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Chapter

Quality Control and Engagement Standards

Q.1	**SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment" categorises the types of assertions used by the auditor to consider the different types of potential misstatements that may occur. Briefly explain with example. [Study Material – ICAI]**

Ans.: Assertions used by the auditor to consider different types of potential misstatements:

- SA 315 "Identifying and Assessing Risk of Material Misstatements through understanding the Entity and its Environment" requires the auditor to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.
- Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing, and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence.
- Assertions used by auditor with respect to **transactions occurred during the year** are:
  1. **Occurrence** – transactions that have been recorded have occurred during the year.
  2. **Completeness** – transactions have been recorded completely.
  3. **Accuracy** – transactions have been recorded accurately.
  4. **Cut-off** – transactions have been recorded in correct accounting period.
  5. **Classification** – transactions have been properly classified into capital and revenue.
- Assertions used by auditor with respect to **account balances at the period end** are:
  1. **Existence** – assets and liabilities shown in the balance sheet exists.
  2. **Rights and obligations** – rights of the entity have been shown as assets and the obligations have been shown as liabilities.
  3. **Completeness** – assets and liabilities have been recorded completely.
  4. **Valuation and allocation** – assets and liabilities are included in the F.S. at appropriate amounts and any allocation adjustments are appropriately recorded.
- Assertions used by auditor with respect to **Presentation and Disclosure** are:
  1. **Occurrence and Rights and obligations** – disclosed transactions have occurred and belong to the entity.
  2. **Completeness** – disclosures in the financial statements are complete.
  3. **Classification and understandability** – financial information is appropriately presented and disclosures are clearly expressed.
  4. **Accuracy and Valuation** – financial and other information are disclosed fairly and at appropriate amounts.

Q.2	**What are the components of an internal control framework? [Study Material – ICAI]**

Ans.: Components of Internal Control Framework:

As specified in SA 315, "Identifying and Assessing Risk of Material Misstatements through understanding the Entity and its Environment", there are five components of an internal control framework, listed as below:

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

Q.3 **The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Explain. [Study Material – ICAI]**

Ans.: Communication and enforcement of integrity and ethical values:

- As per SA 315 "Identifying and Assessing Risk of Material Misstatements through understanding the Entity and its Environment" Communication and enforcement of integrity and ethical values are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
- The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them.
- Integrity and ethical behaviour are the product of the entity's ethical and behavioural 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 behavioural standards to personnel through policy statements and codes of conduct and by example.

Q.4 **Moon Ltd. is a dealer in electronic appliances. The Company has a centralised warehouse at the outskirts of Mumbai. The Auditors of the company M/s JK 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 JK 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. [Nov. 20 – New Syllabus (5Marks)]

Ans.: Audit Procedures to be carried out if physical inventory counting is conducting at a date other the date of financial statements:

SA 501 "Audit Evidence – Specific Considerations for Specific Items", requires from the auditor that when inventory is material to the financial statements, he 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.

If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures as specified above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date 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.

Q.5 **GS & Co., Chartered Accountants, have been appointed Statutory Auditors of MAP Ltd. for the F.Y 2019-20. The audit team has completed the audit and is in the process of preparing audit report Management of the company has also prepared draft annual report.**

Audit in-charge was going through the draft annual report and observed that the company has included an item in its Annual Report indicating downward trend in market prices of key commodities/raw material as compared to previous year. However, the actual profit margin of the company as reported in financial statements has gone in the reverse direction. Audit Manager discussed this issue with partner of the firm who in reply said that auditors are not covered with such disclosures made by the management in its annual report, it being the responsibility of the management.

Do you think that the partner is correct in his approach on this issue.

Discuss with reference to relevant Standard on Auditing the Auditor's duties with regard to reporting. **[Nov. 20 – New Syllabus (4 Marks)]**

Ans.: Auditor's responsibilities as to Other Information included in Annual Report:

- SA 720 "The Auditor's Responsibilities relating to Other Information" deals with the auditor's responsibilities relating to Other Information, whether financial or non-financial information included in an entity's annual report. Accordingly, 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:

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.

Conclusion: Considering the requirements of SA 720 as stated above, it can be concluded that partner is not correct in his approach.

Q.6 **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.** **[Nov. 20 – New Syllabus (5 Marks)]**

Ans.: Examples of transactions outside the entity's normal course of business:

- SA 550 "Related Parties" deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements.
- Accordingly, if the auditor identifies significant transactions outside the entity's normal course of business when performing the audit procedures, the auditor shall inquire of management about:
  1. The nature of these transactions; and
  2. Whether related parties could be involved.
- 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.
- Examples of transactions outside the entity's normal course of business, include the following:
  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.

