some engagement specific safeguards which you may introduce in your work environment toward off such threats. (PYP 5 Marks, May '19)

Answer 9

Engagement-specific safeguards in the work environment may include:

(i) Involving an additional professional accountant to review the work done or otherwise advise as necessary.

(ii) Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant.

(iii) Discussing ethical issues with those charged with governance of the client.

(iv) Disclosing to those charged with governance of the client the nature of services provided and extent of fees charged.

(v) Involving another firm to perform or re-perform part of the engagement.

(vi) Rotating senior assurance team personnel.

Multiple Choice Questions (MCQs)

Question 1

Prakash Limited has around 25 branch offices and all the branch offices were on company's own land and building. Company has the Policy that all the original title deeds for land and building owned by the company will be kept in the custody of authorised official at company's head office and a certified copy of the same is kept with the respective branch for verification. You have been appointed as the internal auditor for the branches of the company and during the course of audit you observed that the orig inal title deeds of some of the branch office are kept in the branch under the custody of branch officials itself. What action will you take in such case?

(a) It is not a material discrepancy, so the auditor is not required to take any action in such case.

(b) The auditor should inform the internal auditor of the Head Office for the compliance of the same.

(c) The auditor should ask the branch office/official to send original title deed to the authorised official at Head Office of the company immediately and submit the Internal Audit Report once the confirmation received from Head office of company.

(d) As an internal auditor, report the matter in the Internal Audit Report and check for the compliance of the same in the next audit period (MTP 1 Mark ,Mar 19)

Answer 1 (d)

Question 2

Management of HFC Ltd. noticed a sudden increase in expense under the head "wages & salaries" for the year 2015-16 and 2016-17. The management felt a need to get the management audit done in order to identify the reason for the sudden increase. Mr. Arsh Gupta, Chartered Accountant was appointed as management auditor by the company on 15th April 2017. What areas do you think the auditor need to verify for the purpose?

(a) Check the payroll sheet prepared as per approved pay and allowances; verify the overtime sanctioned and authorised; and verify the payment process followed by the company for the payment of wages & salaries to employees.

(b) Overtime authorised and the payment done to employees are the main areas need to be verified by the auditor.

(c) Auditor should first understand the HR Policy of the company. Then verify all the authorised vouchers for overtime payments done during the year; verify the payroll preparation and reconcile the gross pay in terms of increments/ promotions & resignations; verify the appointments made during the year as per HR Policy and payments made to agencies providing contractual staff.

(d) Auditor need to verify the new appointments i.e. of company's payroll or outsourced staff and the overtime allowance paid to employees. (MTP 2 Marks , Mar 19)

Answer 3 (c)

INTERNAL AUDIT

Question 4

An educational institute was collecting fees from their students by cash/ cheque / draft and through net banking. Institute follows the policy to account for the fees received in the year of receipt only and for the cheques or drafts received but not deposited in bank or credited in bank account, should be shown in reconciliation statement. The internal auditor of branches noticed that at some branches only the fees received up to 25th March are accounted for in the same year and the receipts after that date are carried forward to be accounted for in the next financial year. The fees collected in these branches between 25th to 31st March amounted to Rs. 15 lakhs for the year 2017-18 and the collection for the financial year ended 31st March 2018 amounted to Rs. 115 crores. The auditor was of the view that it will not give a true and fair view on institute's revenue for the year. What do you think should be the next step of the auditor?

(a) The branches have accounted for those receipts in the next financial year so the auditor can ignore the observation.

(b) Auditor should report the matter in Executive Summary paragraph and highlight it as significant internal control lapse.

(c) Internal auditor can discuss the matter with the management to take a strict action against the branches not following institute's policy.

(d) Auditor should get the accounts modified and report the matter in action taken report. (MTP 2 Marks, Mar 19)

Answer 4 : (d)

Question 5

AFM coaching institute was accepting fees from its students in cash or cheque or online transfer for an amount up to Rs.10000/-, and if the amount of fees is above Rs.10000/- by cheque or online transfer only.

In the year 2017 the institute's total fees collection was of Rs.82 crores. Your firm has been appointed the internal auditor by the Institute and during the verification of vouchers for fee receipts you noticed that cash receipts of approximately Rs.5 lakhs were directly credited in bank account instead of routing through cash account. Management explained that since the deposit slips used for fees received in cash or cheque are same, the accountant has erroneously shown them in the bank account but he has always tallied the cash at day end and those cash receipts were deposited in the bank account same day. Whether the auditor will consider the discrepancy as material for audit report?

(a) The auditor should disclose the fact with his comment in the audit report as it is material for giving a true and fair view on financial statements.

(b) It is not a material discrepancy as the total receipts amount will remain the same and the fees collected in cash are deposited in bank account only.

(c) The auditor should verify that whether such cash receipts reflects in bank statement on the same day and cash ledger reconciles with the cash book on the respective dates or not. If it is followed then auditor can include the matter in observation paragraph with his comments else disclose the matter as major internal control lapse.

(d) Auditor can ask the management to give a representation letter in writing. (MTP 2 Marks , Mar 19)

Answer 5 (c)

Question 6

What is the difference between management audit and operational audit?

(a) Management audit is concerned with 'Quality of Operations' and it is 'Audit for Management', whereas Operational audit is concerned with 'Quality of managing' and it is 'Audit of Management'.

(b) Management audit is concerned with 'Quality of Managing' and it is 'Audit for Management', whereas Operational audit is concerned with 'Quality of Operations' and it is 'Audit of Management'.

(c) Management audit is concerned with 'Quality of Managing' and it is 'Audit of Management', whereas Operational audit is concerned with 'Quality of Operations' and it is 'Audit for Management'.

(d) Management audit is concerned with 'Quality of Operations' and it is 'Audit of Management', whereas Operational audit is concerned with 'Quality of managing' and it is 'Audit for Management'. (MTP 1 Marks, May' 20, Nov'21)

Answer 6 (c).

Question 7

Yellow Steels Ltd. was engaged in the business of manufacturing and selling steel products. The company was having sales offices at different locations in and outside India. The company decided to have a sales office at Kanpur on their own land. A Managing Committee of some officers from the company was formed in order to get a building constructed at land in Kanpur. Budget of Rs.35 crores was approved by the company for the same and it was proposed to complete the construction within two years. Rs. 32 crores were already released by the company within a year of start of the project and the managing committee raised a demand for Rs. 5 crores for further payments to vendors. The management of Yellow Steels wants to get the verification done of all the expenses incurred on site and identify the reasons for increase in construction cost. Which of the following will suffice the purpose of management? (MTP 2 Marks, April 19)

(a) The management should go for operational audit, as it will evaluate the effectiveness, efficiency and economy of operations done at the construction site.

(b) The management should get a Forensic Audit done in order to rule out any possibility of fraud or any other financial crime.

(c) A Financial Due Diligence is required to be done as no fraud has been reported and the management just want to analyse the books of accounts and other financial matters pertaining to financial matters at site.

(d) A management audit should be done to ensure that the increase in cost of construction is not due to any discrepancies in the formulation of objectives, plans and policies of the top management.

Answer 7 (c)

Question 8

Raja ram is appointed as internal auditor for a finance company with 15 branches across the states. He needs to conduct a branch visit in the coming week. Based on management inputs and past year audit reports, he has shortlisted four branches. (MTP 2 Marks, April 19)

Rajaram is not able to decide which branch visit he should prioritize as an internal auditor. Based on the branch information given below, which branch should Rajaram visit first?

(a) Sonpur – 15 people; two instances of fraud in the last year; regional manager present in the branch for supervision

(b) Chandpur – 12 people; no fraud, no visit by internal auditor in last two years due to set processes

(c) Rampur – 18 people; no fraud, 6 of 20 employees are new joiners in the last 6 months; newly opened branch

(d) Laxmanpur–10 people; 1 fraud in the last year, all 10 are long term employees of the company; no audit visit in the last year

Answer 8 (d)

Question 9

The firm from which you are pursuing your articleship training is the internal auditor of Shanti Ltd. While conducting the audit of the medical expense reimbursements of the company employees, you come across some bills which are clearly not medical in nature, and some others which have been overwritten.

During the discussions, the accountant points out that the employee is a functional head who enjoys a significantly higher medical expense reimbursement limit, and that you should ignore those bills as the amount is not material. You will:

(a) Accept the explanation and the bills.

(b) Recommend that the claim should be reduced, and clear guidelines should be issued to all employees on the matter, with a provision for disciplinary action.

(c) Recommend that the employee be asked to submit fresh bills to avail the tax benefit.

(d) Recommend that the employee be taxed on the aggregate amount of the suspect bills . (MTP 1 Mark Oct 21, Mar'21)

Answer 9 (b)

Question 10

Employees of Star Ltd. have to travel frequently for business purposes, so the company entered into a contract with a Sudarshan Travels Ltd. for managing booking, cancellation and other services required by their employees. As per contract terms, Sudarshan travels has to raise its monthly bills for the tickets booked or cancelled during the period and the same are paid by Star Ltd. within 15 days of the bill date.

The bills raised by Sudarshan travels were of huge amount, so the management of Star Ltd. decided to get an audit conducted of the process followed for booking/ cancellation of tickets and verify the accuracy of bills raised by the travel agency. Which audit do you feel the management should opt for?

(a) Internal audit, as it relates to examine the operational efficiency of the organisation.

(b) Management audit, as it is an audit desired by the management.

(c) Performance audit so as to assess the performance of the Sudarshan travels appointed by the organisation.

(d) Operational audit, as it is the audit for the management and involves verifying the effectiveness, efficiency and economy of operations done by the Sudarshan travels for the organisation. (MTP 1 Mark March 22, Oct'22, MTP 2 Marks Oct'19)

Answer 10 : (d)

Question 11

A branch of ABC Bank was having three staff i.e., one cashier, one officer and one manager. The cashier was responsible for the signing of cash slips, passing entries for cash withdrawals and providing cash to customers. You as a Bank's branch Auditor decided to verify the cash withdrawal transaction s and after testing you decided to pass the control over the cash process. Also, there were no observations identified during the testing. Moreover, as the process is present in the branch, work performed by the cashier is not monitored on daily basis. However, on a quarterly basis, certain test checks are performed by an officer of the branch. Internal Audit team reported the said controls over process as operating. You are required to guide whether reporting of the said controls by Internal Audit Team is correct or not

a) The controls over the cash process should be reported as operating because no issues were identified during the testing of controls.

b) The controls over the cash process should be reported operating as test checks are being performed by officers on a quarterly basis.

c) This control should be reported as non-operating because segregation of duties was not present with respect to the processing of payment transactions by the cashier.

d) This control should be reported as non-operating as the manager of the branch should have at least 2 officers for test checks of cash transactions and for cash process. (MTP 1 Mark Sep '22)

Answer 11 : (c)

Question 12

M/s ABC & Co., Chartered Accountants have been approached by PQR Ltd., a company engaged in iron and steel manufacturing industry. The company has been facing following operational issues:

(1) Penal interest for delayed payments to the overseas vendors despite having enough cash flows; and

(2) Despite having regular production and enough inventory, delays in shipping the final goods to the customers leading to its deteriorating vendor rating.

As a partner of M/s ABC & Co., through detailed discussion with the Senior Manager of PQR Ltd., you have concluded that all these delays are because of long decision-making cycles in the company. The company approaches you to advise the type of audit it should get done:

(a) Internal audit.

(b) Management audit.

(c) Operational audit.

(d) Audit is not required. (MTP 1 Mark April '23)

Answer 12 (b)

Question 13

KJ Private Ltd has a business of pharmaceuticals and has an annual turnover of INR 1,500 crores. During the last few years, considering the environment in which the company operates, its profit has reduced and is still falling. Hence the management has been looking at various ways to cut the costs.

AD & Associates are the statutory auditors of the company and RM & Associates are the internal auditors of the company.

Initially the company did not want to appoint any internal auditors to save costs, however, at insistence of the statutory auditors, the company appointed the internal auditors.

During the course of the statutory audit for the financial year ended 31 March, 2019, the statutory auditors requested for the detailed working papers of the internal auditors which the internal auditors refused. However, the statutory auditors told the management if the same are not provided then they would qualify their report.

In this situation, please advise which of the following would be correct.

(a) The statutory auditors should review the detailed working papers but they cannot qualify their report on this ground.

(b) The statutory auditors may review the detailed working papers and even after that they may qualify their report.

(c) The statutory auditors are not required to go to the extent of review of detailed working papers of internal auditors.

(d) The statutory auditors may review the detailed working papers of internal auditors but for that purpose they would require prior approval of the ICAI. (MTP 2 Marks, Oct'19)

Answer 13 : (c)

Question 1

Write a short note on Internal Audit Report.

Answer 1

The internal auditor should carefully review and assess the conclusions drawn from the audit evidence obtained, as the basis for his findings contained in his report and suggest remedial action. However, in case the internal auditor comes across any actual or suspected fraud or any other misappropriation of assets, it would be more appropriate for him to bring the same immediately to the attention of the management.

As per Standard on Internal Audit (SIA) 370 Reporting Results, reporting of internal audit results is generally undertaken in two stages:

1. At the end of a particular audit assignment, an "Internal Audit Report" covering a specific area, function or part of the entity is prepared by the Internal Auditor highlighting key observations arising from those assignments. This report is generally issued with details of the manner in which the assignment was conducted and the key findings from the audit procedures undertaken. This report is issued to the auditee, with copies shared with local and executive management, as agreed during the planning phase.

2. On a periodic basis, at the close of a plan period, a comprehensive report of all the internal audit activities covering the entity and the plan period is prepared by the Chief Internal Auditor (or the Engagement Partner, in case of external service provider). Such reporting is normally done on a quarterly basis and submitted to the highest governing authority responsible for internal audits, generally the Audit Committee. Some part of the aforementioned Internal Audit Reports may form part of the periodic (e.g. Quarterly) report shared with the Audit Committee.

This Standard on Internal Audit (SIA) deals with the internal auditor's responsibility to issue only the first type of reports, the Internal Audit Report pertaining to specific audit assignments and not to t he periodic (e.g. Quarterly) reporting for the whole entity as per the Annual/Quarterly audit plan.

On the basis of the internal audit work completed, the Internal Auditor shall issue a clear, well documented Internal Audit Report which includes the following key elements

(a) An overview of the objectives, scope and approach of the audit assignments;

(b) The fact that an internal audit has been conducted in accordance the Standards of Internal Audit;

(c) An executive summary of key observations covering all important aspects, and specific to the scope of the assignment;

(d) A summary of the corrective actions required (or agreed by management) for each observation; and

(e) Nature of assurance, if any, which can be derived from the observations.

The content and form of the Internal Audit Report are to be established by the Internal Auditor based on his best professional judgement, in consultation with the auditee and, if necessary, with inputs from other key stakeholders. No internal audit report shall be issued in final form unless a written draft of the report has previously been shared with the auditee.

The internal audit report shall be issued within a reasonable time frame from the completion of the internal audit work.

1. **Basis of Internal Audit Report:** Each internal audit report is prepared on the basis of the audit procedures conducted and the analysis of the audit evidence gathered. Conclusions reached shall be based on all the findings rather than on a few deviations or issues noted. Controls operating effectively have their own importance and should be acknowledged, while the risk and significance of observations noted have a role to play in prioritising the matters to be reported.
2. **Conducted in Accordance with SIAs:** Where the internal audit is conducted in compliance with the Standards of Internal Audit, (within the Framework governing Internal Audits), and the internal auditor can substantiate the same with supporting evidence and documentation, the internal audit report shall include a statement confirming that "the internal audit was conducted in accordance with the Standards of Internal Audit issued by the Institute of Chartered Accountants of India".
3. **Content and Format of Internal Audit Report:** The manner in which the internal audit report is drafted and presented is a matter of professional judgment and choice and could be influenced by the preferences of the recipients. The SIA does not mandate any particular format or list of contents since the Internal Auditor is expected to exercise his best professional judgement on matters regarding how and what to report. Where some level of assurance is being provided, the form and content of the report shall be as per SIA 380, "Issuing Assurance Reports". A typical internal audit report should include the following:

- Audit Scope performed
- Audit period Covered
- Executive Summary
- Summary of the critical findings
- Detailed audit findings with elaboration on business impact and root cause of such issues
- Rating of the highlighted issues (E.g High / Medium / Low) in accordance to the rating criteria approved by Audit Committee
- Audit recommendation to improve control environment and address the highlighted finding Response received from the responsible functional authority containing action plan and target timelines for action

4. **Documentation: To confirm compliance of audit procedures with this SIA, the list of documents required is as follows:**

(a) Copies of draft and final internal audit reports to be maintained, appropriately cross referenced to specific observations.

(b) If appropriate, management action plans may be counter signed by respective management personnel.

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Question 2

State the important aspects to be considered by the External auditor in the evaluation of the Internal Audit Function.

Answer 2

Evaluation of Internal Audit Functions by External Auditor: The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect.

The important aspects to be considered in this context are:

a) **Organizational Status -** Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation, his reports to the highest level of management and are free of any other operating responsibility. Any constraints or restrictions placed upon his work by management should be carefully evaluated. In particular, the internal auditor should be free to communicate fully with the external auditor.

b) **Scope of Function -** The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.

c) **Technical Competence -** The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.

d) **Due Professional Care -** The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit Programmes and working papers.

Question 3

AB Pvt. Ltd. company has outstanding loans or borrowings from banks exceeding one hundred crore rupees wants to appoint an internal auditor. Please guide him for the applicability of the same and who can be appointed as an internal auditor and what work would be reviewed by him.

Answer 3

Applicability of Internal Audit: Section 138 of the Companies Act, 2013 states that every private limited company is required to conduct internal audit if its outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

In view of above provisions, AB Pvt. Ltd. is under compulsion to conduct internal audit as its loans or borrowings are falling under the prescribed limit.

Who can be appointed as Internal Auditor- The internal auditor shall either be a chartered accountant or a cost accountant, whether engaged in practice or not, or such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the companies.

The internal auditor may or may not be an employee of the company.

Work to be reviewed by Internal Auditor-

In addition, each of the managerial functions should be reviewed by the internal auditor. The scope of internal auditor's work should also include a review of-

(i) Review of Internal Control System and Procedures -

(a) The review of internal control system and procedures involves assessing the design and operational efficiency and effectiveness of the internal control system to strengthen the overall internal control environment of the entity. The objective to review is to minimise the overall residual risk by suggesting the appropriate controls to reduce the inherent risk.

As far as possible, controls should be in-built in the operating functions for prevention or timely detection of the fraud and errors and minimize the cost of control.

(b) Internal Control System should be reviewed considering the limitations of internal controls, i.e., costbenefit comparison, human errors, collusion, and abuse by process owners.

It should also be seen whether the internal controls were in use throughout the period of intended reliance. A break-down in internal controls for a specific portion of intended reliance would need special attention.

(ii) Review of Custodianship and Safeguarding of Assets -

- This involves verifying the existence of the assets.
- The internal auditor should review the segregation of duties is in place.
- The internal auditor should review the control systems to ensure that all assets are accounted for fully. He should review the means used for safeguarding assets against losses e.g. fire, improper or negligent activity, theft and illegal acts, etc.
- He should review the control systems for intangible assets e.g. the procedures relating to credit control. Where an enterprise uses electronic data processing equipment, the physical and systems control on processing facilities as well as on data storage should be examined and tested.

(iii) Review of Compliance with Policies, Plans, Procedures and Regulations - It is essential that the various functional segments of an enterprise comply with the relevant policies, plans, procedures, laws and regulations so that the operations are carried out in a coordinated manner.

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He should examine the system of periodical review of existing policies particularly when there is a change in the method and nature of operations of the enterprise. By combining the results of his review of the adequacy of the systems with the result of his compliance tests, the internal auditor should be able to evaluate the effectiveness of the former. He should point out specific weaknesses and suggest remedial action.

(iv) Review of Relevance and Reliability of Information - The internal auditor should review the information systems to evaluate the reliability and integrity of financial and operating information given to management and to external agencies such as governmental bodies, investors, trade organisations, labour unions, etc. He should examine the accuracy and reliability of financial and operational records.

The usefulness of the reports as well as of the records should be evaluated with reference to their costs.

The internal auditor should examine whether the reporting is by exception i.e. the reports highlight the significant and distinct ive features. In case of automated management information system, where relevant information used for critical decision making is generated from the computer system, then adequacy of the controls build in the system should be reviewed to ensure data integrity and reliability of such information.

(v) Review of the Organisation Structure - The internal auditor should conduct an appraisal of the organisation structure to ascertain whether it is in harmony with the objectives of the enterprise and whether the assignment of responsibilities is in consonance therewith. For this purpose:

- He should review the manner in which the activities of the enterprise are grouped for managerial control. It is also important to review whether responsibility and authority are in harmony with the grouping pattern.
- The internal auditor should examine the organisation chart to find out whether the structure is simple and economical and that no function enjoys an undue dominance over the others.
- He should particularly see that the responsibilities of managerial staff at headquarters do not overlap with those of chief executives at operating units. He should examine whether there is a satisfactory balance between the authority and responsibility of important executives.
- The internal auditor should examine the reasonableness of the span of control of each executive (the number of subordinates that an executive controls). He should examine whether there is a unity of command i.e., whether each person reports only to one superior.
- Where dual responsibilities cannot be avoided, the primary one should be specified and the specific responsibility to each senior fixed. This must be made known to all concerned.
- He should review adequate segregation of duties is considered while defining the organization structure.
- Finally, he should evaluate the process of managerial development in the enterprise.

(vi) Review of Utilisation of Resources –

- The internal auditor should check whether proper operating standards and norms have been established for measuring the economical and efficient use of resources.
- They should be detailed enough to be identifiable with specific operating responsibilities and should be capable of being used by operating personnel for monitoring and evaluating their performance.
- The internal auditor should review the methods of establishing operating standards and norms. He should carefully examine the assumptions made while setting the standards to ensure that they are appropriate and necessary.
- Where there is a wide divergence between actual performance and the corresponding standards, reasons may be considered. As a part of evaluating resources utilisation, identifying the facilities which are under-utilized is an important function of the internal auditor.

(vii) Review of Accomplishment of Goals and Objectives - The internal auditor should review the overall objectives of the enterprise to evaluate whether they are clearly stated and are attainable. The internal auditor should examine whether, to the extent possible, objectives are expressed in precise quantifiable terms (both monetary and non-monetary) to facilitate detailed planning to be made for achieving them.

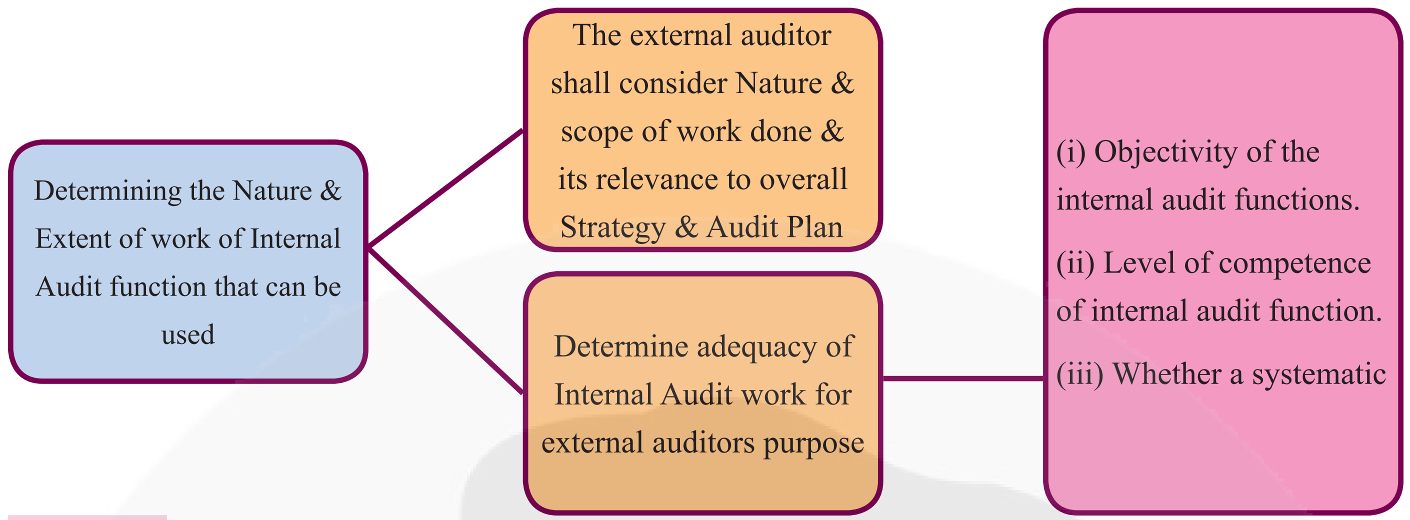
Budgeting forms an important part of such planning. This will ensure that plans anticipate the problem areas. There should also be sufficient flexibility in the plans to permit such improvements in their implementation, as would benefit the enterprises as a whole.

Question 4

Moon Ltd. of which you are the Statutory Auditor, have an internal audit being conducted by an outside agency. State the factors that weigh considerations in opting to make use of direct assistance of the internal auditors for the purpose of statutory audit.

Answer 4

The external auditor shall not use the work of the internal audit function if the external auditor determines that the function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors; the function lacks sufficient competence or the function does not apply a systematic and disciplined approach, including quality control.



Question 5

Mr. A is appointed as a statutory auditor of XYZ Ltd. XYZ Ltd is required to appoint an internal auditor as per statutory provisions given in the Companies Act, 2013 and appointed Mr. B as its internal auditor. The external auditor Mr. A asked internal auditor to provide direct assistance to him regarding evaluating significant accounting estimates by the management and assessing the risk of material misstatements.

a) Discuss whether Mr. A, statutory auditor, can ask direct assistance from Mr. B, internal auditor as stated above in view of auditing standards.

b) Will your answer be different if Mr. A asks direct assistance from Mr. B, internal auditor with respect to external confirmation requests and evaluation of the results of external confirmation procedures?

Answer 5

a) Direct Assistance from Internal Auditor: As per SA 610 "Using the Work of Internal Auditor", the external auditor shall not use internal auditors to provide direct assistance to perform procedures that Involve making significant judgments in the audit.

Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement.

Significant judgments include the following:

- Assessing the risks of material misstatement;
- Evaluating the sufficiency of tests performed;
- Evaluating the appropriateness of management's use of the going concern assumption;
- Evaluating significant accounting estimates; and
- Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.

In view of above, Mr. A cannot ask direct assistance from internal auditors regarding evaluating significant accounting estimates and assessing the risk of material misstatements.

b) Direct Assistance from Internal Auditor in case of External Confirmation Procedures: SA 610 "Using the Work of Internal Auditor", provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors. In determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned.

Further, in accordance with SA 505, "External Confirmation" the external auditor is required to maintain control over external confirmation requests and evaluate the results of external confirmation procedures, it would not be appropriate to assign these responsibilities to internal auditors. However, internal auditors may assist in assembling information necessary for the external auditor to resolve exceptions in confirmation responses.

Question 6

The XYZ Ltd has to appoint Mr. A as Chief Internal Auditor to lead the internal audit function for the Company. The Managing Director of the Company has asked the HR head to define the reporting structure of the Chief Internal Auditor, so that he can discharge his duties objectively? Suggest the ideal reporting structure of the Chief Internal Auditor that HR head may propose to the Managing Director?

Answer 6

HR Head need to evaluate multiple options and identify most suitable option in light of the relevant provisions, guidance and overall governance of the organization. HR head also need to evaluate different option for his administrative reporting and various options for functional reporting of Chief Internal Auditor. The possible options to be considered and evaluated include Board of Directors, Audit Committee, Managing Director of the Company, Chief Executive Officer or Chief Financial Officer.

As per section 138 of the Companies Act 2013, the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company.

As per the revised definition of the term 'Internal Audit' as per para 3 of the ICAI's Framework Governing Internal Audits, "Internal audit provides independent assurance on the effectiveness of internal controls and risk management processes to enhance governance and achieve organizational objectives".

The Internal Auditor shall be free from any undue influences which force him to deviate from the truth. This independence shall be not only in mind but also in appearance. Also, the internal auditor shall resist any undue pressure or interference in establishing the scope of the assignments or the manner in which these are conducted and reported, in case these deviate from set objectives.

As per the requirement of the above stated provision, Chief Internal Auditor need to be independent of the operational activities and report of Audit Committee / Board of Directors to enjoy his true

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status of independent auditor. He may administratively report to CEO or Managing Director for his administrative reporting purpose or any other similar authority till the time it is approved by Board of Directors and it does not impact his independence to be able to perform his duties and report to audit committee / Board of Director independently.

Question 7

The XYZ Ltd is has appointed Mr. A to conduct their internal audit for new financial year. The Audit committee requested Mr. A to present their Internal Audit plan for next financial year? What approach would Mr. A follow to prepare the internal audit plan for next year?

Answer 7

The internal auditor should, in consultation with those charged with governance, including the audit committee, develop and document a plan for each internal audit engagement to help him conduct the engagement in an efficient and timely manner.

Internal audit plan should be developed in such a manner that all the business processes covering both financial as well as operational activities are reviewed by internal audit function within a defined time cycle.

Also, ensuring that appropriate consideration is made and adequate balance is ensured to the following:

- Risk underlying the business process
- Value that the internal audit can provide to the organization
- Effort involved in conducting the internal audit for a particular business process
- Risk Appetite of the organization.
- Coverage of all auditable areas within the defined time range

Question 8

The XYZ Ltd is has appointed Mr. A to conduct their internal audit for new financial year. The Audit committee requested Mr. to perform detailed analysis of their expenses in previous year and report all risks and underlying gaps? What audit approach should Internal Auditor follow to identify such gaps?

Answer 8

Typical internal audit engagement comprises of following five steps:

Step 1 – Obtain knowledge of the Business and its Environment

Internal Auditor must conduct meetings with key stakeholders, Board of Directors and Key management personals to obtain understanding of the organization's business environment, its operations, organization's vision, mission and top management's expectations from the audit functions.

Internal auditor must obtain understanding of various business documents – Standard Operating Procedures and Financial Statement Etc.

Internal auditor must also obtain understanding of the underlying Information Technology landscape, various applications and ERP systems of the organization and Management Information System of the organization.

Internal auditor must also obtain understanding of the regulatory landscape and various laws and regulations that are applicable to the organization.

Step 2 – Perform Audit Planning

Internal Auditor must plan the audit engagement as per the Standard on Internal Audit (SIA) 310, Planning the Internal Audit Assignment. Audit scope must be approved by Audit Committee and Board of Directors.

Once approved, Internal Auditor must share detailed Audit Plan with the key managerial personals and plan in advance the detailed schedule of the Internal Audit to be conducted.

Internal Auditor must conduct the opening meeting with key stakeholders before start of audit engagement and share details of Information and System Access required to perform the audit.

Detailed work plan must be prepared by the audit managers and approved with Head of Internal Audit / Chief Internal Auditor. The work plan must be prepared after performing the evaluation of all major underlying risks in the process being reviewed and the audit checks to be performed to assess the adequacy of the control environment to mitigate such risks.

Step 3 – Gather required information

Internal Auditor must obtain the required information and perform checks to ensure correctness and integrity of information received. To the extent possible, Internal Auditor must obtain the information directly from the source.

Adequate planning should be done and advance intimation should be made for any interim information needed for performing audit checks.

Step 4 – Perform audit checks

Internal Auditor should collate all data and perform analytical procedures to identify key trends and outliers.

Analytical procedures should be performed in accordance with the Standard on Internal Audit (SIA) 6, Analytical Procedures. To the extent possible, relevant analytical tools may be used to perform review of the complete data for the audit period.

Wherever needed, Internal Auditor must select the sample in accordance with Standard on Internal Audit (SIA) 5, Sampling.

Detailed audit testing must be performed as per the audit work plan. Internal Auditor must ensure adequate evidences must be collected and stores in accordance to Standard on Internal Audit (SIA) 320, Internal Audit Evidence Internal Auditor must prepare detailed listed of the Identified audit

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issues and controls gaps. Interim reports may be issued after proper review of the work performed as per the Standard on Internal Audit (SIA) 350, Review and Supervision of Audit Assignments.

Adequate document of the internal audit work papers needs to be ensured as per Standard on Internal Audit (SIA) 330, Internal Audit Documentation

Step 5 – Reporting of Internal Audit Issues

Internal Auditor must prepare a draft report of Internal Audit issues comprising of the business process/ function reviewed as per scope, detailed audit coverage and exclusions, if any, audit period covered during the audit, summary along with detailed issues over the gaps noted along with implication of the business and recommendation to mitigate the identified gaps.

Management Action Plan should be agreed along with responsibility of action and timelines for actions.

Internal Auditor must also review the status of actions taken by the management against the actions agreed during previous audits and report the status of such follow up in the audit report.

Internal Auditor should thereafter circulate Final Report and presentation his findings to the Audit Committee.

Internal auditor must adhere to Standard on Internal Audit (SIA) 360, Communication with Management and Standard on Internal Audit (SIA) 370, Reporting Results while sharing the result of internal audit with the stakeholders.

Question 9

The XYZ Ltd is has appointed Mr. A to conduct their internal audit for new financial year. The Audit committee requested Mr. to present detailed report on their finding and areas where immediate action is needed to mitigate critical risks? What should be the content of internal audit report to address this requirement of the Audit Committee?

Answer 9

As per Standard on Internal Audit (SIA) 370 Reporting Results, reporting of internal audit results is generally undertaken in two stages:

- At the end of a particular audit assignment, an "Internal Audit Report" covering a specific area, function or part of the entity is prepared by the Internal Auditor highlighting key observations arising from those assignments. This report is generally issued with details of the manner in which the assignment was conducted and the key findings from the audit procedures undertaken. This report is issued to the auditee, with copies shared with local and executive management, as agreed during the planning phase.
- On a periodic basis, at the close of a plan period, a comprehensive report of all the internal audit activities covering the entity and the plan period is prepared by the Chief Internal Auditor (or the Engagement Partner, in case of external service provider). Such reporting is normally done on a

quarterly basis and submitted to the highest governing authority responsible for internal audits, generally the Audit Committee. Some part of the aforementioned Internal Audit Reports may form part of the periodic (e.g. Quarterly) report shared with the Audit Committee.

Accordingly, a typical internal audit report should include the following:

- Audit Scope performed;
- Audit period Covered;
- Executive Summary;
- Summary of the critical findings;
- Detailed audit findings with elaboration on business impact and root cause of such issues;
- Rating of the highlighted issues (E.g High / Medium / Low) in accordance to the rating criteria approved by Audit Committee;
- Audit recommendation to improve control environment and address the highlighted finding;
- Response received from the responsible functional authority containing action plan and target timelines for action.

Question 10

The XYZ Ltd is has appointed Mr. A to conduct their internal audit for new financial year. The Audit committee requested Mr. A to present their analysis on the implementation of recommendation of previous audit report and highlight critical areas which need immediate attention of Audit Committee? What should be the steps followed by internal auditor to address this requirement of Audit Committee?

Answer 10

As per SIA 390 Monitoring and Reporting of Prior Audit Issues, the Chief Internal Auditor is responsible for continuously monitoring the closure of prior audit issues through timely implementation of action plans included in past audits. This shall be done with a formal monitoring process, elements of which are pre-agreed with management and those charged with governance. The responsibility to implement the action plans remains with the management.

In monitoring and reporting of prior audit issues, the responsibility of the Internal Auditor is usually in the form of an "Action Taken Report (ATR) of previous audits".

To address the requirement of Audit Committee in the given situation, Internal Auditor should assess the action taken against the previous audit findings and report a summary of the action taken by the management.

Typical Action Taken Report may include the following:

- Reference to the previous audit reporting containing the reported issues

- Implementation Action agreed by the management along with target implementation date
- Status of action taken by management. The same may be classified under Implemented / Not Implemented
- Residual risk and rating for any unimplemented action
- Audit findings not implemented for long period of time
- Any critical audit finding that require immediate action for action or implementation.

Question 11

After an illustrious career in Indian Audit & Accounts Service for about 25 years, Parteek, a post graduate in law, has taken voluntary retirement from government service. Being in fine spirits, he wants to take responsibilities in corporate sector as Chief internal auditor. On looking at attractive compensation packages, he applied for such position in a leading listed company engaged in oil refining business. The Board of company is keen on him due to his impressive credentials.

Can he be appointed in this leading position of said company?

Answer 11

As per section 138 of Companies Act, 2013 the internal auditor shall either be a chartered accountant or a cost accountant (whether engaged in the practice or not), or such other professional as may be decided by the Board to conduct an internal audit of the functions and activities of the company.

The Board can appoint any professional as may be decided by it. The applicant in question is a law post graduate and he has spent 25 years of his career in Indian Audit & Accounts Service. Therefore, he has got the necessary experience and skills required for the said vacancy. The Board would be in a position to appoint such a competent and experienced person in the field of auditing as its Chief Internal auditor.

Question 12

CA Deva is internal auditor of a listed company. The company wants to make sure that it is in compliance with SEBI requirements at all times and it is never on the wrong side of law. It asks its internal auditor to manage its compliance tracking system including directly corresponding with regulator in this regard. The profile and scope of internal audit agreed at time of appointment included "compliance with laws and regulations."

Can he perform such type of activities in capacity of internal auditor of company?

Answer 12

The Internal Auditor does not assume any responsibility to manage or operate the compliance framework or to take compliance related decisions. It is not responsibility of the Internal Auditor to execute or resolve compliance related risks (e.g., engaging directly with regulators, etc.).

Although internal audit function provides independent assurance to enhance governance (which includes compliance with laws and regulations), it does not assume operational responsibility of its compliance framework. It is the responsibility of the management. He is responsible for auditing the compliance framework and not managing it. Similarly, he does not accept compliance related risks like directly engaging with regulator.

Question 13

Up Down Limited is in doldrums since last two years. The demand for its products has declined drastically.

The statutory auditor is of the view that situation has put into question going concern assumption of the company. Its internal auditor has helped management in devising a strategy to deal with such risks and come out of the situation. The plan includes venturing into different product lines using same plant with minor modifications. Further, internal auditor has also prepared estimates of revenue generation along with cash flows.

Can statutory auditor place total reliance on work performed by internal auditor in this regard?

Answer 13

The greater the judgment needed to be exercised in planning and performing the audit procedures and evaluating the audit evidence, the external auditor will need to perform more procedures directly because using the work of the internal audit function alone will not provide the external auditor with sufficient appropriate audit evidence.

The appropriate use of going concern assumption requires significant judgment on part of statutory auditor.

Therefore, statutory auditor cannot place total reliance on internal auditor's work in this regard and he should perform more procedures directly.

Illustration 14

The Managing Director of X Ltd is concerned about high employee attrition rate in his company. As the internal auditor of the company he requests you to analyze the causes for the same. What factors would you consider in such analysis?

Answer 14

The factors responsible for high employee attrition rate are as under:

a) Job Stress & work life imbalance;

b) Wrong policies of the Management;

c) Unbearable behavior of Senior Staff;

d) Safety factors;

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e) Limited opportunities for promotion;

f) Low monetary benefits;

g) Lack of Labour welfare schemes;

h) Whether the organization has properly qualified and experienced personnel for the various levels of works?

i) Is the number of people employed at various work centers excessive or inadequate?

j) Does the organization provide facilities for staff training so that employees and workers keep themselves abreast of current techniques and practices?

CASE STUDY

JKT Pvt. Ltd. having ₹ 40 lacs paid-up capital, ₹9.50 crores reserves and turnover of last three consecutive financial years, immediately preceding the financial year under audit, being ₹ 49 crores, ₹ 145 crores and ₹ 260 crores, but does not have any internal audit system. In view of the management, the internal audit system is not mandatory. Comment.

Applicability of Provisions of Internal Audit: As per section 138 of the Companies Act, 2013, read with rule 13 of Companies (Audit and Auditors) Rules, 2014, every private company shall be required to appoint an internal auditor or a firm of internal auditors, having

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

Conclusion: In the instant case, JKT Pvt. Ltd. is having a turnover of ` 260 crores during the preceding financial year which is more than two hundred crore rupees. Hence, the company has the statutory requirement to appoint an Internal Auditor and mandatorily conduct an internal audit

INTERNAL AUDIT

17
CHAPTER

DUE DILIGENCE, INVESTIGATION AND FORENSIC AUDIT

Question 1

A Ltd who is one of the leading manufacturer of kids clothing is interested to acquire B Ltd. B Ltd is currently a manufacturer of women' clothing. As a professional consultant in due diligence and valuation, A Ltd entrusted you to value B Ltd. The valuation of B Ltd is dependent on future maintainable sales. Discuss the factors you would consider in assessing the future maintainable turnover of B Ltd? (MTP 4 Marks Mar 19, PYP 4 Marks Nov 22)

Answer 1

In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:

(a) **Trend:** Whether in the past, sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.

(b) **Marketability:** Is it possible to extend the sales into new markets or that these have been fully exploited? Product wise estimation should be made.

(c) **Political and economic considerations:** Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?

(d) **Competition:** What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company's share in the total trade constant or has it been fluctuating?

Question 2

Lamba, Malhora and Khandelwal are partners in a firm sharing profits and losses in the ratio 2:2:1. The partners have agreed to take Mr. Jain as a partner with effect from 1st April, 2019 as 1/4th partner. What are the important steps involved while conducting investigation on behalf of Mr. Mistri, the incoming partner? (MTP 5 Marks May 20, MTP 5 Marks Apr'18, MTP 5 Marks March '23)

Answer 2

Steps involved while conducting investigation on behalf of an incoming partner: The general approach of the investigating accountant in this type of investigation would be more or less similar, irrespective of the nature of business of the firm-manufacturing, trading or rendering a service.

Primarily, an incoming partner would be interested to know whether the terms offered to him are reasonable having regard to the nature of the business, profit records, capital distribution, personal capability of the existing partners, socio-economic setting, etc., and whether he would be capable of deriving continuing benefit in the shape of return on capital to be contributed and remuneration for services to be rendered, which can be justified by the overall economic conditions prevailing and other considerations considering his own personality and achievements. In addition, he would be interested to ascertain whether the capital to be contributed by him would be safe and applied usefully.

Broadly, the steps involved are the following:

(i) Ascertainment of the history of the inception and growth of the firm.

(ii) Study of the provisions of the deed of partnership, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, financial management, goodwill, etc.

(iii) Scrutiny of the record of profitability of the firm's business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits. Particular attention should, however, be paid to the nature of partners' remuneration, which may be excessive or inadequate in relation to the nature and profitability of the business, qualification and expertise of the partners and such other factors as may be relevant.

(iv) Examination of the asset and liability position to determine the tangible asset backing for the partner's investment, appraisal of the value of intangibles like goodwill, know how, patents, etc. impending liabilities including contingent liabilities and those for pending tax assessment. In case of firms rendering services, the question of tangible asset backing usually is not important, provided the firm's profit record, business coverage and standing of the partners are of the acceptable order.

(v) Position of orders at hand and the range and quality of clientele should be thoroughly examined, which the firm is presently operating.

(vi) Position and terms of loan finance would call for careful scrutiny to assess its usefulness and implication for the overall financial position; reason for its absence should be studied.

(vii) It would be interesting to study the composition and quality of key personnel employed by the firm and any likelihood of their leaving the organisation in the near future.