Q.7 **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.**

[Nov. 20 – New Syllabus (5 Marks)]

Ans.: Matters to be considered while determining significant deficiency:

- SA 265 "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" defines the term significant deficiency in internal control 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.
- 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:**
  (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 non-recurring 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.

Q.8 **M/S NK & Co., Chartered Accountants were appointed as Statutory Auditors of Fresh Juice Limited for the FY 2020-2021. The previous year's audit was conducted by M/s. LP & Associates. After the audit was completed and report submitted, it was found that closing balances of last financial year i.e., 2019-20 were incorrectly brought forward. It was found that M/s NK & 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 NK & Co. in relation to this matter.

You are required to inform what policies are required to be implemented by NK & Co. for dealing with such complaints and allegations as required by Standard on Quality Control (SQC). [Jan. 21 – New Syllabus (5 Marks)]

Ans.: Complaints and Allegations:

- As required by SQC-1 "Quality Control for Firms that Perform Audits & Reviews of Historical Financial Information, and Other Assurance & Related Services Engagements" 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.
- 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.
- 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.
- 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.

- 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 shall take appropriate action.

Q.9 **GHK Associates, Chartered Accountants, conducting the audit of PBS Ltd., a listed company for the year ended 31.03.2021 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.** **[Jan. 21 – New Syllabus (5 Marks)]**

Ans.: Examples of Matters relevant in obtaining an understanding of the methods used by the management for determining segment information:

- As per SA 501, "Audit Evidence – Specific Consideration for Selected Items", the auditor shall obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework by obtaining an understanding of the methods used by management in determining segment information, and evaluating whether such methods are likely to result in disclosure in accordance with the applicable FRF.
- 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:
  (1) Sales, transfers and charges between segments, and elimination of intersegment amounts.
  (2) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales.
  (3) The allocation of assets and costs among segments.
  (4) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

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Q.10 **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?**

[Jan. 21 – New Syllabus (4 Marks)]

Ans.: Evaluation of Accounting Estimates which involves significant Risks:

- As per SA 540 "Auditing Accounting Estimates including Fair Value Accounting Estimates and Related Disclosures" for accounting estimates that give rise to significant risks, the auditor shall evaluate the following:

(a) 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.

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

(c) 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.

- 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.

Q.11 **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-March 21 (5 Marks)]**

Ans: Consideration to be given while reviewing the work:

- 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.
- 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.

Q.12 **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.**

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]

Ans: Audit Procedure for verification of opening balances in case of initial audit engagements:

SA 510 "Initial Audit Engagements – Opening Balances" deals with the auditor's responsibilities relating to the opening balances in case of initial audit engagements.

(I) Audit procedure if F.S. Audited by another Auditor:

- If the prior period's F.S. 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 F.S. 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 procedures if F.S. are audited for the First Time:

- When the audit of F.S. is being conducted for the first time, the auditor has to perform auditing procedures to obtain sufficient appropriate audit evidence.
- 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.

Considerations while 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.

Q.13 **Star 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 2020-21, a scam regarding allotment of coal blocks was unveiled leading to a ban on the allotment of coal blocks to various companies including Star Ltd. This happened in the month of Dec. 2020 and as such entire power generation process of Star 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 Star Ltd. What course of action should the statutory auditor of the Company consider in such situation? [RTP-May 21]

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Ans.: Evaluation of appropriateness of Going Concern Basis of Accounting:

- As per SA 570- "Going Concern" auditor is required to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern basis of accounting in the preparation of the F.S. and to conclude 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, the auditor shall express an adverse opinion.
- In the present case, the following circumstances indicate the inability of Star Ltd. to continue as a going concern:
  (a) Ban on the allotment of coal blocks
  (b) Halt in power generation
  (c) Key Managerial Personnel leaving the Company.
  (d) Banks decided not to extend further finance and not to fund the working capital requirements of the Company.
  (e) Non availability of sound action plan to mitigate such circumstances.

Conclusion: Considering the factors as stated above, it is clear that the going concern basis is inappropriate for the Company and such circumstances are not reflected in the F.S. of the Company. As such, the statutory auditor of Star Ltd. should:

(1) Express an adverse opinion in accordance with SA 705; and
(2) In the Basis of 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 F.S. do not adequately disclose this matter.

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