(viii) Various important contractual and legal obligations should be ascertained and their nature studied. It may be the case that the firm has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits. Full import of such standing agreements would be gauged before a final decision is reached.

(ix) Reasons for the offer of admission to a new partner should be ascertained and it should be determined whether the same synchronises with the retirement of any senior partner whose association may have had considerable bearing on the firm's success.

DUE DILIGENCE, INVESTIGATION AND FORENSIC AUDIT

(x) Appraisal of the record of capital employed and the rate of return. It is necessary to have a comparison with alternative business avenues for investments and evaluation of possible results on a changed capital and organisation structure, if any, envisaged along with the admission of the partner.

(xi) It would be useful to have a first hand knowledge about the specialisation, if any, attained by the firm in any of its activities.

(xii) Manner of computation of goodwill on admission as also on retirement, if any, should be ascertained.

(xiii) Whether any special clause exists in the deed of partnership to allow admission in future of a new partner, who may be specified, on concessional terms.

(xiv) Whether the incomplete contracts which will be transferred to the reconstituted firm will be a liability or a loss.

It would always be worthwhile to remember that, in a partnership, personal considerations count predominantly over other considerations and assessment of standing of the firm, standing and reliability of other partners, their personal reputation and the goodwill enjoyed by the products/services are important.

On the basis of the broad frame of considerations as given above, the investigating accountant should devise his own considerations in each case which may be quite diverse. Additional considerations may come up in the case of service-rendering firms where profit and business record, goodwill of the firm and of individual partners would assume greater significance.

Again, in the case of industrial firms, the network of customers, their scatter, size, etc., would be relevant for consideration.

Question 3

A nationalized bank received an application from a Limited company seeking sanction of a term loan to expand its existing business. In this connection, the Loan Manager of the Bank approaches you to conduct a thorough investigation of the items of the Balance Sheet of this Limited company and submit a confidential report based on which he will decide whether to sanction this loan or not. List out the major steps an investigating accountant would keep in mind while verifying assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank (5 Marks, Oct 20)

Answer 3

Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank - The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

(i) **Fixed assets -** A full description of each item, its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

(ii) **Inventory -** The value of different types of inventories held (raw materials, work-in-progress and finished goods) and the basis on which these have been valued.

Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of inventory subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.

If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.

(iii) **Trade Receivables, including bills receivable -** Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.

Further, the total amount outstanding at the close of the period should be segregated as follows:

(a) debts due in respect of which the period of credit has not expired;

(b) debts due within six months; and

(c) debts due but not recovered for over six months.

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The recoveries out of various debts subsequent to the date of the Balance sheet should be stated.

(iv) **Investments -** The schedule of investments should be prepared. It should disclose the date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.

(v) **Secured Loans -** Debentures and other loans should be included together in a separate schedule. Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re-payment of a liability should be disclosed.

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(vi) **Provision of Taxation -** The previous years up to which taxes have been assessed should be ascertained. If provision for taxes not assessed appears in be inadequate, the fact should be stated along with the extent of the shortfall.

(vii) **Other Liabilities -** It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade payables should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.

(viii) **Insurance -** A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an anne xure to the statements of assets, together with a report as to whether or not the insurance-cover appears to be adequate, having regard to the value of assets.

(ix) **Contingent Liabilities -** By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced those of machinery suppliers and the legal adviser, for example, the investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.

Finally, the investigating accountant should ascertain whether any application for loan to another bank or any other party has been made. If so, the result thereof should be examined.

Question 4

LMN Ltd. entered into a deal with SP Ltd. for buying its business of manufacturing wooden products/ goods. LMN Ltd. has appointed your firm for conducting due diligence review and they want to know the cash generating abilities of SP Ltd. What points will you check in order to ensure that the manufacturing unit of SP Ltd. will be able to meet the cash requirements internally? (MTP 5 Marks, March' 21, Old & New SM)

Answer 4

In order to ensure that the manufacturing unit of SP Ltd. will be able to meet the cash requirements internally, one is required to verify:

(i) Is the company able to honour its commitments to its trade payables, to the banks, to the government and other stakeholders?

(ii) How well is the company able to convert its trade receivables and inventories?

(iii) How well the Company deploys its funds?

(iv) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?

(v) What is the investment pattern of the company and are they easily realizable?

Cash Flow - A review of historical cash flows and their pattern would reflect the cash generating abilities of the target company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time

Question 5

Ekbote Co. is currently a large organisation trading in items of office furniture. The entity wants to expand and hence are looking at acquisition of Rawat Co which deals in items of household furniture. Ekbote Co. hires a Chartered accountant to conduct a due diligence to consider whether there is the potential for additional value to be brought out of the target company by improving its operational function and also whether there are serious operational risks about which the potential buyer should be concerned (thereby allowing the buyer to consider aborting the deal or renegotiating the price). Which of the due diligence review would be helpful to achieve the above objective? You are also required to briefly discuss the contents of a due diligence report. (MTP 4 Marks, April 19)

Answer 5

In the instant case Operational Due Diligence is required to confirm that the business plan provided is achievable with the existing facilities plus the capital expenditure outlined in the business plan.

Contents of a Due Diligence Report: Briefly, the contents of a due diligence report can be discussed under:

- Terms of reference and scope of verification.
- Objective of due diligence.
- Brief history of the company including shareholding pattern.
- Assessment of management structure.
- Assessment of financial liabilities with special emphasis on Interlocking investments and financial obligations with group/associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account.
- Assessment of valuation of assets including comments on properties, terms of leases, lien and encumbrances including status of charges, liens, mortgages, assets and properties of the company.
- Assessment of operating results.
- Assessment of taxation and statutory liabilities.
- Assessment of possible liabilities on account of litigation and legal proceedings against the company and suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities.
- Assessment of net worth.

- Suggestions on various aspects to be taken care of before and after the proposed merger / acquisition.
- Status of franchises, license and patents.

Finally, an executive summary may be prepared highlighting the significant areas.

Question 6

A German Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India, request you to conduct a "Due Diligence" of this Indian Company and submit your Report. As due Diligence Auditor, discuss the key areas you will cover in your review. (MTP 5 Marks, Oct 18)

Answer 6

Due Diligence – Key Areas: The German company engaged in the business of manufacturing and distribution of industrial gases wishing to acquire a listed Indian company has commissioned the Due Diligence Audit to assess the strengths and weaknesses of this company. It is quite important for the acquirer to assess the proposal from different angles and specifically as per terms of the assignment and also see whether proposed merger would create operational synergies. On the other hand, financial due diligence review would be performed after the commercial valuation. Accordingly, while a preliminary review might be performed during initial stages of the restructuring exercise and may in fact, be performed simultaneously with the commercial evaluation, at a later stage, financial due diligence may be performed on the books of account and other information directly pertaining to the financial matters of the entity. In addition, a legal due diligence may be required where legal aspects of functioning of the entities are reviewed; for example, the lega l aspects of property owned by the entity or compliance with various statutory requirements under various laws. Like other due diligence exercises, environmental and personnel due diligence are also carried out in order to establish whether various propositions with regard to environment and personnel of the enterprise under review are appropriate. In any case, it is quite important to look behind the veil of initial information provided by the company and to assess the benefits and costs of the proposed acquisition/merger by inquiring into all relevant aspects of the past, present and future of the business to be acquired. Some of the significant key areas which shall be covered under the review are as under:

(1) Historical Background: The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters. The details of how the company was set up and who were the original promoters have to be gone into, before verification of financial data in detail. An eye into the history of the company may reveal its turning points, survival strategies adopted from time to time, the market share enjoyed by and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the said company. This could, inter alia, include the nature of business(es), location of production facilities, warehouses, offices, products or services and markets.

(2) Significant Accounting Policies: The accountant should study the accounting policies being followed by the target and ascertain whether any accounting policy is inappropriate. The accountant should also see the effects of the recent changes in the accounting policies. The target might have changed its accounting policies in the recent past keeping in view its intention of offering itself for sale.

The overall scope has to be based on the accounting policies adopted by the management. The accountant has to look at the main effect of accounting policies on the overall profitability and their correctness. It is reiterated that the accountant should mainly look at all material changes in Accounting Policies in the period subjected to review very carefully.

The accountant's report should include a summary of significant accounting policies used by the target, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the target are different from those adopted by the acquiring enterprise, the effect of such differences.

(3) Review of Financial Statements: An evaluation of the profit reported by the company would be largely based upon its operating results. Any extraordinary item of income or expense that might have affected the operating results would require close examination. It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period. It is important that the trading results for the past four to five years are compared and the trend of normal operating profit arrived at. The normal operating profits should further be benchmarked against other similar companies. Besides the above, and based on the trend of operating results, the accountant has to advise the acquiring enterprise, through due diligence report, on the indicative valuation of the business. The exercise to evaluate the balance sheet of the company has to take into consideration the basis upon which assets have been valued and liabilities have been recognized. The net worth of the business has to be arrived at by taking into account the impact of over/under valuation of assets and liabilities.

(4) Taxation - Tax due diligence is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. It is important to check if the company is regular in paying various taxes to the Government. The accountant has to also look at the tax effects of the merger or acquisition.

(5) Cash Flow: A review of historical cash flows and their pattern would reflect the cash generating abilities of the target company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time. It is necessary to check that:

(a) Is the company able to honour its commitments to its trade payables, to the banks, to government and other stakeholders?

(b) How well is the company able to turn its trade receivables and inventories

(c) How well does it deploy its funds

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(d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?

(6) Financial Projections: The accountant should obtain from the target company the projections for the next five years with detailed assumptions and workings. He should ask the target to give projections on optimistic, pessimistic and most likely bases.

(7) Management and Employees - In most of the companies which are available for take over the problem of excess work force is often witnessed. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these match the requirements of the new incumbents. Due to complex set of labour laws applicable to them, companies often have to face protracted litigation from its workforce and it is important to gauge the likely impact of such litigation. The aspects whether all employee benefits like PF, Gratuity, ESI and superannuation have been properly paid/ funded. The pay packages of the key employees will be thoroughly reviewed since this can be a crucial factor in future employee costs.

(8) Statutory Compliance: During a due diligence this is one aspect that has to be investigated in detail.

It is important therefore, to make a list of laws that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance it could lead to punitive charges under the law. These may have to be quantified and factored into the financial results of the company.

Question 7

HSDC Bank Ltd., received an application from a pharmaceutical company for take over of their outstanding term loans secured on its assets, availed from and outstanding with a nationalised bank. HSDC Bank Ltd., requires you to make a due diligence audit in the areas of assets of pharmaceutical company especially with reference to valuation aspect of assets. State what may be your areas of analysis in order to ensure that the assets are not stated at overvalued amounts. (MTP 4 Marks March 22 & Nov 21, Old & New SM, PYP 5 Marks May 18, RTP Nov'20)

Answer 7

Over-Valued Assets: In case of due diligence exercise, the area of analysis in order to ensure that the assets are not stated at over-valued amounts are:

- Uncollected/uncollectable receivables.
- Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company.
- Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.

- Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
- Litigated assets and property.
- Investments carried at cost though realizable value is much lower.
- Investments carrying a very low rate of income / return.
- Infructuous project expenditure/deferred revenue expenditure etc.
- Group Company balances not reconciled.
- Intangibles having no relisable value.

Question 8

CA Rani has been appointed as Forensic Audit Accountant by ATM Bank Limited for one of its borrowal accounts FAR Ltd. CA Rani started the audit by first reviewing the transactions of the borrower in Bank statement as per Bank records to identify any hidden patterns in that information. She had to review huge volume of data, as the number of transactions per day were in hundreds and the data was to be reviewed for the last three years. So, she was stuck up as to how to proceed further to identify any hidden patterns in information, if any. Guide CA Rani, suggesting which technique to be used for identifying any hidden patterns in the information. (MTP 4 Marks Sep 22, MTP 4 Marks Mar'22, PYP 4 Marks, Nov '20)

Answer 8

Data Mining Techniques:

i. Data mining technique is a set of assisted techniques designed to automatically mine large volumes of data for new, hidden or unexpected information or patterns.

ii. It discovers the usual knowledge or patterns in data, without a predefined idea or hypothesis about what the pattern may be, i.e. without any prior knowledge of fraud.

iii. It explains various affinities, association, trends and variations in the form of conditional logic.

iv. Data mining techniques are categorized in three ways: Discovery, Predictive modeling and Deviation and Link analysis.

In the given case of ATM Bank Ltd., CA Rani appointed as forensic auditor accountant for its borrower, FAR Ltd, shall use above stated data mining techniques to identify any hidden patterns of information.

Question 9

An American company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of 51% and assets over ` 1000 Crore. It requests you to conduct "Due Diligence" of assets of this listed Indian Company to find out, if any of the assets is overvalued. List down the areas of due diligence exercise to find out overvalued assets. (MTP 5 Marks Oct '22, PYP 5 Marks Jan'21)

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Answer 9

An American company which is manufacturing and distributing industrial gases is looking forward to acquire an Indian company having 51% market share and assets beyond ` 1000 crores. Areas to be covered as a part of due diligence exercise to find out over valued assets would be as under:

1. Uncollected/uncollectable receivables.
2. Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company.
3. Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
4. Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
5. Litigated assets and property.
6. Investments carried at cost though realizable value is much lower.
7. Investments carrying a very low rate of income / return.
8. Infructuous project expenditure/deferred revenue expenditure etc.
9. Group Company balances under reconciliation etc.
10. Intangibles of no value.

Question 10

Mr. Shah is reviewing the anti-fraud controls for a construction company. The company has witnessed a few frauds in the past mainly in the nature of material stolen from the sites and fake expense vouchers.

Mr. Shah is evaluating options for verifying the process in detecting fraud and the corrective action to be taken in such cases. As an expert, you are required to advise Mr. Shah as how inventory fraud occurs and the verification procedure to be followed for detecting the same. (MTP 5 Marks, Oct 19, RTP May 19)

Answer 10

Inventory frauds - Inventory frauds are many and varied but here we are concerned with misappropriation of goods and their concealment.

(i) Employees may simply remove goods from the premises.

(ii) Theft of goods may be concealed by writing them off as damaged goods, etc.

(iii) Inventory records may be manipulated by employees who have committed theft so that book quantities tally with the actual quantities of inventories in hand.

Verification Procedure for Defalcation of inventory - It may be of trading stock, raw materials, manufacturing stores, tools or of other similar items (readily) capable of conversion into cash. The loss may be the result of a theft by an employee once or repeatedly over a long period, when the same have not been detected. Such thefts usually are possible through collusion among a number of persons. Therefore, for their detection, the entire system of receipts, storage and dispatch of all goods, etc. should be reviewed to localize the weakness in the system.

The determination of factors which have been responsible for the theft and the establishment of guilt would be difficult in the absence of:

(a) a system of inventory control, and existence of detailed record of the movement of inventory, or

(b) availability of sufficient data from which such a record can be constructed.

The first step in such an investigation is to establish the different items of inventory defalcated and their quantities by checking physically the quantities in inventory held and those shown by the Inventory Book.

Afterwards, all the receipts and issues of inventory recorded in the Inventory Book should be verified by reference to entries in the Goods Inward and Outward Registers and the documentary evidence as regards purchases and sales. This would reveal the particulars of inventory not received but paid for as well as that issued but not charged to customers. Further, entries in respect of returns, both inward and outward, recorded in the financial books should be checked with corresponding entries in the Inventory Book. Also, the totals of the Inventory Book should be checked. Finally, the shortages observed on physical verification of inventory should be reconciled with the discrepancies observed on checking the books in the manner mentioned above. In the case of an industrial concern, issue of raw materials, stores and tools to the factory and receipts of manufactured goods in the godown also should be verified with relative source documents. Defalcations of inventory, sometimes, also are committed by the management, by diverting a part of production and the consequent shortages in production being adjusted by inflating the wastage in production; similar defalcations of inventories and stores are covered up by inflating quantities issued for production. For detecting such shortages, the investigating accountant should take assistance of an engineer.

For that he will be more conversant with factors which are responsible for shortage in production and thus will be able to correctly determine the extent to which the shortage in production has been inflated. In this regard, guidance can also be taken from past records showing the extent of wastage in production in the past. Similarly, he would be able to better judge whether the material issued for production was excessive and, if so to what extent. The per hour capacity of the machine and the time that it took to complete one cycle of production, also would show whether the issues have been larger than those required.

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Question 11

CA. Rajul is acting as Credit manager in branch of DFC Bank Limited. A company has approached the branch for a request to sanction credit facilities worth ₹10 crore for meeting usual business requirements. It is a prospective new client. She checks past history of the company, back ground of promoters & directors, shareholding pattern and nature of business. Assessment of financial results of past years and future projections is also undertaken. She also carries out SWOT analysis of the company.

Besides, assessment of net worth of directors is also undertaken. Status of CIBIL score and position of name of promoters/directors in RBI defaulter list is also verified.

She also makes discreet inquiries from few clients of the branch engaged in similar line of activity regarding credit worthiness of company, its promoters and directors.

Based on above:

(i) Identify activity being performed by CA Rajul and discuss its nature.

(ii) Would your answer be different if this activity was to be performed by a person not qualified as a Chartered Accountant? Can a non-CA perform such activity? State reason.

(iii) Name any three other areas where identified activity can be undertaken. (MTP 6 Marks April ’23, RTP May’23, New SM)

Answer 11

i. The activity described in the situation is Due diligence. Due diligence is a measure of prudence activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstance, not measured by any absolute standard but depending upon the relative facts of the case. It involves a careful study of financial and non-financial possibilities. It implies a general duty to take care in any transaction.

Due diligence is a process of investigation, performed by investors, into the details of a potential investment such as an examination of operations and management and the verification of material facts. It entails conducting inquiries for the purpose of timely, sufficient and accurate disclosure of all material statements/information or documents, which may influence the outcome of the transaction. Due diligence involves a careful study of the financial as well as non-financial possibilities for successful implementation of restructuring plans.

Due diligence involves an analysis carried out before acquiring a controlling interest in a company to determine that the conditions of the business conform with what has been presented about the target business. Also, due diligence can apply to recommendation for an investment or advancing a loan/credit.

ii. There would be no difference in answer if above activity was to be performed by a person who is not a Chartered Accountant. The activity would remain due diligence. Due diligence can be performed by any person. It is not necessary that due diligence can only be carried out by a Chartered Accountant.

As due diligence involves exercise of prudence and general duty to take care in any transaction, it can be undertaken by any person.

iii. The areas where due diligence may be undertaken are: -

(1) Corporate restructuring.

(2) Venture capital financing.

(3) Public offerings.

Question 12

ABC Ltd. is a listed company having turnover of Rs.50 crores & plans expansion by installation of new machines at new building-having total additional project cost of Rs.20 crore.

Rupees (In crore)	Purpose
10.0	- for Building
8.5	- for Machinery
1.5	- for Working Capital
20 Crore	

Project gets implemented in 2017-18 and one of the accountants points out to Managing Director that something wrong has happened in the purchase of building material.

On hearing this, the management is planning to appoint Forensic ~~Auditor~~ Accountant. Advise management that how is a forensic accounting analysis is different from an audit. (RTP May 18)

Answer 12

Difference between a forensic accounting analysis and an audit: The general public believes that a financial auditor would detect a fraud if one were being perpetrated during the financial auditor's audit. The truth, however, is that the procedures for financial audits are designed to detect material misstatements, not immaterial frauds. While it is true that many of the financial statements and frauds could have, perhaps should have, been detected by financial auditors, the vast majority of frauds could not be detected with the use of financial audits. Reasons include the dependence of financial auditors on a sample and the auditors' reliance on examining the audit trail versus examining the events' and activities behind the documents. The latter is simply resource prohibitive in terms of costs and time.

There are some basic differences today between the procedures of ~~auditor~~ **accountant** and those of financial auditors. In comparison, forensic accounting and audit differ in specific ways, as shown below:

DUE DILIGENCE, INVESTIGATION AND FORENSIC AUDIT

Forensic Accounting	Audit
• In response to an event • Financial investigation • Finding used as evidence in court or to resolve disputes	• Mandatory • Measures compliance with reporting standards • Obtain reasonable assurance that financial statements are free of material misstatement in practice, there are difference in mind set between forensic accounting and audit • "Investigative mentality" vs. "Professional scepticism". A forensic accountant will often require more extensive corroboration. • A forensic accountant may focus more on seemingly immaterial transactions.

A forensic accountant will often look for indications of fraud that are not subject to the scope of a financial statement audit.

Question 13

A nationalized bank received an application from an export company seeking sanction of a term loan to expand the existing sea food processing plant. In this connection, the General Manager, who is in charge of Advances, approaches you to conduct a thorough investigation of this limited company and submit a confidential report based on which he will decide whether to sanction this loan or not.

List out the points you will cover in your investigation before submitting your report to the General Manager. (RTP Nov 18, RTP May 20)

Answer 13

Investigation on Behalf of the Bank for Advances: A bank is primarily interested in knowing the purpose for which a loan is required, the sources from which it would be repaid and the security that would be available to it, if the borrower fails to pay back the loan. On these considerations, the investigating accountant, in the course of his enquiry, should attempt to collect information on the under mentioned points:

(i) The purpose for which the loan is required and the manner in which the borrower proposes to invest the amount of the loan.

- The schedule of repayment of loan submitted by the borrower, particularly the assumptions made therein as regards amounts of profits that will be earned in cash and the amount of cash that would be available for the repayment of loan to confirm that they are reasonable and valid in the circumstances of the case. Institutional lenders now-a-days rely more for payment of loans on the reliability of annual profits and loss on the values of assets mortgaged to them.

- The financial standing and reputation for business integrity enjoyed by directors and officers of the company.

Sr. No.	Particulars	Other Audits	Forensic Audit
1.	Objectives	Express an opinion as to 'True & Fair' presentation	Whether fraud has taken place in books
2.	Techniques	Substantive & Compliance. Sample based	Investigative, substantive or in depth checking
3.	Period	Normally for a particulars accounting period.	No such limitations
4.	Verification of stock, Estimation realizable value of assets, provisions, liability etc.	Relies on the management certificate/Management Representation	Independent/verification of suspected/selected items where misappropriation in suspected
5.	Off balance sheet items (like contracts etc.)	Used to vouch the arithmetic accuracy & compliance with procedures.	Regulatory & propriety of these transactions/contracts are examined.
6.	Adverse findings if any	Negative opinion or qualified opinion expressed with/ without quantification	Legal determination of fraud impact and identification of perpetrators depending on scope.

- Whether the company is authorised by the Memorandum or the Articles of Association to borrow money for the purpose for which the loan will be used.
- The history of growth and development of the company and its performance during the past 5 years.
- How the economic position of the company would be affected by economic, political and social changes that are likely to take place during the period of loan.

To investigate the profitability of the business for judging the accuracy of the schedule of repayment furnished by the borrower, as well as the value of the security in the form of assets of the business already possessed and those which will be created out of the loan, the investigating accountant should take the under-mentioned steps:

(a) Prepare a condensed income statement from the Statement of Profit and Loss for the previous five years, showing separately therein various items of income and expen- ses, the amounts of gross and net profits earned and taxes paid annually during each of the five years. The amount of maintainable profits determined on the basis of foregoing statement should be increased by the amount by which these would increase on the investment of borrowed funds.

(b) Compute the under-mentioned ratios separately and then include them in the statement to show the trend as well as changes that have taken place in the financial position of the company:

(i) Sales to Average Inventories held.

(ii) Sales to Fixed Assets.

(iii) Equity to Fixed Assets.

(iv) Current Assets to Current Liabilities.

(v) Quick Assets (the current assets that are readily realisable) to Quick Liabilities.

(vi) Equity to Long Term Loans.

(vii) Sales to Book Debts.

(viii) Return on Capital Employed.

(c) Enter in a separate part of the statement the break-up of annual sales product-wise to show their trend.

Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank - The investigating accountant should prepare schedules of assets and liabilities of the borrower and include in the particulars stated below:

(a) Fixed assets - A full description of each item, its gross value, the rate at which depreciation has been charged and the total depreciation written off. In case the rate at which depreciation has been adjusted is inadequate, the fact should be stated. In case any asset is encumbered, the amount of the charge and its nature should be disclosed. In case an asset has been revalued recently, the amount by which the value of the asset has been decreased or increased on revaluation should be stated along with the date of revaluation. If considered necessary, he may also comment on the revaluation and its basis.

(b) Inventory - The value of different types of inventories held (raw materials, work-in- progress and finished goods) and the basis on which these have been valued.

Details as regards the nature and composition of finished goods should be disclosed. Slow-moving or obsolete items should be separately stated along with the amounts of allowances, if any, made in their valuation. For assessing redundancy, the changes that have occurred in important items of inventory subsequent to the date of the Balance Sheet, either due to conversion into finished goods or sale, should be considered.

If any inventory has been pledged as a security for a loan the amount of loan should be disclosed.

(c) Trade Receivables, including bills receivable - Their composition should be disclosed to indicate the nature of different types of debts that are outstanding for recovery; also whether the debts were being collected within the period of credit as well as the fact whether any debts are considered bad or doubtful and the provision if any, that has been made against them.

Further, the total amount outstanding at the close of the period should be segregated as follows:

(i) debts due in respect of which the period of credit has not expired;

(ii) debts due within six months; and

(iii) debts due but not recovered for over six months.

If any debts are due from directors or other officers or employees of the company, the particulars thereof should be stated. Amounts due from subsidiary and affiliated concerns, as well as those considered abnormal should be disclosed. The recoveries out of various debts subsequent to the date of the Balance sheet should be stated.

(d) Investments - The schedule of investments should be prepared. It should disclose the date of purchase, cost and the nominal and market value of each investment. If any investment is pledged as security for a loan, full particulars of the loan should be given.

(e) Secured Loans - Debentures and other loans should be included together in a separate schedule.

Against the debentures and each secured loan, the amounts outstanding for payments along with due dates of payment should be shown. In case any debentures have been issued as a collateral security, the fact should be stated. Particulars of assets pledged or those on which a charge has been created for re - payment of a liability should be disclosed.

(f) Provision of Taxation - The previous years up to which taxes have been assessed should be ascertained. If provision for taxes not assessed appears in be inadequate, the fact should be stated along with the extent of the shortfall.

(g) Other Liabilities - It should be stated whether all the liabilities, actual and contingent, are correctly disclosed. Also, an analysis according to ages of trade payables should be given to show that the company has been meeting its obligations in time and has not been depending on trade credit for its working capital requirements.

(h) Insurance - A schedule of insurance policies giving details of risks covered, the date of payment of last premiums and their value should be attached as an annexure to the statements of assets, together with a report as to whether or not the insurance- cover appears to be adequate, having regard to the value of assets.

(i) Contingent Liabilities - By making direct enquiries from the borrower company, from members of its staff, perusal of the files of parties to whom any loan has been advanced those of machinery suppliers and the legal adviser, for example, the investigating accountant should ascertain particulars of any contingent liabilities which have not been disclosed. In case, there are any, these should be included in a schedule and attached to the report.

(j) The impact on economic position of the company by economic, political and social changes those are likely to take place during the period of loan.

Finally, the investigating accountant should ascertain whether any application for loan to another bank or any other party has been made. If so, the result thereof should be examined.

Question 14

(a) General objective of an audit is to find out whether the financial statements show true and fair view.

On the other hand, investigation implies systematic, critical and special examination of the records of a business for a specific purpose.

In view of the above, you are required to brief out the difference between Audit and Investigation. (Old & New SM)

(b) Beta Ltd. is anticipating taking over a manufacturing concern and appoints you for duediligence review. While reviewing, it requests you to look specifically for any hidden liabilities and overvalued assets. State in brief the major areas you would examine for hidden liabilities and overvalued assets. (RTP Nov 19)

Answer 14

(a) Etymologically, auditing and investigation are largely overlapping concepts because auditing is nothing but an investigation used in a broad sense. Both auditing and investigation are fact finding techniques but their basic nature and objectives differ as regards scope, frequency, basis, thrust, depth and conclusiveness. Audit and investigation differ in objectives and in their nature. Auditing is general while investigation is specific.

Basis of Difference	Investigation	Audit
(i) Objective	An investigation aims at establishing a fact or a happening or at assessing a particular situation.	The main objective of an audit is to verify whether the financial statements display a true and fair view of the state of affairs and the working results of an entity.
(ii) Scope	The scope of investigation may be governed by statute or it may be non-statutory.	The scope of audit is wide and in case of statutory audit the scope of work is determined by the provisions of relevant law.
(iii) Periodicity	The work is not limited by rigid time frame. It may cover several years, as the outcome of the same is not certain.	The audit is carried on either quarterly, half- yearly or yearly.
(iv) Nature	Requires a detailed study and examination of facts and figures.	Involves tests checking or sample technique to draw evidences for forming a judgement and expression of opinion.
(v) Inherent Limitations	No inherent limitation owing to its nature of engagement.	Audit suffers from inherent limitation.

(vi) Evidence	It seeks conclusive evidence.	Audit is mainly concerned with prima- facie evidence.
(vii) Observance of Accounting Principles	It is analytical in nature and requires a thorough mind capable of observing, collecting and evaluating facts.	Is governed by Compliance with Generally accepted accounting principles, audit procedures and disclosure requirements.
(viii) Reporting	The outcome is reported to the person(s) on whose behalf investigation is carried out.	The outcome is reported to the owners of the business entity.

(b) Major areas to examine in course of Due Diligence Review: 'Due Diligence' is a term that is often heard in the corporate world these days in relation to corporate restructuring. The purpose of due diligence is to assist the purchaser or the investor in finding out all he can, reasonably about the business he is acquiring or investing in prior to completion of the transaction including its critical success factors as well as its strength and weaknesses.

Due diligence is an all pervasive exercise to review all important aspects like financial, legal, commercial, etc. before taking any final decision in the matter. As far as any hidden liabilities or overvalued assets are concerned, this shall form part of such a review of Financial Statements. Normally, cases of hidden liabilities and overvalued assets are not apparent from books of accounts and financial statements.

Review of financial statements does not involve examination from the view point of extraordinary items, analysis of significant deviations, etc.

However, in order to investigate hidden liabilities, the auditor should pay his attention to the following areas:

- The company may not show any show cause notices which have not matured into demands, as contingent liabilities. These may be material and important.
- The company may have given "Letters of Comfort" to banks and Financial Institutions. Since these are not "guarantees", these may not be disclosed in the Balance sheet of the target company.
- The Company may have sold some subsidiaries/businesses and may have agreed to take over and indemnify all liabilities and contingent liabilities of the same prior to the date of transfer. These may not be reflected in the books of accounts of the company.
- Product and other liability claims; warranty liabilities; product returns/discounts; liquidated damages for late deliveries etc. and all litigation.
- Tax liabilities under direct and indirect taxes.
- Long pending sales tax assessments.
- Pending final assessments of customs duty where provisional assessment only has been completed.
- Agreement to buy back shares sold at a stated price.

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- Future lease liabilities.
- Environmental problems/claims/third party claims.
- Unfunded gratuity/superannuation/leave salary liabilities; incorrect gratuity valuations.
- Huge labour claims under negotiation when the labour wage agreement has already expired.
- Contingent liabilities not shown in books.

Regularly Overvalued Assets:

The auditor shall have to specifically examine the following areas:

- Uncollected/uncollectable receivables.
- Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company.
- Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
- Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
- Litigated assets and property.
- Investments carried at cost though realizable value is much lower.
- Investments carrying a very low rate of income / return.
- Infructuous project expenditure/deferred revenue expenditure etc.
- Group Company balances under reconciliation etc.
- Intangibles of no value.

Question 15

Important issues to be kept in mind by the investigator while preparing his report. (RTP May 21)

Answer 15

The important issues to be kept in mind by the investigator while preparing his report are as follows:

(i) The report should not contain anything which is not relevant either to highlight the nature of the investigation or the final outcome thereof.

(ii) Every word or expression used should be properly considered so that the possibility of arriving at a different meaning or interpretation other than the one intended by the investigator can be minimized.

(iii) Relevant facts and conclusions should be properly linked with evidence.

(iv) Bases and assumptions made should be explicitly stated. Reasonableness of the bases and assumptions made should be well examined and care should be taken to see that none of the bases and assumptions can be considered to be in conflict with the objective of the investigation. For example, in an investigation into over-stocking of raw materials, inventories and spares etc. it should not be assumed that the ordering levels indicated on bin cards provide fair guidance about acquisition of further materials. Also, since investigation is a fact -finding assignment, assumptions should be made only when it is unavoidably necessary.

(v) The report should clearly spell out the nature and objective of the assignment accepted its scope and limitations, if any.

(vi) The report should be made in paragraph form with headings for the paragraphs. Any detailed data and figures supporting any finding may be given in Annexures.

(vii) The report should also state restrictions or limitations, if any, imposed on the instructions given by the client. Preferably the reasons for placing such restrictions and their impact on the final result should also be stated.

(viii) The opinion of the investigator should appear in the final paragraph of the report.

Question 16

Technology based /Digital Forensics Techniques (RTP May 21)

Answer 16

Technology based/Digital Forensics Techniques: Every transaction leaves a digital footprint in today's computer-driven society. Close scrutiny of relevant emails, accounting records, phone logs and target company hard drives is a requisite facet of any modern forensic ~~audit~~ **accounting**. Before taking steps such as obtaining data from email etc. the forensic ~~auditor~~ **accountant** should take appropriate legal advice so that it doesn't amount to invasion of privacy. Digital investigations can become quite complex and require support from trained digital investigators. However, many open-source digital forensics tools are now available to assist in this phase of the investigation .

• Cross Drive Analysis	• EnCase
• Live Analysis	• MD5
• Deleted Files	• Tracking Log File
• Stochastic Forensics	• PC System Log
• Steganography	• Free Log Tools

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Question 17

Write a short note on the following: Example of Headings of a Due Diligence Report. (RTP Nov '21)

Answer 17

(a) Example of Headings of a Due Diligence Report

a. Executive Summary

b. Introduction

c. Background of Target company

d. Objective of due diligence

e. Terms of reference and scope of verification

f. Brief history of the company

g. Share holding pattern

h. Observations on the review

i. Assessment of management structure

j. Assessment of financial liabilities

k. Assessment of valuation of assets

l. Comments on properties, terms of leases, lien and encumbrances.

m. Assessment of operating results

n. Assessment of taxation and statutory liabilities

o. Assessment of possible liabilities on account of litigation and legal proceedings against the company

p. Assessment of net worth

q. Interlocking investments and financial obligations with group / associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account

r. SWOT Analysis

s. Comments on future projections

t. Status of charges, liens, mortgages, assets and properties of the company

u. Suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities

v. Suggestions on various aspects to be taken care of before and after the proposed merger/acquisition.

Question 18

CA. Kushal has been appointed as an Investigator by M/s. XYZ and Associates. While undertaking this assignment of investigation, the subordinate staff of CA. Kushal inqui red about the following issues:

(i) Whether an investigator is required to undertake the cent per cent verification approach or whether he can adopt selective verification?

(ii) Whether an investigator necessarily requires assistance of expert?

(iii) Whether an investigator can retain working papers or not?

Guide CA. Kushal in solving the queries raised by his sub-ordinate staff. (RTP Nov '23)

Answer 18

Investigations broadly range between two extremes; on the one hand there are those in respect of which complete accounts, documents, records and other information are available, and on the other, those in respect of which little information, besides published accounts and statistical data, is available. Then again, investigation may cover the whole of accounting or may relate to only a part or parts of accounting as may be specified. Some more issues often arise in investigation. They are stated below:

(a) Whether an investigator is required to undertake a cent per cent verification approach or whether he can adopt selective verification - The answer to this question depends on the exact circumstances of the case under investigation. If the investigator has to establish the amount of cash defalcated by the cashier, he has probably no option but to carefully examine all the cash vouchers and related records. On the other hand, if he is to arrive at the profitability of a concern, he may verify constituent transactions on a selective basis taking extreme care to see that no material transaction that affects profit has remained concealed from his eyes. In investigation, it is always safer to go by statistically recognised sampling methods than to depend on the so-called "test checks" where circumstances permit selective verification.

(b) Whether an investigator necessarily requires assistance of expert - Often an investigator may feel the necessity of obtaining views and opinions of experts in various fields to properly conduct the investigation. It would be therefore, proper for the investigator to get the written general consent of his client, to refer special matters for views of different experts at the beginning of investigation and he should settle the question of costs for obtaining the views and other related implications.

(c) Whether to retain working papers or not - Another important precaution is that the investigating accountant should retain in his files full notes of the work carried out, copies of schedules and all working papers, annexures, facts, figures, record of conversations and the like. Also, the working papers should link up the figures as shown by the books of business with the final figures produced by the investigating accountant. Wherever required the investigator should take representation letter from the appointing authority. In the absence thereof, he would not be able to explain the figures when he is called upon to give evidence in a court of law to support his figures; for quite often the conclusions of the accountant are challenged by parties whose interest is adversely affected by his findings, for example, when the value of shares of a company taken over by the Government has

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been determined by him. This will also be of immense help to the investigator in correlating facts and events and later in drafting the report.

Question 19

Write a short note on the following: Services rendered by Forensic Auditors .(RTP Nov'22)

Answer 19

(a) Services rendered by Forensic Auditors are:

- Crafting questions to be posed
- Responding to questions posed
- Identifying documents to be requested and/or subpoenaed
- Identifying individuals to be most knowledgeable of facts
- Conducting research relevant to facts of the case
- Identifying and preserving key evidence
- Evaluating produced documentation and information for completeness
- Analysing produced records and other information for facts
- Identifying alternative means to obtain key facts and information
- Providing questions for deposition and cross examination of fact and expert witnesses

Question 20

Explain how a Forensic ~~Audit~~ Accounting differs from an Assurance Engagement. (PYP 4 Marks, May '18)

Answer 20

Difference between Forensic ~~Audit~~ Accounting and Assurance Engagement:

Sr. No.	Particulars	Assurance Engagement	Forensic ~~Audit~~ Accounting
1.	Objectives	Express an opinion as to 'True & Fair presentation	Whether fraud has taken place in books
2.	Techniques	Substantive & Compliance. Sample based	Investigative, substantive or in depth checking
3.	Period	Normally for a particulars accounting period.	No such limitations

4.	Verification of stock, Estimation realizable value of assets, provisions, liability etc.	Relies on the management certificate/Management Representation	Independent / verification of suspected/selected items where misappropriation in suspected
5.	Off balance sheet items (like contracts etc.)	Used to vouch the arithmetic accuracy & compliance with procedures.	Regulatory & propriety of these transactions/contracts are examined.
6.	Adverse findings if any	Negative opinion or qualified opinion expressed with/ without quantification	Legal determination of fraud impact and identification of perpetrators depending on scope.

Question 21

The Board of Directors of XYZ Ltd. is concerned with decreasing operating efficiency in material consumption. As an Auditor entrusted with investigating the causes for this poor state, what may be the areas of your focus in this respect. (PYP 4 Marks, Nov '18)

Answer 21

Decreasing Operating Efficiency in Material Consumption: It is the input-output ratio. In the case of public spending, efficiency is achieved when the output is maximized at the minimum of inputs, or input is minimized for any given quantity and quality of output.

- The auditor should make an analytical procedure to compare the material consumption with output for the current year as well as previous years.
- The internal control system should be studied.
- The auditor should have discussions/ inquiry with different personnel of the company including production personnel.
- The production process, scheduling, machine usage, material mix should be studied.
- A reconciliation of variation as to various causes – Price, quantity efficiency are to be analyzed.
- The budget, standard coasting and other MIS reports should be called for and studied.
- Internal audit report should be thoroughly studied and whether any pilferage, fraud etc. were noticed. These are to be looked into.
- The key material should be picked up for detailed study of their ordering, receipts, issue, normal loss yield percentage etc.

Question 22

You have been appointed as a forensic accountant in M/s Secure Ltd. to carryout various analysis as a part of your assignment to arrive at a particular result. Specify the various analysis which might have to be carried out by you to arrive at your result. (PYP 5 Marks, May '19)

Answer 22

Perform the Analysis: The actual analysis performed will be dependent upon the nature of the assignment and may involve:

(i) calculating economic damages;

(ii) summarizing a large number of transactions;

(iii) performing a tracing of assets;

(iv) performing present value calculations utilizing appropriate discount rates;

(v) performing a regression or sensitivity analysis;

(vi) utilizing a computerized application such as a spread sheet, data base or computer model; and

(vii) utilizing charts and graphics to explain the analysis.

Question 23

MF. Ltd., engaged in the manufacturing of various products in its factory, is concerned with shortage in production and there arose suspicion of inventory fraud. You are appointed by MF Ltd. To evaluate the options for verifying the process to reveal fraud and the corrective action to be taken. As an investigating accountant what will be your areas of verification and the procedure to be followed for verification of defalcation of inventory? (PYP 4 Marks, Nov '19)

Answer 23

Inventory frauds - Inventory frauds are many and varied but here we are concerned with misappropriation of goods and their concealment.

(i) Employees may simply remove goods from the premises.

(ii) Theft of goods may be concealed by writing them off as damaged goods, etc.

(iii) Inventory records may be manipulated by employees who have committed theft so that book quantities tally with the actual quantities of inventories in hand.

Verification Procedure for Defalcation of inventory - Such thefts usually are possible through collusion among a number of persons. Therefore, for their detection, the entire system of receipts, storage and despatch of all goods, etc. should be reviewed to localize the weakness in the system.

The determination of factors which have been responsible for the theft and the establishment of guilt would be difficult in the absence of:

(a) a system of inventory control, and existence of detailed record of the movement of inventory, or

(b) availability of sufficient data from which such a record can be constructed.

The step in such an investigation is to establish the different items of inventory defalcated and their quantities by checking physically the quantities in inventory he ld and those shown by the Inventory Book.

Defalcations of inventory, sometimes, also are committed by the management, by diverting a part of production and the consequent shortages in production being adjusted by inflating the wastage in production; similar defalcations of inventories and stores are covered up by inflating quantities issued for production. For detecting such shortages, the investigating accountant should take assistance of an engineer. For that he will be more conversant with factors which are responsible for shortage in production and thus will be able to correctly determine the extent to which the shortage in production has been inflated.

In this regard, guidance can also be taken from past records showing the extent of wastage in production in the past. Similarly, he would be able to better judge whether the material issued for production was excessive and, if so to what extent.

The per hour capacity of the machine and the time that it took to complete one cycle of production, also would show whether the issues have been larger than those required.

Question 24

Milk Ltd. is engaged in the business of manufacturing and distribution of various milk products like cheese, curd, paneer, etc. Government made certain changes in rules and regulations relating to this sector, consequently management decided to go for expansion. Management was looking for some financial investor, who can fund some part of the proposed expansion. Mr. X is interested in the venture and appoints you to act as an advisor to the proposed investment in the business of Milk Ltd. You have to investigate the audited financial statements and ensure that the valuation of shares of the company on the basis of audited financial statements is appropriate. What process will be used for checking and whether you can put reliance on already audited statement of accounts? (PYP 5 Marks July 21)

Answer 24

Process used for checking and reliance on already audited statement of accounts -

Following process may be carried out-

1. If the statements of account produced before the investigator were not audited by a qualified accountant, then of course there arises a natural duty to get the figures in the accounts properly checked and verified.
2. However, when the accounts produced to the investigator have been specially prepared by a professional accountant, who knows or ought to have known that these were prepared for purposes of the investigation, he could accept them as correct relying on the principle of liability to third parties.

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3. Nevertheless, it would be prudent to see first that such accounts were prepared with objectivity and that no bias has crept in to give advantage to the person on whose behalf these were prepared.

Whether the investigator can put reliance on the already audited statement of account - If the investigation has been launched because of some doubt in the audited statement of account, no question of reliance on the audited statement of account arises. However, if the investigator has been requested to establish value of a business or a share or the amount of goodwill payable by an incoming partner, ordinarily the investigator would be entitled to put reliance on audited materials made available to him unless, in the course of his test verification, he finds the audit to have been carried on very casually or unless his terms of appointment clearly require t o test everything afresh.

Question 25

M/s GSB Limited is into the business of construction for the past 25 years. Management of the Company came to know that building material sent to construction sites are of substandard quality whereas the payment released by the accounts department of the Company are on the higher side. Forensic ~~Auditor~~ Accountant was asked to carry out detailed investigation. Forensic ~~Auditor~~ Accountant completed his investigation and now preparing his report. What are the broad areas of information that needs to be incorporated in the report of Forensic ~~Auditor~~ Accountant? (PYP 4 Marks July 21)

Answer 25

Broad areas of information to be incorporated in the report of Forensic Auditor Accountant -

Issuing an audit report is the final step of a fraud audit. Auditors will include information detailing the fraudulent activity, if any has been found. The client will expect a report containing the findings of the investigation, including a summary of evidence, a conclusion as to the amount of loss suffered as a result of the fraud and to identify those involved in fraud. The report may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitations of scope and findings and/or opinions.

The report will include schedules and graphics necessary to properly support and explain the findings. The report will also discuss how the fraudster set up the fraud scheme, and which controls, if any, were circumvented. It is also likely that the investigative team will recommend improvements to controls within the organization to prevent any similar frauds occurring in the future. The Forensic ~~Auditor~~ **Accountant** should have active listening skills which will enable him to summarize the facts in the report. It should be kept in mind that the report should be based on the facts assimilated during the process and not on the opinion of the person writing the report.

Question 26

TQR Limited is engaged in the business of garment manufacturing having registered office at Mumbai and branches across India. Mr. Shyam, one of the senior Managers was involved in creating false documents and legitimate documents were altered to support fictitious transactions. Consequently, the management appointed you to get Forensic ~~Audit~~ Accounting done based on the digital foot-print of transactions handled by Mr. Shyam. The use of sound techniques will enable to discover the defalcations on a timely basis. As a Forensic ~~Auditor~~ Accountant how will you deal and suggest Technology based/Digital forensic techniques. (PYP 5 Marks May '22)

Answer 26

Technology based /Digital Forensics Techniques: Every transaction leaves a digital footprint in today's computer-driven society. Close scrutiny of relevant emails, accounting records, phone logs and target company hard drives is a requisite facet of any modern Forensic ~~Audit~~ Accounting.

Before taking steps such as obtaining data from email etc. the Forensic ~~Auditor~~ Accountant should take appropriate legal advice so that it doesn't amount to invasion of privacy.

Digital investigations can become quite complex and require support from trained digital investigators. Many open-source digital forensics tools are now available to assist you in this phase of the investigation.

(i) Cross Drive Analysis (ii) Live Analysis (iii) Deleted Files

(iv) Stochastic Forensics (v) Steganography (vi) EnCase

(vii) MD5 (viii) Tracking Log Files (ix) PC System Log

(x) Free Log Tools

Question 27

You have been requested to carry out a forensic audit of a listed entity by the Board of Directors, based on a whistle blower complaint received. Before the commencement of the forensic audit, you and your team, are discussing the various aspects relating to the scope and the procedures to be carried out.

What would be the items of discussion with respect to the differences between forensic audit and other audit? (PYP 4 Marks Nov 22)

OR

Shipra recently qualified as a Chartered Accountant and started her own practice. One of her friends told her that Forensic ~~Audit~~ Accounting is a new area and has a lot of potential in terms of professional opportunities and remuneration. Seema said that there is nothing new in this as ultimately Forensic ~~Audit~~ Accounting is also like other audits. Do you agree with the views of Seema? Support your answer with relevant explanation. (RTP May 22)

OR

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ABC Ltd. is a listed company having turnover of ` 50 crores & plans expansion by installation of new machines at new building-having total additional project cost of ` 20 crore.

Rupees (In crore)	Purpose
10.0	- for Building
8.5	- for Machinery
1.5	- for Working Capital
20 Crore	Total

Project gets implemented in 2019-20 and one of the accountants report to the Managing Director that some suspicious transactions are noticed in the purchase of building material. But the Management is confused as to whether they should get an audit or Forensic ~~Audit~~ Accounting done for the same. Advise Management about the difference in forensic accounting and audit. (Old & New SM)

Answer 27

Difference between forensic audit and other audit is as under:

Sr. No.	Particulars	Other Audits	Forensic Audit
1.	Objectives	Express an opinion as to 'True & Fair' presentation	Whether fraud has taken place in books
2.	Techniques	Substantive & Compliance. Sample based	Investigative, substantive or in depth checking
3.	Period	Normally for a particulars accounting period.	No such limitations
4.	Verification of stock, Estimation realizable value of assets, provisions, liability etc.	Relies on the management certificate/Management Representation	Independent/verification of suspected/selected items where misappropriation in suspected
5.	Off balance sheet items (like contracts etc.)	Used to vouch the arithmetic accuracy & compliance with procedures.	Regulatory & propriety of these transactions/contracts are examined.
6.	Adverse findings if any	Negative opinion or qualified opinion expressed with/ without quantification	Legal determination of fraud impact and identification of perpetrators depending on scope.

Question 28

AB Ltd wants to acquire a unit of CT Ltd. AB Ltd is uncertain about the future viability of the unit under consideration. You are appointed to investigate economic and financial position of the unit. What are the factors that you shall consider while studying the economic and financial position of the business? (PYP 4 Marks May '23, MTP 4 Marks Sep'23)

Answer 28

For studying the economic and financial position of the business, the following should be considered:

i) The adequacy or otherwise of fixed and working capital. Are these sufficient for the growth of the business?

ii) What will be the trend of the sales and profits in the future? Establishing the trend of sales, productwise and area-wise will ordinarily help in drawing a conclusion on whether the trend will be maintained in the future.

iii) Whether the profit which the business could be expected to maintain in the future would yield an adequate return on the capital employed?

iv) Whether the business is operating at its 100 percent capacity or improvements can be made to reach at full productivity?

Question 29

Enumerate the steps to be undertaken in case of Forensic ~~Audit~~ Accounting process. (Old & New SM)

OR

PQR Ltd. Is a listed company having turnover of Rs. 50 crores & plans expansion by installation of new machines at new building-having total additional project cost of Rs. 20 crore.

Rupees (In crore)	Purpose
10.0	- for Building
8.5	- for Machinery
1.5	- for Working Capital
20 Crore	

Project gets implemented in 2017-18 and one of the accountants points out to Managing Director that something wrong has happened in the purchase of building material.

On hearing this, the management is planning to appoint Forensic Auditor. Advise the Forensic Auditor about the steps to be undertaken in case of forensic audit process. (MTP 5 Marks, Aug 18)

OR

ACT Silk Industries is a leading textile manufacturing listed company. In the course of evidence collection and analysis, it was observed that the company is involved in siphoning of funds through payments to shell companies. Hence, SEBI appointed B & S Associates, Chartered Accountants, as forensic auditors of the company. Enumerate in brief the steps to be taken by B & S Associates in forensic audit process. (PYP 5 Marks Dec '21)

Answer 29

The steps to be taken are as follows:

- **Step 1. Initialization-**

It is vital to clarify and remove all doubts as to the real motive, purpose and utility of the assignment. It is helpful to meet the client to obtain an understanding of the important facts, players and issues at hand.

A conflict check should be carried out as soon as the relevant parties are established. It is often useful to carry out a preliminary investigation prior to the development of a detailed plan of action. This will allow subsequent planning to be based upon a more complete understanding of the issues.

- **Step 2. Develop Plan**

This plan will take into account the knowledge gained by meeting with the client and carrying out the initial investigation and will set out the objectives to be achieved and the methodology to be utilized to accomplish them.

- **Step 3. Obtain Relevant Evidence**

Depending on the nature of the case, this may involve locating documents, economic information, assets, a person or company, another expert or proof of the occurrence of an event. In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed. The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered. It is important that the investigating team is skilled in collecting evidence that can be used in a court case within the stipulated time period, and in keeping a clear chain of custody until the evidence is presented in court. If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s).

- **Step 4. Perform the analysis**

The actual analysis performed will be dependent upon the nature of the assignment and may involve

- calculating economic damages;
- summarizing a large number of transactions;
- performing a tracing of assets;
- performing present value calculations utilizing appropriate discount rates;

• performing a regression or sensitivity analysis;

• utilizing a computerized application such as a spread sheet, data base or computer model; and

• utilizing charts and graphics to explain the analysis.

• Step 5. Reporting

Issuing an audit report is the final step of a fraud audit. Auditors will include information detailing the fraudulent activity, if any has been found. The client will expect a report containing the findings of the investigation, including a summary of evidence, a conclusion as to the amount of loss suffered as a result of the fraud and to identify those involved in fraud. The report may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitations of scope an d findings and/or opinions. The report will include schedules and graphics necessary to properly support and explain the findings.

The report will also discuss how the fraudster set up the fraud scheme, and which controls, if any, were circumvented. It is also likely that the investigative team will recommend improvements to controls within the organization to prevent any similar frauds occurring in the future.

The Forensic ~~Auditor~~ **Accountant** should have active listening skills which will enable him to summarize the facts in the report. It should be kept in mind that the report should be based on the facts assimilated during the process and not on the opinion of the person writing the report.

• Step 6. Court proceedings

The investigation is likely to lead to legal proceedings against the suspect, and members of the investigative team will probably be involved in any resultant court case. The evidence gathered during the investigation will need to be presented at court, and team members may be called to court to describe the evidence they have gathered and to explain how the suspect was identified.

Question 30

BR Construction was into the business of building roads and other infrastructure facilities for government contracts. Mr. Tiwari, one of the senior official, was looking after the procurement of cement required at the construction sites. There was a substantial increase in the price of cement bags bought as compared to those bought prior to the appointment of Mr. Tiwari. The management of the company decides to get a Forensic ~~Audit~~ Accounting done for the transactions handled by Mr. Tiwari. What points should be kept in mind by the management while appointing a Forensic ~~Auditor~~ Accountant? (Old SM, MTP 4 Marks Apr'22)

Answer 30

While appointing a Forensic ~~Auditor~~ **Accountant**, the Management of BR Construction must initially consider whether the firm has the necessary skills and experience to accept the work.

A Forensic Auditor should necessarily possess the following characteristics and skills:

Characteristics- Forensic ~~Auditor~~ Accountant

• Out of the Box Thinking

• Strong Visualization and Imagination

• Curiosity

• Persistence

• Detail-oriented

• Inquisitiveness

• Creativity

• Discretion

• Skepticism

• Confidence

• Sound professional judgement

• Objectivity and credibility

Skills - Forensic ~~Auditor~~ Accountant should possess

• Auditing standards, procedures and related methodologies

• Accounting & Business reporting systems

• Information Technology

• Data Analytics

• Criminology

• Legal Framework

• Litigation processes & procedures

• InvestigativeTechniques

• Evidence gathering

• Network of professional contacts in related fields' viz. enforcement, regulatory bodies, law, industry, peers etc

Multiple Choice Questions (MCQs)

Question 1

ZARI & Associates is a partnership firm and has been in existence for the last 15 years. The firm is engaged in consultancy business related to various areas and has built a good name for itself over the period.

Some of the clients of the firm are very old who have been continuing since its existence. The business of the firm has gone through various phases some of them were very bad. But currently the business is going very well and the firm is looking to expand its operations into different geographies. For this, the firm's management decided that some of its senior partners will move to new offices and new partners would be inducted.

A team of new partners is in discussion with the senior old partners regarding their joining the firm.

The new partners would be interested to know whether the terms offered to them are reasonable having regard to the nature of the business, profit records, capital distribution, personal capacity of the existing partners, socio-economic setting etc. and whether they would be able to derive continuing benefits in the shape of return of capital to be contributed and remuneration of services to be offered. In addition, they also want to ascertain whether the capital to be contributed by them would be safe and applied usefully or not.

For this purpose, an investigation of the business of the firm was set up on behalf of these new partners. At the time of scrutiny of the record of profitability of the firm's business, the investigating accountant picked up records of last 4-5 years wherein he observed 2 years which were unusual because the profits during those 2 years were highly erratic and fluctuating. The investigating accountant, therefore, went into the profits of last 7-8 years to iron out the fluctuation. He also examined the provisions of the partnership deed particularly the composition of partners, their capital contribution, drawing rights, retirement benefits and goodwill. He also asked for details of jobs/ contracts in hand and the range of current clientele of the firm for his examination. Some of these procedures of the investigating accountant were not found appropriate by the senior partners of the firm and they advised the investigating accountant not to go beyond his scope. In the given situation, which of the following is correct:

(a) The investigating accountant should not have asked for the records of the profits of last 7 -8 years as that would be too much of the information for his review. Also the details of jobs/ contracts in hand and the range of current clientele of the firm are confidential and hence does not get covered in his scope.

(b) After finding 2 years which were unusual because the profits during those 2 years were highly erratic and fluctuating, the investigating accountant should have reported the matter to the new partners instead of asking for more details related to the profits of last 7-8 years. Also he is not required to examine the provisions of the partnership deed as these details would have already been discussed with the new partners and they would have checked that.

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(c) The procedures of the investigating accountant looks completely reasonable considering his scope of work. Further, no changes are required in his work approach.

(d) At the outset, it can be said that investigation in the given case was not required. However, even if the new partners decided to carry out the investigation it should have been limited to mainly inquiry procedures by the investigating accountant. The investigating accountant could have also reviewed the manner of computation of goodwill which doesn't seem to have been performed on the basis of the above mentioned facts. (MTP 2 Marks, Oct 19)

Answer 1 : (c)

Question 2

In accordance with provisions of Companies Act, 2013 with respect to investigation into the affairs of a company, who can be appointed as an inspector?

I. Raj & Associates, a firm

II. CA Rahul

III. Mihim Pvt. Ltd, a body corporate

IV. ABC & Partners LLP, a body corporate

(a) I, III & IV

(b) I only

(c) III & IV

(d) II only (MTP 1 Marks, Oct 20)

Answer 2 (d).

Question 3

The notes to the account statement of Nemi Ltd. shows the break-up of accounts payable for the Financial Year 2020-21 as follows:

Accounts Payable	Amount (in `)
Mr. K	1,20,000
Mr. R	40,000
Mr. B	14,56,000
Total	16,16,000

CA. Raju, the auditor of Nemi Ltd., wants to investigate the valuation of accounts payable of Mr. B amounting to ` 14,56,000. Which of the following procedures is best fitted & more reliable to be followed by CA. Raju to get more reliable evidence for the existence of such balance as on 31st March, 2021?

(a) Inspect each and every journal entry passed in the books of Nemi Ltd.

(b) Ask Nemi Ltd. to provide the details of payment made during the year 2021-22.

(c) Inspect the invoices issued by Mr. B and the payments made.

(d) Interrogate the cash manager of Nemi Ltd. (MTP 1 Mark Oct 21)

Answer 3 (c)

Question 4

Bhagwan & Co. has received an order in writing from the Central Government, in respect of one of its clients, to carry out an investigation under section 210 of the Companies Act 2013. During the course of carrying out investigation as above, Bhagwan & Co. requires certain evidence from a place outside India in order to establish the correctness of an investment in the shares of a company outside India. What should be the procedure of Bhagwan & Co. to seek evidence from outside India for the investigation?

(a) Seeking evidence from outside India for investment in shares outside India is outside the scope of investigation.

(b) An application is to be made to the competent court in India by the inspector and such court may issue a letter of request to a court or an authority in such country for seeking evidence.

(c) The evidence can be sought by electronic mail by writing to the concerned authorities of the entity outside India.

(d) Powers of seeking evidence outside India is available only to an investigator under section 212 - Serious Fraud Investigation. (MTP 1 Mark April 22)

Answer 4 : (b)

Question 5

ABC & Co were appointed to conduct a Forensic ~~Audit~~ Accounting of XYZ Limited. After successfully conducting the Forensic ~~Audit~~ Accounting, ABC & Co prepared its report for the appointing authority. A copy of the report was also shared with the Board of Directors of the company. In the report, Forensic Auditors enumerated the findings of the investigation, including a summary of the evidence, a conclusion as to the amount of loss suffered as a result of the fraud and identification of those involved in fraud. The report also cover ed sections on the nature of the assignment, scope of the investigation, approach utilized, limitations of scope and opinions. Upon receiving the report, the Board of Directors raised objections as to how Forensic ~~Audit~~ Accountant can mention the names of those who are involved in fraud. You as a Forensic Expert guide whether is it appropriate to mention the details of the person who are involved in fraud in the final report.

a) Report can include a section to identify those involved in fraud. This is recommendatory and in line with the appropriate practice of reporting.

b) Report should not contain such details till the time it is proved in a court of law.

c) Report can include a section to identify those involved in fraud but subject to prior approval of the Board of Directors of the company.

d) Report should not include a section to identify those involved in fraud as it is not permitted under SA 700. (MTP 1 Mark Sep '22)

Answer 5 : (a)

Question 6

JIN Ltd. which is based in Mumbai, is in the business of manufacturing leather products since 1995 and wants to acquire OM Leathers Private Limited, which is based in Pune and engaged in the business of selling leather products manufactured by different companies. Before acquisition JIN Ltd. wants to get a due diligence review to be done of OM Leathers. JIN Ltd. appointed S & S Associates for conducting overall due diligence of OM Leathers. During review, the accountant asked OM Leathers to provide financial projections of the company for next five years, but OM leathers refused to provide the same and claimed that financial projections are not part of due diligence review.

Whether the objection raised by the management of OM Leathers is correct? Give reason.

(a) The objection raised by OM Leathers is correct, as due diligence doesn't include review of financial projections.

(b) The objection raised by OM Leathers is not correct, as due diligence refers to an examination of a potential investment to confirm all material facts of the prospective business which a company wants to acquire and financial projection is a part of same.

(c) The objection raised by OM Leathers is correct, as reviewer cannot comment on financial projections in his report.

(d) The objection raised by OM Leathers is not correct, as the target company cannot refuse in providing any information required by the reviewer. (MTP 1 Mark Oct 22)

Answer 6 : (b)

Question 7

Which among the following are the skills to be possessed by M/s ABC & Associates as forensic accountants?

(a) Criminology and evidence gathering.

(b) Confidence and curiosity.

(c) Discretion and creativity.

(d) Inquisitiveness and persistence. (MTP 1 Mark April '23)

Answer 7 (a)

Question 8

Suvrat & Co. Chartered Accountants, mainly into statutory audit and tax audit, is now exploring the areas of due diligence and investigation assignments. During the course of due diligence, an articled assistant enquires to the principal whether it is required to verify the letter of comfort given by the target company to a bank. You are required to guide the articled assistant regarding whether letter of comfort given to banks by the target company needs to be reviewed as part of the financial due diligence. Choose the correct reasoning from below?

(a) Yes, the objective of due diligence exercise will be to look specifically for any hidden liabilities or over-valued assets and since, letter of comfort given to banks is a hidden liability, it should be reviewed.

(b) Yes, letter of comfort given to banks is a guarantee and will be disclosed in the notes to accounts of the financial statements and calls for verification and review.

(c) No, due diligence involves the review of only disclosed assets and liabilities of the target company and hence, letter of comfort does not call for review.

(d) No, letter of comfort does not involve financial implications and hence it need not be reviewed as part of financial due diligence. (MTP 1 Mark Sep '23)

Answer 8 (a)

Question 9

Which among the following are the skills to be possessed by M/s ABC & Associates as forensic ~~auditor~~ accountant?

(a) Criminology and evidence gathering.

(b) Confidence and curiosity.

(c) Discretion and creativity.

(d) Inquisitiveness and persistence. (RTP May 22)

Answer 9 : (a)

Question 1

Sri Rajan is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. Ceta Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business.

What procedures you would adopt before you could render any advice to Ceta Ltd.?

Answer 1

If a full-fledged financial due diligence is conducted, it would include the following matters, inter alia, in its scope

(a) Brief history of the target company and background of its promoters - The accountant should begin the financial due diligence review by looking into the history of the company and the background of the promoters.

The details of how the company was set up and who were the original promoters has to be gone into, before verification of financial data in detail. An eye into the history of the target company may reveal its turning points, survival strategies adopted by the target company from time to time, the market share enjoyed by the target company and changes therein, product life cycle and adequacy of resources. It could also help the accountant in determining whether, in the past, any regulatory requirements have had an impact on the business of the target company. Broadly, the accountant should make relevant enquiries about the history of target's business products, markets, suppliers, expenses, operations. This could, inter alia, include the following:

- Nature of business(es)
- Location of production facilities, warehouses, offices.
- Employment
- Products or services and markets
- History of the business with important suppliers of goods and services
- Inventories
- Franchises, licenses, patents.
- Important expense categories.
- Research and development.
- Foreign currency assets, liabilities and transactions.
- Legislation and regulation that significantly affect the entity.
- Information systems.

(b) Accounting policies - The accountant should study the accounting policies being followed by the target company and ascertain whether any accounting policy is inappropriate.

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The accountant should also see the effects of the recent changes in the accounting policies. The target company might have changed its accounting policies in the recent past keeping in view its intention of offering itself for sale.

The overall scope has to be based on the accounting policies adopted by the management. The accountant has to look at any material effect of accounting policies on the overall profitability and their correctness. It is reiterated that the accountant should have a detailed look at all material changes in Accounting Policies in the period subjected to review very carefully.

The accountant's report should include a summary of significant accounting policies used by the target company, that changes that have been made to the accounting policies in the recent past, the areas in which accounting policies followed by the target company are different from those adopted by the acquiring enterprise, the effect of such differences.

(c) Review of Financial Statements - Before commencing the review of each of the aspect covered by the financial statements, the accountant should examine whether the financial statements of the target company have been prepared in accordance with the Statute governing the target company, Framework for Preparation and Presentation of the Financial Statements and the relevant Accounting Standards. If not, the accountant should record the deviations from the above and consider whether it warrant an inclusion in the final report on due diligence.

After having an overall view of the financial statements, as mentioned in the above paragraphs, the accountant should review the operating results of the target company in great detail. It is important to make an evaluation of the profit reported by the target company. The reason being that the price of the target company would be largely based upon its operating results.

The accountant should consider the presence of an extraordinary item of income or expense that might have affected the operating results of the target company.

It is advisable to compare the actual figures with the budgeted figures for the period under review and those of the previous accounting period. This comparison could lead the accountant to the reasons behind the variations. It is important that the trading results for the past four to five years are compared and the trend of normal operating profit arrived at.

The normal operating profits should further be benchmarked against other similar companies. Besides the above, and based on the trend of operating results, the accountant has to advise the acquiring enterprise, through due diligence report, on the indicative valuation of the business.

In the case of many enterprises, the valuation is mainly based on the value of net worth only. For valuation of immovable properties and plant, if required, the assistance of expert valuers could also to be taken.

The exercise to evaluate the balance sheet of the target company has to take into consideration the basis upon which assets have been valued and liabilities have been recognised. The net worth of the business has to be arrived at by taking into account the impact of over/under valuation of assets and liabilities.

The accountant should pay particular attention to the valuation of intangible assets.

(d) Taxation - Tax due diligence is a separate due diligence exercise but since it is an integral component of the financial status of a company, it is generally included in the financial due diligence. It is important to check if the company is regular in paying various taxes to the Government. The accountant has to also look at the tax effects of the merger or acquisition.

(e) Cash Flow - A review of historical cash flows and their pattern would reflect the cash generating abilities of the target company and should highlight the major trends. It is important to know if the company is able to meet its cash requirements through internal accruals or does it have to seek external help from time to time.

(f) Financial Projections - The accountant should obtain from the target company the projections for the next five years with detailed assumptions and workings. He should ask the target company to give projections on optimistic, pessimistic and most likely bases.

(g) Management and Employees - In most of the companies which are available for take over the problem of excess work force is often witnessed. It is important to work out how much of the labour force has to be retained. It is also important to judge the job profile of the administrative and managerial staff to gauge which of these matches the requirements of the new incumbents. Due to complex set of labour laws applicable to them, companies often have to face protracted litigation from its workforce, and it is important to gauge the likely impact of such litigation.

The assumptions regarding increase in salaries, interest rate, retirement etc. have to be gone into to see if they are reasonable. It is also necessary to see if the basic salary /wage considered for the valuation is correct and includes all elements subject to payment of Gratuity. In the case of PF, ESI etc. the accountant has to see if all eligible employees have been covered.

It is very important to consider the pay packages of the key employees as this can be a crucial factor in future costs. One has to carefully look at Employees Stock Option Plans; deferred compensation plans; Economic Value Addition and other performance linked pay; sales incentives that have been promised etc. It is also important to identify the key employees who will not continue after the acquisition either because they are not willing to continue or because they are to be transferred to another company within the 'group' of the target company.

(h) Statutory Compliance - During a due diligence this is one aspect that has to be investigated in detail. It is important therefore, to make a list of laws/ statues that are applicable to the entity as well as to make a checklist of compliance required from the company under those laws. If the company has not been regular in its legal compliance it could lead to punitive charges under the law. These may have to be quantified and factored into the financial results of the company.

Question 2

An American Company engaged in the business of manufacturing and distribution of industrial gases, is interested in acquiring a listed Indian Company having a market share of more than 65% of the industrial gas business in India. It requests you to conduct a "Due Diligence" of this Indian Company and submit your Report. List out the contents of your Due Diligence Review Report that you will submit to your USA based Client.

Answer 2

The contents of a due diligence report will always vary with individual circumstances. Following headings are illustrative:

Example of Headings of a Due Diligence Report

- Executive Summary
- Introduction
- Background of Target company
- Objective of due diligence
- Terms of reference and scope of verification
- Brief history of the company
- Share holding pattern
- Observations on the review
- Assessment of management structure
- Assessment of financial liabilities
- Assessment of valuation of assets
- Comments on properties, terms of leases, lien and encumbrances.
- Assessment of operating results
- Assessment of taxation and statutory liabilities
- Assessment of possible liabilities on account of litigation and legal proceedings against the company
- Assessment of net worth
- Interlocking investments and financial obligations with group / associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account
- SWOT Analysis
- Comments on future projections
- Status of charges, liens, mortgages, assets and properties of the company
- Suggestion on ways and means including affidavits, indemnities, to be executed to cover unforeseen and undetected contingent liabilities
- Suggestions on various aspects to be taken care of before and after the proposed merger/acquisition.

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Question 3

KDK Bank Ltd., received an application from a pharmaceutical company for takeover of their outstanding term loans secured on its assets, availed from and outstanding with a nationalized bank. KDK Bank Ltd., requires you to make a due diligence audit in the areas of assets of pharmaceutical company especially with reference to valuation aspect of assets. State what may be your areas of analysis in order to ensure that the assets are not stated at overvalued amounts.

Answer 3

Over-Valued Assets:

- Uncollected/uncollectable receivables.
- Obsolete, slow non-moving inventories or inventories valued above NRV; huge inventories of packing materials etc. with name of company.
- Underused or obsolete Plant and Machinery and their spares; asset values which have been impaired due to sudden fall in market value etc.
- Assets carried at much more than current market value due to capitalization of expenditure/foreign exchange fluctuation, or capitalization of expenditure mainly in the nature of revenue.
- Litigated assets and property.
- Investments carried at cost though realizable value is much lower.
- Investments carrying a very low rate of income / return.
- Infructuous project expenditure/deferred revenue expenditure etc.
- Group Company balances under reconciliation etc
- Intangible assets of no value.

Question 4

"Due diligence is different from audit" – Explain the difference between due diligence and audit.

Answer 4

It needs be underlined that due diligence is different from audit. Audit is an independent examination and evaluation of the financial statements on an organization with a view to express an opi nion thereon. Whereas due diligence refers to an examination of a potential investment to confirms all material facts of the prospective business opportunity. It involves review of financial and non- financial records as deemed relevant and material. Simply put, due diligence aims to take the care that a reasonable person should take before entering into an agreement or a transaction with another party.

Question 5

PB Ltd. entered into a deal with SV Ltd. for buying its business of manufacturing wooden products/ goods.

PB Ltd. has appointed your firm for conducting due diligence review and they want to know the cash generating abilities of SV Ltd. What points will you check in order to ensure that the manufacturing unit of SV Ltd. will be able to meet the cash requirements internally?

Answer 5

In order to ensure that the manufacturing unit of SV Ltd. will be able to meet the cash requirements internally, one is required to verify:

a) Is the company able to honor its commitments to its trade payables, to the banks, to the government and other stakeholders?

b) How well is the company able to convert its trade receivables and inventories?

c) How well the Company deploys its funds?

d) Are there any funds lying idle or is the company able to reap maximum benefits out of the available funds?

e) What is the investment pattern of the company and are they easily realizable?

Question 6

CA. Sanjana is acting as Credit manager in branch of DFC Bank Limited. A company has approached the branch for a request to sanction credit facilities worth ₹10 crore for meeting usual business requirements.

It is a prospective new client. She checks past history of the company, back ground of promoters & directors, shareholding pattern and nature of business. Assessment of financial results of past years and future projections is also undertaken. She also carries out SWOT analysis of the company.

Besides, assessment of net worth of directors is also undertaken. Status of CIBIL score and position of name of promoters/directors in RBI defaulter list is also verified.

She also makes discreet inquiries from few clients of the branch engaged in similar line of activity regarding credit worthiness of company, its promoters and directors.

Based on above

a) Identify activity being performed by CA Sanjana and discuss its nature.

b) Would your answer be different if this activity was to be performed by a person not qualified as a Chartered Accountant? Can a non-CA perform such activity? State reason.

c) Name any three other areas where identified activity can be undertaken.

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Answer 6

a) The activity described in the situation is Due diligence. Due diligence is a measure of prudence activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstance, not measured by any absolute standard but depending upon the relative facts of the case. It involves a careful study of financial and non-financial possibilities. It implies a general duty to take care in any transaction.

Due diligence is a process of investigation, performed by investors, into the details of a potential investment such as an examination of operations and management and the verification of material facts. It entails conducting inquiries for the purpose of timely, sufficient and accurate disclosure of all material statements/information or documents, which may influence the outcome of the transaction. Due diligence involves a careful study of the financial as well as non-financial possibilities for successful implementation of restructuring plans.

Due diligence involves an analysis carried out before acquiring a controlling interest in a company to determine that the conditions of the business conform with what has been presented about the target business. Also, due diligence can apply to recommendation for an investment or advancing a loan/credit.

b) There would be no difference in answer if above activity was to be performed by a person who is not a Chartered Accountant. The activity would remain due diligence. Due diligence can be performed by any person. It is not necessary that due diligence can only be carried out by a Chartered Accountant. As due diligence involves exercise of prudence and general duty to take care in any transaction, it can be undertaken by any person.

c) The areas where due diligence may be undertaken are: -

(i) Corporate restructuring

(ii) Venture capital financing

(iii) Public offerings

Question 7

A nationalized bank received an application from an export company seeking sanction of a term loan to expand the existing sea food processing plant. In this connection, the General Manager, who is in charge of Advances, approaches you to conduct a thorough investigation of this limited company and submit a confidential report based on which he will decide whether to sanction this loan or not.

List out the points you will cover in your investigation before submitting your report to the General Manager.

Answer 7

The investigating accountant, in the course of his enquiry, should attempt to collect information on the undermentioned points (Make into points)

(i) The purpose for which the loan is required and the manner in which the borrower proposes to invest the amount of the loan.

(ii) The schedule of repayment of loan submitted by the borrower, particularly the assumptions made therein as regards amounts of profits that will be earned in cash and the amount of cash that would be available for the repayment of loan to confirm that they are reasonable and valid in the circumstances of the case.

Institutional lenders now-a- days rely more, for repayment of loans, on the annual profits and loss, and on the values of assets mortgaged to them.

(iii) The financial standing and reputation for business integrity enjoyed by directors and officers of the company.

(iv) Whether the company is authorized by the Memorandum or the Articles of Association to borrow money for the purpose for which the loan will be used.

(v) The history of growth and development of the company and its performance during the past 5 years.

(vi) How the economic position of the company would be affected by economic, political and social changes that are likely to take place during the period of loan.

(vii) Whether any loan application to any other Bank or Financial Institution was made, and if so, the reasons for rejection thereof.

Question 8

What are the important steps involved while conducting Investigation on behalf of an Incoming Partner?

Answer 8

Broadly, the steps involved are the following:

a) Ascertainment of the history of the inception and growth of the firm.

b) Study of the provisions of the deed of partnership, particularly for composition of partners, their capital contribution, drawing rights, retirement benefits, job allocation, financial management, goodwill, etc.

c) Scrutiny of the record of profitability of the firm's business over a suitable number of years, with usual adjustments that are necessary in ascertaining the true record of business profits. Particular attention should, however, be paid to the nature of partners' remuneration, which may be excessive or inadequate in relation to the nature and profitability of the business, qualification and expertise of the partners and such other factors as may be relevant.

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d) Examination of the asset and liability position to determine the tangible asset backing for the partner's investment, appraisal of the value of intangibles like goodwill, know how, patents, etc. impending liabilities including contingent liabilities and those pending for tax assessment. In case of firms rendering services, the question of tangible asset backing usually is not important, provided the firm's profit record, business coverage and standing of the partners are of the acceptable order.

e) Position of orders at hand and the range and quality of clientele should be thoroughly examined, which the firm is presently operating.

f) Position and terms of loan finance would call for careful scrutiny to assess its usefulness and implication for the overall financial position; reason for its absence or negative impact should be studied.

g) It would be interesting to study the composition and quality of key personnel employed by the firm and any likelihood of their leaving the organisation in the near future.

h) Various important contractual and legal obligations should be ascertained and their nature studied. It may be the case that the firm has standing agreement with the employees as regards salary and wages, bonus, gratuity and other incidental benefits. Full impact of such standing agreements would be gauged before a final decision is reached.

i) Reasons for the offer of admission to a new partner should be ascertained and it should be determined whether the same synchronises with the retirement of any senior partner whose association may have had considerable bearing on the firm's success.

j) Appraisal of the record of capital employed and the rate of return. It is necessary to have a comparison with alternative business avenues for investments and evaluation of possible results on a changed capital and organisation structure, if any, envisaged along with the admission of the partner.

k) It would be useful to have a firsthand knowledge about the specialisation, if any, attained by the firm in any of its activities.

l) Manner of computation of goodwill on admission as also on retirement, if any, should be ascertained.

m) Whether any special clause exists in the deed of partnership to allow admission in future of a new partner, who may be specified, on concessional terms.

n) Whether the incomplete contracts which will be transferred to the reconstituted firm will be a liability or a loss.

Question 9

Mr. Clean who proposes to buy the proprietary business of Mr. Perfect, engages you as investigating accountant. Specify the areas which you will cover in your investigation.

Answer 9

We discuss below the factors to be considered by a professional accountant while carrying out the investigation for attaining satisfactory results:

(a) Studying the overall picture

(b) Statement of Profit and Loss

(c) Turnover

(d) Wage structure

(e) Depreciation and Maintenance

(f) Managerial Remuneration

(g) Exceptional and non-recurring items

(h) Repairs and maintenance

(i) Unusual year

(j) Balance Sheet - Fixed Assets

(k) Investments

(l) Inventories

(m) Trade Receivables

(n) Other liquid assets

(o) Idle assets

(p) Liabilities

(q) Taxation

(r) Capital

(s) Interpretation of figures - Fixed Assets

(t) Turnover

(u) Working Capital

(v) Estimating Future Maintainable Profits

Scope of investigation - The objective of such an investigation is to collect such information as would enable the purchaser to decide whether it is worthwhile to buy the business and if so, for what amount. The investigation should proceed broadly on the same lines as for valuation of shares.

Additional matters which must receive the attention of the investigating accountant on which, if appropriate, information to the client should be given.

In case of proprietary concerns or partnerships -

(i) Reasons for the sale of the business and the effect on turnover and profits that there would be on retirement of the present proprietor (or partners).

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(ii) The length of lease under which the premises are held, the prospects of its renewal or extension.

(iii) The unexpired period of any patents owned by the vendors.

(iv) The age of the present managerial staff and the prospects of continuing in service under the new proprietorship and the possible liability, not already provided for that would arise as regards payment of pensions or gratuities in case of old and aged employees/ retrenched employees.

(v) If the bulk of sales are made to customers whose number is small, the profitability of the business would be greatly shaken on withdrawing their support. This would be an element of weakness which should be investigated as it might affect future profitability.

(vi) The valuation that could be placed on goodwill to determine whether that appearing in the book is less or more; if none is included to determine the amount that should be included, if at all.

Question 10

In a Company, it is suspected that there has been embezzlement in cash receipts. As an investigator, what are the areas that you would verify?

Answer 10

(a) Cash receipts - In cases like holding back cash sales, collections by travelling salesmen, V.P.P receipts, or casual receipts, e.g., sales of scrap, recoveries out of debts written off earlier, etc., the amount or amounts of receipts embezzled may be subsequently covered up by the perpetrator adopting one or other of the under-mentioned devices:

(i) Issuing a receipt to the payee for the full amount collected and entering only a part of the amount on the counterfoil.

(ii) Showing a larger cash discount than actually allowed.

(iii) Adjusting a fictitious credit in the account of a customer for the value of goods returned by him.

(iv) Adjusting a cash sale as a credit sale, and raising a debit in the account of the customer.

(v) Writing off a good debt as bad and irrecoverable to cover up the amount collected which has been misappropriated.

(vi) Short-debiting the customer's account in the ledger with an intention to withdraw the difference when the full amount payable by him is collected.

(vii) Under-casting the receipts side of the Cash Book or over-casting the payment side.

(viii) Carrying over a shorter total of the receipts from one page of the Cash Book to the next or overcarrying the total of the payment from one page of the Cash Book to the next with a view to covering up misappropriation; either short banking of cash collection or a part of the amount of withdrawal from the bank.

Verification of Cash Receipts: On the assumption that some of these may have been diverted before being entered in the books, evidence as regards income received from different sources should be scrutinised, e.g., inventory, sales summaries, rental registers, correspondence with customers, advices of travelling salesmen and counterfoils or receipts. Carbon copies of receipts marked 'duplicate', should be scrutinised to confirm that they are in fact copies of receipts issued earlier. In addition, by recalling paying-in-slips from the bank the details of cash deposited on each day should be compared with those shown in the Cash Book. The record of sales of scrap of waste paper, that of collection of rents from labourers temporarily accommodated in the company's quarters, that of refunds of amounts deposited with the electric supply co., or any other Government authorities should be examined for finding out if any of these amounts have been misappropriated. Cash sales should be vouched in detail. Recoveries from customers and sundry parties should be checked with the copies of receipts issued to them; deductions made on account of cash discounts should be reviewed. All withdrawals from the bank should be checked by reference to corresponding entries in the bank pass book.

Question 11

J Ltd. is interested in acquiring S Ltd. The valuation of S Ltd. is dependent on future maintainable sales. As the person entrusted to value S Ltd., what factors would you consider in assessing the future maintainable turnover?

Answer 11

In assessing the turnover which the business would be able to maintain in the future, the following factors should be taken into account:

(i) Trend: Whether in the past, sales have been increasing consistently or they have been fluctuating. A proper study of this phenomenon should be made.

(ii) Marketability: Is it possible to extend the sales into new markets or that these have been fully exploited?

Product wise estimation should be made.

(iii) Political and economic considerations: Are the policies pursued by the Government likely to promote the extension of the market for goods to other countries? Whether the sales in the home market are likely to increase or decrease as a result of various emerging economic trends?

(iv) Competition: What is the likely effect on the business if other manufacturers enter the same field or if products which would sell in competition are placed on the market at cheaper price? Is the demand for competing products increasing? Is the company's share in the total trade constant or has it been fluctuating?

Question 12

MF. Ltd., engaged in the manufacturing of various products in its factory, is concerned with shortage in production and there arose suspicion of inventory fraud. You are appointed by MF Ltd. To evaluate the options for verifying the process to reveal fraud and the corrective action

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to be taken. As an investigating accountant what will be your areas of verification and the procedure to be followed for verification of defalcation of inventory?

Answer 12

(a) Inventory Frauds-Inventory frauds are many and varied but here we are concerned with misappropriation of goods and their concealment.

(i) Employees may simply remove goods from the premises.

(ii) Theft of goods may be concealed by writing them off as damaged goods, etc.

(iii) Inventory records may be manipulated by employees who have committed theft so that book quantities tally with the actual quantities of inventories in hand.

(iv) Inflating the quantities issued for production is another way of defalcating raw materials and store items.

(v) Stocks actually dispatched but not entered in sales/ debtor's account.

Verification Procedure for Defalcation of inventory - It may be of trading stock, raw materials, manufacturing stores, tools or of other similar items (readily) capable of conversion into cash. The loss may be the result of a theft by an employee once or repeatedly over a long period, when the same have not been detected. Such thefts usually are possible through collusion among a number of persons. Therefore, for their detection, the entire system of receipts, storage and dispatch of all goods, etc. should be reviewed to localise the weakness in the system.

The determination of factors which have been responsible for the theft and the establishment of guilt would be difficult in the absence of: (a) a system of inventory control, and existence of detailed record of the movement of inventory, or (b) availability of sufficient data from which such a record can be constructed. The first step in such an investigation is to establish the different items of inventory defalcated and their quantities by checking physically the quantities in inventory held and those shown by the Inventory Book. Investigating accountant should ascertain the exact duties of persons handling the stocks received in and issued from store for production/ sale or any other purpose. Identify the excessive control in the hands of a single person, without any supervision as it will widen the scope of investigation.

Afterwards, all the receipts and issues of inventory recorded in the Inventory Book should be verified by reference to entries in the Goods Inward and Outward Registers and the documentary evidence as regards purchases and sales. This would reveal the particulars of inventory not received but paid for as well as that issued but not charged to customers. Further, entries in respect of returns, both inward and outward, recorded in the financial books should be checked with corresponding entries in the Inventory Book. Also, the totals of the Inventory Book should be checked. Finally, the shortages observed on physical verification of inventory should be reconciled with the discrepancies observed on checking the books in the manner mentioned above.

In the case of an industrial concern, issue of raw materials, stores and tools to the factory and receipts of manufactured goods in the godown also should be verified with relative source documents.

Defalcations of inventory, sometimes, also are committed by the management, by diverting a part of production and the consequent shortages in production being adjusted by inflating the wastage in production; similar defalcations of inventories and stores are covered up by inflating quantities issued for production. For detecting such shortages, the investigating accountant should take assistance of an engineer. For that he will be more conversant with factors which are responsible for shortage in production and thus will be able to correctly determine the extent to which the shortage in production has been inflated. In this regard, guidance can also be taken from past records showing the extent of wastage in production in the past. Similarly, he would be able to better judge whether the material issued for production was excessive and, if so to what extent. The per hour capacity of the machine and the time that it took to complete one cycle of production, also would show whether the issues have been larger than those required.

Question 13

In a Public Limited Company, it is suspected by the Management that there has been embezzlement in supplier's ledger. As an auditor of the Company, you have been asked to investigate the matter. What are the major areas that you would verify in this regard?

Answer 13

(a) Frauds through suppliers' ledger -

(i) Adjusting fictitious or duplicate invoices as purchases in the accounts of suppliers and subsequently misappropriating the amounts when payments are made to the suppliers in respect of these invoices.

(ii) Suppressing the Credit Notes issued by suppliers and withdrawing the corresponding amounts not claimed by them.

(iii) Withdrawing amounts unclaimed by suppliers, for one reason or another by showing that the same have been paid to them.

(iv) Accepting purchase invoices at prices considerably higher than their market prices and collecting the excess amount, paid in cash, from the suppliers.

Verification of balances in suppliers' ledger - The Purchase Journal should be vouched by reference to entries in the Goods Inward Book and the suppliers' invoices to confirm that amounts credited to the accounts of suppliers were in respect of goods, which were duly received and the suppliers' accounts had been credited correctly. All the suppliers should be requested to furnish statements of their accounts to see whether or not any balance is outstanding or due so as to confirm that allowances and rebates given by them have been correctly adjusted and were duly authorized by the authorized person/ officer. Examine the system of internal control in relation to purchase orders issued and identify possibilities of collusion with suppliers.

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Question 14

General objective of an audit is to find out whether the financial statements show true and fair view. On the other hand, investigation implies systematic, critical and special examination of the records of a business for a specific purpose.

In view of the above, you are required to brief out the difference between Audit and Investigation.

Answer 14

Basis of Difference	Investigation	Audit
(i) Objective	An investigation aims at establishing a fact or a happening or at assessing a particular situation.	The main objective of an audit is to verify whether the financial statements display a true and fair view of the state of affairs and the working results of an entity.
(ii) Scope	The scope of investigation may be governed by statute or it may be non-statutory.	The scope of audit is wide and in case of statutory audit the scope of work is determined by the provisions of relevant law.
(iii) Periodicity	The work is not limited by rigid time frame. It may cover several years, as the outcome of the same is not certain.	The audit is carried on either quarterly, half-yearly or yearly.
(iv) Nature	Requires a detailed study and examination of facts and figures. Investigation is voluntary in nature.	Involves tests checking or sample technique to draw evidences for forming a judgement and expression of opinion. It is mandatory for companies.
(v) Inherent Limitations	No inherent limitation owing to its nature of engagement.	Audit suffers from inherent limitation.
(vi) Evidence	It seeks conclusive evidence.	Audit is mainly concerned with primafacie evidence.
(vii) Observance of Accounting Principles	It is analytical in nature and requires a thorough mind, capable of observing, collecting and evaluating facts.	Is governed by compliance with generally accepted accounting principles, audit procedures and disclosure requirements.
(viii) Appointing Agency	Even third party can appoint Investigator	Auditor is appointed by owner/ shareholders of company/ enterprise
(ix) Reporting	The outcome is reported to the person(s) on whose behalf investigation is carried out.	The outcome is reported to the owners of the business entity.

Question 15

Enumerate the steps to be undertaken in case of forensic accounting process.

Answer 15

Each Forensic Accounting assignment is unique. Accordingly, the actual approach adopted and the procedures performed will be specific to it. However, in general, many Forensic Accounting assignments will include the steps detailed below.

Step 1. Initialization

It is vital to clarify and remove all doubts as to the real motive, purpose and utility of the assignment. It is helpful to meet the client to obtain an understanding of the important facts, players and issues at hand. A conflict check should be carried out as soon as the relevant parties are established. It is often useful to carry out a preliminary investigation prior to the development of a detailed plan of action. This will allow subsequent planning to be based upon a more complete understanding of the issues.

Step 2. Develop Plan

This plan will take into account the knowledge gained by meeting with the client and carrying out the initial investigation and will set out the objectives to be achieved and the methodology to be utilized to accomplish them.

Step 3. Obtain Relevant Evidence

Depending on the nature of the case, this may involve locating documents, economic information, assets, a person or company, another expert or proof of the occurrence of an event. In order to gather detailed evidence, the investigator must understand the specific type of fraud that has been carried out, and how the fraud has been committed. The evidence should be sufficient to ultimately prove the identity of the fraudster(s), the mechanics of the fraud scheme, and the amount of financial loss suffered. It is important that the investigating team is skilled in collecting evidence that can be used in a court case within the stipulated time period, and in keeping a clear chain of custody until the evidence is presented in court. If any evidence is inconclusive or there are gaps in the chain of custody, then the evidence may be challenged in court, or even become inadmissible. Investigators must be alert to documents being falsified, damaged or destroyed by the suspect(s).

Step 4. Perform the analysis

The actual analysis performed will be dependent upon the nature of the assignment and may involve:

• calculating economic damages;

• summarizing a large number of transactions;

• performing a tracing of assets;

• performing present value calculations utilizing appropriate discount rates;

• performing a regression or sensitivity analysis;

• utilizing a computerized application such as a spread sheet, data base or computer model; and

• utilizing charts and graphics to explain the analysis.

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Step 5. Reporting

Issuing an report is the final step of a forensic accounting. Accountant / Investigators will include information detailing the fraudulent activity, if any has been found. The client will expect a report containing the findings of the investigation, including a summary of evidence, a conclusion as to the amount of loss suffered as a result of the fraud and to identify those involved in fraud. The report may include sections on the nature of the assignment, scope of the investigation, approach utilized, limitations of scope and findings and/or opinions.

The report will include schedules and graphics necessary to properly support and explain the findings. The report will also discuss how the fraudster set up the fraud scheme, and which controls, if any, were circumvented. It is also likely that the investigative team will recommend improvements to controls within the organization to prevent any similar frauds occurring in the future.

Step 6. Court proceedings

The investigation is likely to lead to legal proceedings against the suspect, and members of the investigative team will probably be involved in any resultant court case. The evidence gathered during the investigation will need to be presented at court, and team members may be called to court to describe the evidence they have gathered and to explain how the suspect was identified.

Question 16

Briefly discuss the key content of Forensic Accounting and Investigation Report.

Answer 16

Key Elements of the Report: The Professional shall consider the inclusion of the following key elements in the report (indicative list):

- Title, addressee and distribution list (if any)
- Scope and objectives of the assignment
- Approach and broad work procedures undertaken
- An Executive Summary of the results, covering all important aspects and the essence of the findings
- Reference to use of an expert, where applicable
- The fact that the assignment has been conducted in accordance with FAIS, or any material departures therefrom
- List of findings supported by key evidences, sources of evidences, and other relevant matter;
- Assumptions, limitations and disclaimers of the assignment
- Conclusions (if any) drawn from the assessment undertaken.

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Question 17

ABC Ltd. is a listed company having turnover of 50 crores & plans expansion by installation of new machines at new building-having total additional project cost of ₹ 20 crore

Rupees (In crore)	Purpose
10.0	- for Building
8.5	- for Machinery
1.5	- for Working Capital
20 Crore	Total

Project gets implemented in 2022-23 and one of the accountants report to the Managing Director that some suspicious transactions are noticed in the purchase of building material. But the Management is confused as to whether they should get an audit or Forensic Accounting done for the same. Advise Management about the difference in forensic accounting and audit.

Answer 17

Sr. No.	Particulars	Other Audits	Forensic Accounting
1.	Objectives	Express an opinion as to 'True & Fair' presentation	Whether fraud has actually taken place in books
2.	Techniques	Substantive & Compliance. Sample based	Investigative, substantive or indepth checking
3.	Period	Normally for a particulars accounting period.	No such limitations
4.	Verification of stock, Estimation realisable value of assets, provisions, liability etc.	Relies on the management certificate/Management Representation	Independent/verification of suspected/selected items where misappropriation in suspected
5.	Off balance sheet items (like contracts etc.)	Used to vouch the arithmetic accuracy & compliance with procedures.	Regulatory & propriety of these transactions/contracts are examined.
6.	Adverse findings if any	Negative opinion or qualified opinion expressed with/ without quantification	Legal determination of fraud impact and identification of perpetrators depending on scope.

Question 18

CA. Y is employed with a leading private sector BDFP Bank posted in NOIDA branch. One of the existing borrowers has approached branch with a proposal to sanction fresh term loan of ₹5 crore with commensurate increase in working capital credit facilities relating to expansion of its garment manufacturing unit. While performing due diligence, he notices that company was formed just two years ago and had availed term loan of ₹ 10 crore and cash credit facilities of ₹5 crore respectively. Its sales have increased from ₹ 25 crores in first year to ₹45 crores in year just ended. It is generating cash profits and is timely servicing its debts.

The borrower was earlier catering to domestic market. However, now it is in process of procuring export orders and working assiduously in this regard. The expansion plans are in line with development in area of marketing relating to exports.

However, there are a large number of units catering to domestic and export market of garments in NOIDA, Delhi and surrounding areas. There is also demand slump in biggest US market.

Besides, the unit is family-based and relies upon marketing skills of its main promoter. There is lack of wellpaid qualified staff with the borrower to deal effectively with its customers both domestic as well as foreign.

He starts jotting down and elaborating above points. Identify what he is trying to do as part of due diligence

Answer 18

As part of due diligence exercise, he is performing SWOT analysis of borrower. He is making analysis of strengths, weaknesses, opportunities and threats (SWOT) pertaining to borrower. Features such as rise in sales, generation of cash profits and timely service of debts represent borrower strengths. Lack of well-paid qualified staff to deal effectively with its domestic and foreign customers is an area of weakness. Entering into export market presents opportunity for borrower and presence of large number of competitors and demand slump in US market reflect threats.

Question 19

A company has installed an Effluent treatment plant (ETP) in compliance with pollution control regulations of the state government. The authority structure in the company is fairly decentralized and top management of the company has given considerable leeway to different departments for meeting their manpower requirements in accordance with emerging and changing needs from time to time. Of late, the top management has grown suspicious over manpower expenditure in section maintaining and beautifying area around ETP. There is a system in the company where time cards are punched by all employees to mark attendance.

Suggest any one procedure you would perform as an investigator to bring out the facts.

Answer 19

The attendance record of employees pertaining to that section can be analyzed with regards to in and out time. Further, surprise visit to the site can be conducted to see the actual number of workers at a point of time. It may reveal ghost workers. Discrepancies in attendance records vis-à-vis actual number of workers present could reveal dummy workers. Such a visit would also give indication of actual work done in the area and give an inkling of productivity of employees.

Question 20

X Limited engaged in manufacturing of floor coverings has taken a Product Liability Insurance policy (PLI). Such a policy covers risk of liabilities for damages for bodily injury resulting from sale and distribution of floor coverings by vendors of X Limited's products. The policy is also subject to "claim series" clause. A Claims Series event is a series of two or more claims arising from one specific common cause which are attributable to the same fault in design or manufacture of products or to the supply of the same products showing the same defect. A claim series event is deemed to be one claim under the terms & conditions of PLI policy.

The company has been asked to shell out damages of `5 crore due to supply of faulty products to one of its vendors. The vendor had sold floor coverings to a 5 -star hotel which has alleged that harmful chemicals used in dyeing of floor coverings have resulted in skin ailments to some of its guests.

Being in capacity of forensic accountant Professional appointed by insurance company, what special issues you would keep in mind while dealing with claims involving PLI policy covering such matters?

Answer 20

(i) In claims involving product liability insurance policies, many documents are required from third parties. The third party may be unwilling to provide relevant documents to forensic accountant concerning the very organization responsible for causing damages.

(ii) Independence of forensic accountant become paramount in such types of assignments because it involves engagement with parties who are not directly claiming from insurance company. Forensic accountant needs to resist any pressure or interference in establishing the scope of the assignments or the manner in which the work is conducted and reported.

(iii) The company might be willing to negotiate it to salvage its reputation. It can lead to additional complexities.

(iv) Quantification of legal liability under the policy can prove to be a challenging task and it has to be determined in accordance with policy terms & conditions.

(v) Careful analysis of date of loss when first claim occurred in accordance with "claim series" clause and whether the same falls under the policy.

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18
CHAPTER

SUSTAINABLE DEVELOPMENT

Question 1

What type of companies are required to mandatorily furnish the Business Responsibility and Sustainability Report (BRSR) as per the SEBI circular with effect from FY 2022-23 ?

Answer 1

The BRSR seeks disclosures from listed entities on their performance against the nine principles of the 'National Guidelines on Responsible Business Conduct' (NGBRCs) and reporting under each principle is divided into essential and leadership indicators.

The essential indicators are required to be reported on a mandatory basis while the reporting of leadership indicators is on a voluntary basis. Listed entities should endeavour to report the leadership indictors also.

Reporting under BRSR is mandatory from financial year 2022-23. However, disclosure was voluntary in financial year 2021-22.

Question 2

What are the nine principles of BRSR? How are the nine principles of BRSR linked with the 17 UN Sustainable Development Goals?

Answer 2

The nine principles in BRSR are categorized into the ESG components of Environment, Social and Governance with two of the nine in Environment, three in social and four in Governance. Even though they are separate, they are interlinked to each other in some way. For example, the environmental protection is closely linked to the stakeholder engagement and inclusive growth.

Principle 1 –Ethics, Transparency and Accountability:

The first principle emphasizes that the business decisions in an organisation should be open to disclosure and accessible to the relevant interested parties.

The essence of the core elements associated with the first principle are:

a) The entities' governing structure should develop policies, procedures, and practices for their offices, factories, and work areas, ensuring that ethics is not compromised.

b) The information relating to the policies, procedures, and practices along with the performance should be made available to the stakeholders.

c) In case of adverse effects, more care has to be taken for transparent disclosures.

d) The entities in the value chain should be encouraged to adopt these principles by the governance structure.

e) The entities should proactively respond to the outside entities that violate the nine principles of the BRSRs.

This includes their suppliers, distributors, sub-contractors, or regulatory officers that may engage with the business concern.

Principle 2 –Safe and Sustainable Goals and Service:

The entities should make sure that their goods, services, and the operations result in better life for the consumers and end-users.

The essence of the core elements associated with the second principle is:

a) When a product is designed by the entity, the production methods and technologies have to be devised in such a way so as to minimize the resource usage to make it sustainable.

b) The entities are also responsible to educate and make aware their consumers and clients about their rights.

c) The entities should take measures that reduce the over exploitation of the nature's resources by consuming sustainably and encourage methods for reduce, reuse and recycling of the resources.

Principle 3 –Promote wel-lbeing of all employees including those in the value chain:

The third principle relates to all the initiatives an entity has to take for the benefit of its employees from the point of view of their dignity, health, well-being.

The essence of the core elements associated with the principle is:

a) The entity should ensure compliance with all regulatory requirements as far as employees are concerned.

b) The entities are to respect the dignity of employee as a human being and should not restrict their freedom of associations, unions, and other participatory mechanism for collective bargaining of their rights and redressal of issues they face at the workplace.

c) The entities should prevent all kinds of child labour, bonded labour, and any other forms of involuntary labour.

d) The entities should have a system in which the work-life balance of the employees is not compromised.

e) The businesses have to ensure timely payment of the worker's wages and compensation.

f) The payment of the wages has to be as per the living wages, that can take care of the basic needs and provide economic security to the employees.

g) The entities are responsible to create a workplace and work environment that is safe, hygienic, and comfortable for people to work for long durations.

SUSTAINABLE DEVELOPMENT

h) The skill development, career development and training of the workforce is another responsibility of the entities employing them.

i) The creation of a workplace which is free of harassment and violence is also a responsibility of the entity.

Principle 4 -Respect for stakeholders' interests and responsiveness:

The concept of interested party or stakeholders to a business has been a point of discussion in all the regulatory and voluntary systems that relate to the management system of any organisation, be it related to the quality, environment or the occupational health and safety of the workers.

The essence of the core elements associated with the principle is:

a) The entities have to be transparent and communicate with the stakeholders about the impacts of their operations and business decisions on the people and the nature. The policies, decisions, and the impact of the operations of the organisation to the stakeholders have to be disclosed transparently with no ambiguity on the extent of the issues.

b) The entities have to systematically determine the context of their operation and identify their interested parties.

c) The entities should fairly share the benefits to the stakeholders or give an opportunity to them to benefit from the operations in an equitable manner.

Principle 5 -Respect and promote human rights:

The concept of human rights is a vast topic that covers a wide variety of violence and belligerent abusive issues faced by people. It refers to the human rights issues that happen directly or indirectly due to the operation of the business.

The essence of the core elements associated with the principle are:

a) The entities should have a clear understanding of the human rights and various ways by which human rights can be violated from the perspective of the Constitution of India, national laws and policies and the content of International Bill of Human Rights.

b) The entities when developing their management systems, should integrate the human rights element into their policies, procedures, and practices.

c) Businesses should recognize and respect the human rights of all relevant stakeholders and groups within and beyond the workplace, including that of communities, consumers, and vulnerable and marginalized groups.

Principle 6 –Protection and restorationof Environment:

The sixth principle looks at the environmental responsibility as a basic requirement for the economic prosperity and sustainability.

The core elements associated with the principle are:

a) The entities should have policies, procedures, and practices in place to assess and rectify impacts to the environment. This should cover the whole life cycle of the product.

b) The entities have to make use of natural and manmade resources in an optimum manner to ensure their sustainability by taking feedback from the stakeholders.

c) The entities have to measure their performance relating to the prevention of pollution, destruction of forests, waste generation, energy use, land use, etc.

d) The entities have to contribute towards climate change resilience in line with India's commitment to various international mechanisms such as, Paris Agreement and National Action Plans for Climate Change.

e) The entities should explore the comparison of its activities with industry best practices to reduce, reuse and recycle/ recover materials, resources.

f) The companies have to look out for avenues by which they can improve their performance towards various environmental responsibilities.

Principle 7 –Influence on Public and Regulatory Policy:

The seventh principle of influencing the policy formulation positively recognizes that the businesses operate within the framework of statutory and legislative policies of the governing authority.

The principle further highlights that -

a) The core elements of BRSR are to have met holistically when the organisation go ahead with their contributions to policy formulation and policy advocacy.

b) The collective associations such as, the trade groups and industry chambers have to be utilized when moving ahead with the policy advocacy and formulation.

c) The role in policy advocacy by the organisation should be in such a way that it encourages fair competition and prevents human rights abuses.

Principle 8 –Promote Inclusive Growth and equitable development:

This can work only with close participation and collaboration amongst the entities, authorities, the civil associations contributing to one another for a better livelihood, and assistance to the marginalized communities.

The core elements of the eighth principle are:

a) The entities should have systems in place to identify and address impacts of their activities on the social, cultural, and economic aspects of the people. This includes business created issues like, land acquisition and use and construction activities for new facilities.

b) The entities should review, measure, and track the adverse impacts of their activities on the society and environment and make action plans to mitigate them adequately.

c) The entities should make efforts to bring up creative products, technologies, and business concerns that help the marginalized communities to have well-being and a better quality of life.

d) Entities when designing their CSR activities should review the local and regional development priorities to help the marginalized groups and communities.

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e) The entities should take care to ensure that business induced displacement or relocation of communities does not happen, and in unavoidable cases, should make sure to have mutually agreed, participative, and informed negotiations to provide fair compensation to the affected people.

f) All forms of intellectual property and traditional knowledge should get the deserved respect from the organisation, and efforts should be made to ensure that benefits derived from their knowledge are shared equitably.

Principle 9 –Provide value to the consumers in a responsible manner:

The primary purpose of any business is to create or provide useful products and services to the customer in exchange of reasonable profits.

The core elements associated with the principle are:

a) Entities should put in their efforts to reduce the negative impacts of their products and services on consumers, natural environment, and society at large.

b) When conceptualizing, designing, and marketing their products, the organisation should not in any manner prevent the freedom of choice and fair competition.

c) The entities should transparently and accurately disclose all kinds of adverse impacts to the user, planet, society, on the biodiversity from their products.

d) When handling customer data, the right to privacy of the customer needs to be maintained.

e) Entities should inform the customers on the safe and responsible ways of usage, reuse, recycling, and disposal of their products, and ways to eliminate over-consumption.

f) When advertising about their products, the organisations should ensure that misleading and confusing information is not exposed to the customers about their products or its usage.

g) Business enterprises should make available transparent and accessible grievance redressal and feedback management system for their customers to raise their voices or to seek clarifications.

h) Entities, when in the business of providing essential goods and services (e.g., Utilities), should enable universal access, including to those whose services have been discontinued for any reason, in a nondiscriminatory and responsible manner.

Question 3

What are the global trends in sustainable reporting?

Answer 3

In March 2022, the US Securities and Exchange Commission (SEC) proposed climate-risk disclosure requirements, which would expand the annual reporting requirements of publicly traded companies. In their SEC filings, companies would be required to discuss financially material, climate-related risks guided by the TCFD recommendations. Reporting would include:

• The company's climate risk management processes

• How the risks identified would impact financial performance

• How these risks are managed and mitigated

• Any scenario analysis, transition plans, and publicly announced climate goals

In 2019, the UK passed a law targeting net zero greenhouse gas (GHG) emissions by 2050.

A key regulation for UK ESG disclosures is the Companies Act of 2006, which includes requirements for annual reporting. These rules apply to large companies that are either listed, exceed £500 million in annual turnover, or have more than 500 employees. Non-financial information has always been required in annual reports, but in 2022, the Act was expanded to include sustainability matters. The new requirements align with the recommendations from the Task Force on Climate-Related Financial Disclosure (TCFD). As such, companies are required to discuss the strategy, processes, and due diligence regarding matters of:

- The environment (including the company's impact on the environment)

- The company's employees

- Social matters

- Respect for human rights

- Anti-corruption and anti-bribery

Specifically for the environment, climartel-ated disclosures must include:

- Climate change-related risks and opportunities

- How these risks and opportunities are managed through targets and KPIs

- How climate change is addressed in corporate governance

- How climate risk impacts strategy

Additionally, large UK companies are required to report on their UK energy use and carbon emissions within their annual reports through the Streamlined Energy and Carbon Reporting.

Further, in 2023 ESG reporting in the UK will be further formalized through the Sustainability Disclosure Requirements (SDRs). The SDRs will provide a framework for corporates to manage sustainability-related risks, opportunities, and impacts, as well as set relevant metrics and targets. Following table showcases the evolution of sustainable development reporting in the recent past:

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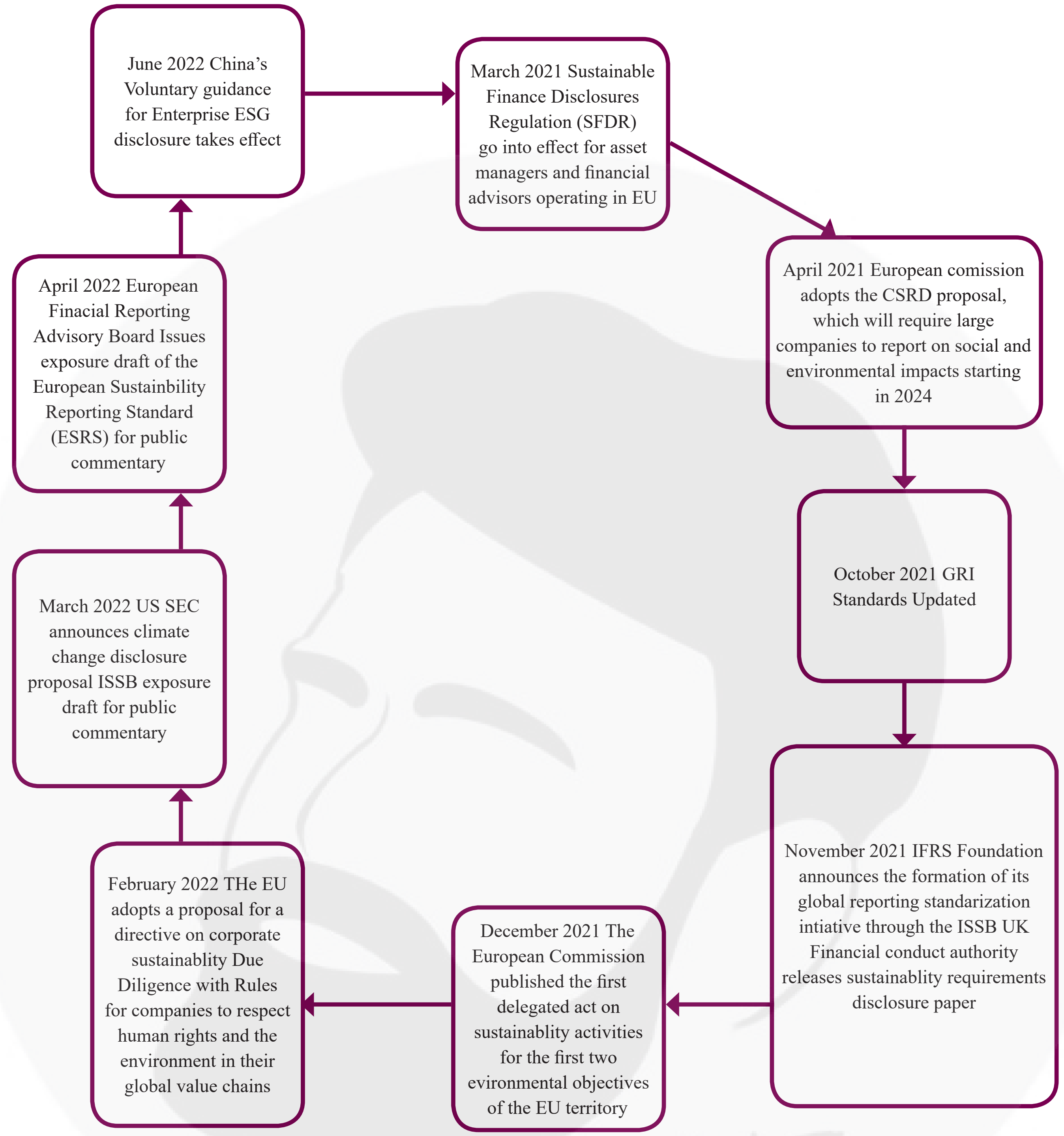

Question 4

What are the 6 C's of Integrated reporting?

Answer 4

There are 6 Cs of Integrated Reporting – also known as 6 capitals:

(i) Financial Capital:

- Pool of funds that is available to the organization for use in the production of goods or provision of services.

- Obtained through financing, such as debt, equity, or grants, or generated through operations or investments.

(ii) Manufactured Capital:

- Seen as human-created, production-oriented equipment and tools.
- Available to the organization for use in the production of goods or the provision of services, including buildings, equipment, infrastructure (such as roads, ports, bridges & waste, and water treatment plants).

(iii) Natural Capital:

- Is an input to the production of goods or the provision of services.
- An organization's activities also impact, positively or negatively, on natural capital.
- Includes water, land, minerals and forests, biodiversity, and ecosystem health.

(iv) Human Capital:

- People's skills and experience, their capacity, and motivations to innovate, including their:
- Alignment with and support of the organization's governance framework & ethical values such as its recognition of human rights.
- Ability to understand and implement an organization's strategy.
- Loyalties and motivations for improving processes, goods, and services, including their ability to lead and to collaborate.

(v) Social Capital:

- Institutions and relationships established within and between each community, group of stakeholders and other networks to enhance individual and collective well-being.

Includes:

o Common values and behaviour.

o key relationships, the trust and loyalty that an organization has developed and strives to build and protect with customers, suppliers, and business partners.

o an organization's social license to operate.

(vi) Intellectual Capital:

Key element in an organization's future earning potential, with a tight link and contingency between investment in R&D, innovation, human resources, and external relationships, which can determine the organization's competitive advantage.

Asia Pacific region continues to dominate in presenting sustainability data in annual reports.

Approximately with 60% of Companies reporting in 2022. Integrated reporting is strong in the Middle East.

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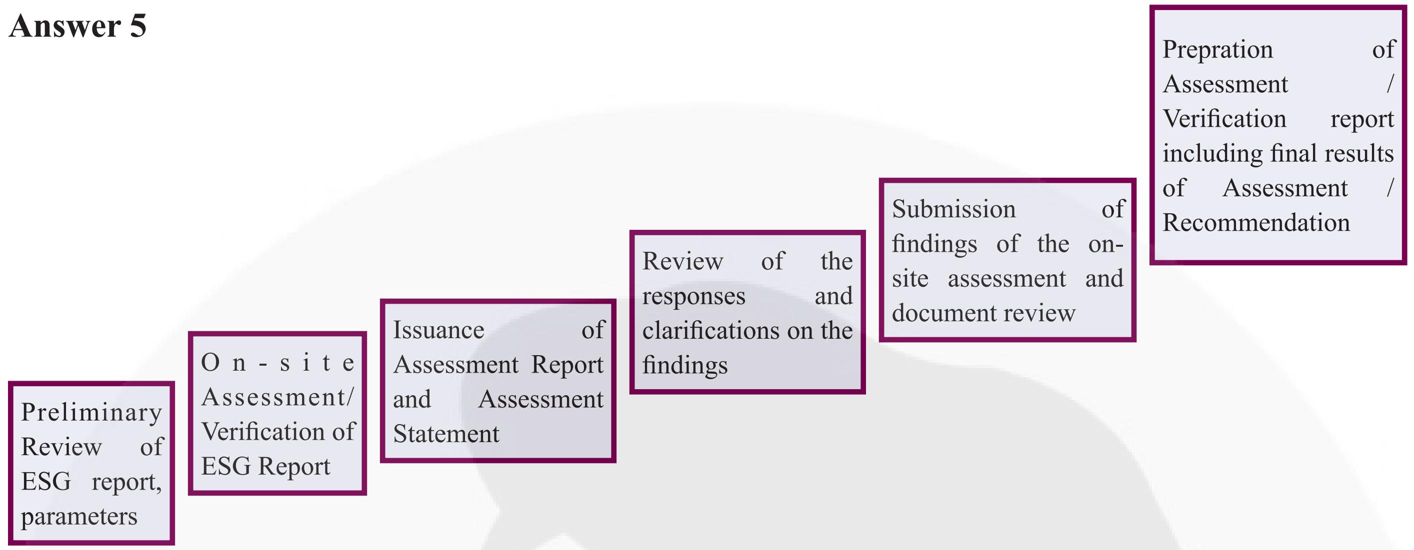
Question 5

What is the methodology of providing assurance in BRSR?

Answer 5



Question 6

What is the auditor's role on ESG aspects in an audit of financial statements of the Company?

Answer 6

The role of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, to enable auditor to report whether the financial statements are prepared and presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

In developing the understanding of an entity, the auditor should include the consideration of climate-related risks and how these risks may be relevant to the audits. The climate-related risks could be more relevant in certain sectors or industries, e.g., banks and insurance, energy, transportation, materials and buildings, agriculture, food, and forestry products.

Many investors and stakeholders are seeking information from auditor's reports about how climate-related risks were addressed in the audit. With this increased user focus on climate change, auditor need to be aware of, and may face, increasing pressure for transparency about climate matters in our auditor's reports.

However, the auditor's reports must follow the requirements of applicable auditing standards.

The auditor's report is a key mechanism of communication to users about the audit that was performed. In addition to the audit opinion, it provides information about auditor's responsibilities and, when required, an understanding of the matters of most significance in our audit and how they were addressed.

In some circumstances, it may warrant inclusion of an Emphasis of matter paragraph to draw attention to disclosures that are of fundamental importance to users' understanding of the financial statements. The auditor should also determine whether the entity has appropriately disclosed relevant climate-related information in the financial statements in accordance with the applicable financial reporting framework e.g., Indian Accounting Standards or Accounting Standards, when relevant before considering climate-related matters in the auditor's report.

The auditor should also read the other information for consistency with information disclosed in the financial statements and information that may be publicly communicated to stakeholders outside the financial statements, such as management report narratives in the annual report, press releases, or investor updates.

This is a requirement under ISA 720 and SA 720, The Auditor's Responsibilities Relating to Other Information.

Question 7

You have recently joined a listed company after qualifying CA final exams through campus placement programmed conducted by CMI&B at ICAI. Although the company you have joined in is not amongst top 1000 listed companies in the country, it wants to include "Sustainability reporting" in accordance with Global Reporting Initiative framework (GRI) in its annual report on voluntary basis. "Sustainability reporting" seems to be new buzzword in corporate circles and you are assigned responsibility for collating all the information required for such reporting.

In above context, dwell upon what is your understanding of "Sustainability reporting"? Can you list some of its expected benefits?

Answer 7

Sustainability reporting is an organization's practice of reporting publicly on its economic, environmental, and/or social impacts, and hence its contributions – positive or negative – towards the goal of sustainable development.

Sustainability reporting refers to the information that companies provide about their performance to the outside world on a regular basis in a structured way. It is the comprehensive mechanism of measuring and disclosing sustainability data with performance indicators and management disclosures.

Expected Benefits can help stakeholders to understand organizations performance vis a vis sustainability and impacts. The reporting process emphasizes the link between financial and non-financial performance.

Such reporting can help entities to focus on long-term value creation, by addressing environmental, social and governance (ESG) issues. Since investors are increasingly recognizing that environmental and social issues provide both risks and opportunities in respect of their investments and are seeking disclosures on environmental and social performance of businesses, they can use ESG performance of companies to make investment decisions.

Investing in social and environmental issues will not only improve own business continuity of companies but also put them in a better position with their B2B (Business to Business) customers as well as enable them to acquire new ones.

Question 8

Trustworthy Industries Limited (a listed company) has already been preparing and disclosing its sustainability report based upon internationally accepted reporting framework of "Integrated Reporting" on a voluntary basis even some years before BRSR reporting became mandatory. Even after BRSR reporting became mandatory, it is cross-referencing disclosures made under such reporting to disclosures sought under BRSR. The key thrust of "Integrated Reporting" is how company creates value over short, medium and long term.

Following further information is provided in respect of the above company: -

(i) It has increased the number of customers using digital customer mobile app of the company from 2 lac users to 4 lac users. There is 100% increase in digital collection. It has benefitted customers of the company and resulted in use of digital methods for business operations of the company.

(ii) It has increased the number of beneficiaries under its flagship CSR Programmes from previous 10000 to 75000. It has provided value for communities and provided sustainable livelihood to them.

Discussing above information, identify which of the capitals of "Integrated Reporting" are being referred to at [i] and [ii] respectively?

Answer 8

The information at [i] states that company has increased the number of customers using digital mobile app.

Besides, it has led to 100% increase in digital collection. Therefore, it involves use of technology for deriving business benefits. It has invested in innovation deriving business benefits from digitization. The capital referred to at [i] is "Intellectual Capital".

Increase in number of beneficiaries under flagship CSR Programmes providing value for communities and sustainable livelihood is an example of relationships established within and between each community, group of stakeholders and other networks to enhance individual and collective well-being. The capital referred to at [ii] is "Social and Relationship Capital."

Integrated Case Scenario

"Quick Push Finance Limited one of the top listed 1000 companies by market capitalization. As per a SEBI circular, Business Responsibility and Sustainability Report (BRSR) based on ESG parameters is mandatory from financial year 2022-23 for top listed 1000 companies. The company is an NBFC and is engaged mainly in providing finance for commercial vehicles.

The report is to be prepared in three sections- Section A, B and C. Whereas Section A and B relate to general disclosures and management & process disclosures respectively, Section C of the report relates to principle wise performance disclosures. Under this section C, information is sought on each of the 9 principles of "National Guidelines on Responsible Business Conduct" (NGBRCs). This information is categorized on two indicators i.e., "Essential indicators" and

"Leadership indicator.

The said company has an anti-corruption/anti-bribery policy which is available on its website. Besides, the company has regularly conducted awareness Programmes for its dealers highlighting relevant governance practices of the company.

The company is sensitive to environmental concerns. It has established mechanisms to recycle hazardous e waste in accordance with applicable laws. Further, disposal of paper waste is also made responsibly. It is also a member of 5 prominent industry chambers/trade associations including FICCI, CII and ASSOCHAM. Besides, regular inputs to government are provided by the company through various forums for improvement in administrative processes relating to automobile and financial sectors.

One of the NGBRC principles states that businesses should promote inclusive growth and equitable development. The scope of this principle is wide and quite encompassing. Many activities of company could fall under promotion of inclusive growth and equitable development.

The CFO of company is clueless as to preparation of BRSR. Help him out by answering the following questions.

Based upon above, answer the following questions:

1. As regards anti-corruption/anti-bribery policy and organization of awareness Programmes for dealers conducted during the year, which of the following is most likely to be true?

a) Having an anti-corruption/anti-bribery policy and organization of awareness Programmes for dealers are in nature of essential indicators.

b) Having an anti-corruption/anti-bribery policy and organization of awareness Programmes for dealers are in nature of leadership indicators.

c) Having an anti-corruption/anti-bribery policy is in nature of essential indicators. Organization of awareness Programmes for dealers is in nature of leadership indicators.

d) Having an anti-corruption/anti-bribery policy is in nature of leadership indicators. Organization of awareness Programmes for dealers is in nature of essential indicators.

Answer 1 (c)

2. As regards established mechanisms for recycle of hazardous e- waste and disposal of paper waste by company, which of the NGBRC principle(s) are involved?

a) Principle 5 only

b) Principle 9 only

c) Principles 6 and 9

d) Principles 2 and 6

Answer 2 (d)

3. Considering description of membership of various industry chambers/Trade associations and providing of inputs to government from improvement in administrative processes, which of the NGBRC principle is referred to?

a) Principle 8

b) Principle 4

c) Principle 3

d) Principle 7

Answer 3 (d)

4. Which of the following activities relates to the principle that businesses should pro inclusive growth and equitable development?

a) CSR projects undertaken by the company in designated aspirational districts of country

b) Carrying out real time digital Net Promoter score (NPS) with all public customers to gauge customer reactions and satisfaction

c) Getting conducted "energy audits" in the company

d) Conducting Programmes to assist employees in finding employment after retirement.

Answer 4 (a)

5. Which of the following statements is true in respect of essential indicators and leadership indicators as far as their reporting in BRSR is concerned?

a) Both types of indicators are mandatorily required to be disclosed.

b) Essential indicators require mandatory disclosure whereas leadership indicators require voluntary disclosure.

c) Essential indicators require voluntary disclosure whereas leadership indicators require mandatory disclosure.

d) All indicators based information whether relating to essential indicators or leadership indicators is voluntary.

Answer 5 (b)

Case Study

The agrochemical sector is about a $35 billion industry in India. The Indian agrochemicals market is segmented by product type (fertilizers, pesticides, adjuvants, and plant growth regulators) and application (crop-based and non-crop-based). India is one of the most prominent exporters of agrochemicals in the world and is being keenly looked at as an ideal hub for export-oriented

production of agrochemicals. There has been a recent surge in the production of agrochemicals to overcome problems such as lack of right nutritious elements required for proper growth of crops, etc. While there is low awareness about the use and impact of agrochemicals, there is also a push from the industries to use more agrochemicals, linking it to better yield. The continuous and increased use of agrochemicals seems to have an adverse effect on humans, animals, and nature in whole.

The toxicity levels of the agrochemicals are harmful, not only to the workers in the manufacturing process but also to farmers, the soil, and the end consumers. The Central Insecticide Board (CIB) of India has categorized agrochemical toxicity levels based on a labeling system—using red, yellow, blue, and green labels—where red is the most toxic and green is the least. Most of the red-labeled products are banned abroad but are being sold in India due to the lack of a strong regulatory environment.

In India, it is estimated that almost 25% of the total amount of agrochemicals sold are counterfeit products.

The quality and the efficacy of these counterfeit products differ from the original products, which can lead to reputational damages for the companies. Agrochemical companies need to add barcodes or other identifying technologies to their product packaging, to allow end- use consumers to check for authenticity.

Also, since India is a multilingual country, the companies will have to publish the usage instructions in multiple languages.

Company A and B are both listed companies and part of top 1000 listed companies. They are engaged in the production of agrochemicals. Company A has been looking for opportunities to comply with the recently launched and evolving guidelines for ESG in India while Company B on the other hand is just focused to increase revenue and profits. In December 2022, Company A made a decision to eliminate red-labeled products from its portfolio and to increase its research and development (R&D) spending to safeguard itself from the market shift due to the new regulatory norms; in 2022, it also discontinued yellow-labeled products. Company A is also planning to incur a small expenditure to improve their backend systems and provide for all its products a unique labeling system that is user friendly and interactive. At the other end of the spectrum, 14% of Company B's top-selling products are derived from red- and yellow labeled products.

Initially, Company A's phasing out of its toxic products negatively affected its revenues by 8%. But as the country's regulatory landscape evolves toward more stringent norms, Company A will be cushioned for regulatory changes and thus, would not face potential future downsides. Company B has recently witnessed a 9% year on year growth in revenue from the last financial year and is planning to increase the production of its bestselling product, an insecticide DDT, categorized as red labelled by the Central Insecticide Board.

Company B has recently been approached by the regulatory authority for an investigation for its products which include performing additional tests and studies to testify that its products have no adverse effects.

1. What would be the reporting requirements for each of the two companies?

Answer

Both Companies A and B are among part of top 1000 listed companies. Hence, these companies have to mandatorily provide BRSR reporting (Business responsibility and Sustainability reporting) in accordance with 9 principles of NGBRC as mandated by SEBI.

2. Which Company has absorbed the impacts of possible future regulatory changes? What are the steps taken by that Company for complying with the regulatory standards?

Answer

Company A has absorbed impact of regulatory changes. It has decided to eliminate red- labelled and yellow-labelled products from its portfolio which are toxic in nature. Besides, it has increased its expenditure on R & D to meet with new regulatory norms. It has also incurred expenditure for improving its labelling system which would help end users to know about the nature of the product. All these steps have been taken by Company A for complying with regulatory standards.

Company A is trying to meet with requirements of Principle 2 by making R & D expenditure. Further, it has also eliminated red-labelled/yellow-labelled products from its portfolio. Principle 2 relates to the requirement that businesses should provide goods and services in a manner that is sustainable and safe.

Besides, by adopting a friendly bar-coded packaging labelling system, company is adhering to requirements of Principle 9 which states that businesses should engage with and provide value to their consumers in a responsible manner. Steps taken by a company to inform its consumers about safe and responsible usage of products fall in its domain.

Since toxic agrochemicals are also harmful to workers engaged in their manufacturing process, their discontinuation bodes well for workers in the company A in line with Principle 3 which states that businesses should respect and promote the well-being of all employees including those in their value chains. By discontinuing products which are harmful to soil, company A is meeting requirements of Principle 6 which states that businesses should respect and make efforts to protect and restore the environment.

3. What would be the consideration by the auditors of Company A and B in the audit of financial statements?

Answer

Company A is complying with regulatory norms whereas 14% of company B's revenue are derived from red and yellow labelled products. In fact, company B is planning to increase production of its red labelled product i.e., insecticide DDT which has been categorized as such by Central Insecticide Board. The auditor of Company B would have to keep in mind requirements of SA 250 in this regard. Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements. It can result in material misstatements. Central Insecticide Board has already launched its investigation into products of company. All these factors would be taken into consideration by auditor of Company B.

Auditors of Company A and Company B need to obtain audit evidence regarding compliance with laws and regulations and audit procedures have to be designed accordingly. Auditor of Company A can obtain assurance from regulatory compliance by the company. Fall of revenue by 8% in one year is not a matter of concern to them as it is a transitory phase.

However, auditors of Company B would also have to take into consideration requirements of SA 570 as non-compliance with regulatory requirements could result into claims from such proceedings which the company may not be able to satisfy.

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