# Standards on Auditing

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SQC 1 – Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements

Question 1

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.

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.

Answer

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 client is aggressively concerned with maintaining firm’s fees as low as possible.
(v) Indications of an inappropriate limitation in the scope of work.
(vi) Indications that client might be involved in money laundering or other criminal activities.
(vii) The reasons for proposed appointment of firm and non-reappointment of previous firm.
(viii) 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.
SA 200 – Overall Objectives of the Independent Auditor and the Conduct of an Audit as per SA

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%. At his part the Auditor assesses that the procedure he could apply in the remaining time to complete Audit gives him satisfaction level of detection of frauds & error to an extent of 60%. Analyse the Risk of Material Misstatement and find out the overall Audit Risk.

Answer
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.

\[ \text{Audit Risk} = \text{Risk of material Misstatement} \times \text{Detection Risk} \]

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

\[ \text{Risk of material Misstatement} = \text{Inherent risk} \times \text{control risk} \]

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%
SA 210 – Agreeing the Terms of Audit Engagements

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 2019-20. 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?

Answer

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.

Question 4

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**

**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 5**

R & Co, a firm of Chartered Accountants have not revised the terms of engagements and obtained confirmation from the clients, for last 5 years despite changes in business and professional environment. Please elucidate the circumstances that may warrant the revision in terms of engagement.

**Answer**

As per SA 210 on “Agreeing the Terms of Audit Engagements”, the auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

(i) Any indication that the entity misunderstands the objective and scope of the audit.
(ii) Any revised or special terms of the audit engagement.
(iii) A recent change of senior management.
(iv) A significant change in ownership.
(v) A significant change in nature or size of the entity's business.
(vi) A change in legal or regulatory requirements.
(vii) A change in the financial reporting framework adopted in the preparation of the financial statements.
(viii) A change in other reporting requirements.
SA 220 – Quality Control for an Audit of Financial Statements

Question 6
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
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 7
M/s Sureshchandra & Co. has been appointed as an auditor of SC Ltd. for the financial year 2019-20. CA. Suresh, one of the partners of M/s Sureshchandra & Co., completed entire routine audit work by 29th May, 2020. Unfortunately, on the very next morning, while roving towards office of SC Ltd. to sign final audit report, he met with a road accident and died. CA. Chandra, another partner of M/s Sureshchandra & Co., therefore, signed the accounts of SC Ltd., without reviewing the work performed by CA. Suresh. State with reasons whether CA. Chandra is right in expressing an opinion on financial statements the audit of which is performed by another auditor.

Answer
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. Suresh. However, the report could not be signed by him due to his unfortunate death. Later on, CA. Chandra signed the report relying on the work performed by CA. Suresh. Here, CA. Chandra is allowed to sign the audit report, though, will be responsible for expressing the opinion. He may rely on the work performed by CA. Suresh provided he further exercises adequate skill and due care and review the work performed by him.
SA 230 – Audit Documentation

Question 8
Discuss the Auditor’s responsibility to provide access to his audit working papers to Regulators and third parties.

Answer
The auditor should not provide access to working papers to any third party without specific authority or unless there is a legal or professional duty to disclose. Clause (1) of Part I of Second Schedule to the Chartered Accountants Act, 1949 states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by law for the time being in force. SA 200 on “Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with Standards on Auditing” also reiterates that, “the auditor should respect the confidentiality of the information obtained and should not disclose any such information to any third party without specific authority or unless there is a legal or professional duty to disclose”.

If there is a request to provide access by the regulator based on the legal requirement, the same has to be complied with after informing the client about the same.

Further, 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.

As per SA 230, Audit documentation serves a number of additional purposes, including the enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Therefore, it is auditor’s responsibility to provide access to his audit working papers to Regulators whereas it’s at auditor’s discretion, to make portions of, or extract from his working paper to third parties.

Question 9
Mr. A, a practising Chartered Accountant, has been appointed as an auditor of True Pvt. Ltd. What factors would influence the amount of working papers required to be maintained for the purpose of his audit?

Answer
As per SA 230 “Audit Documentation”, which refers to the record of audit procedures performed, relevant audit evidence obtained and conclusions the auditor reached, the amount of audit working papers depend on factors such as:

(i) The size and complexity of the entity.
(ii) The nature of the audit procedures to be performed.
(iii) The identified risks of material misstatement.
(iv) The significance of the audit evidence obtained.
(v) The nature and extent of exceptions identified.
(vi) The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
(vii) The audit methodology and tools used.
(viii) Timely preparation of Audit Documentation.
SA 240 – The Auditor’s responsibilities relating to Fraud in an Audit of Financial Statements

Question 10

While auditing accounts of a public limited company for the year ended 31st March 2020, an auditor found out an error in the valuation of inventory, which affects the financial statement materially. Comment as per standards on auditing.

Answer

SA 240, “The Auditor’s Responsibilities Relating Fraud in an Audit of Financial Statements”, requires that if circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. SA 240 also requires that when the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud. If there is such an indication, the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. Further, SA 320 Materiality in Planning and Performing an Audit, also requires that in such circumstances, the auditor should consider requesting the management to adjust the financial information or consider extending his audit procedures. If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should express a qualified or adverse opinion, as appropriate. In the instant case, the auditor has detected the material errors affecting the financial statements; the auditor should communicate his findings to the management on a timely basis, consider the implications on true and fair view and also ensure that appropriate disclosures have been made.

Question 11

M/s Honest Limited has entered into a transaction on 5th March, 2020, near year-end, whereby it has agreed to pay ₹ 5 lakhs per month to Mr. Y as annual retainer-ship fee for “engineering consultation”. No amount was actually paid, but ₹ 60 lakhs is provided in books of account as on March 31, 2020.

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 Honest Limited, what would be your approach?

Answer

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 ₹ 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 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 12**

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 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’.

**Answer**

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.

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 ₹ 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 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 13**

In the course of audit of A Ltd. you suspect the management has indulged in fraudulent financial reporting. State the possible source of such fraudulent financial reporting.

**Answer**

As per SA 240, “The Auditor’s responsibilities relating to Fraud in an Audit of Financial Statements”, fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. It may be accomplished by manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared or Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information or intentional misstatements involve intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure etc.

It often involves management override of controls, misappropriation of assets etc that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

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

(iv) Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.

(v) Altering records and terms related to significant and unusual transactions.

(vi) Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).

(vii) 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).

(viii) Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).

(ix) Using an entity's assets for personal use (for example, using the entity's assets as collateral for a personal loan or a loan to a related party).

Question 14

Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud.

Answer

Misstatement in the financial statements can arise from fraud or error. The term fraud refers to an 'Intentional Act' by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

As per SA 240 “The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements”, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. The auditor, conducting an audit, 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. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

As described in SA 200, the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls.
and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

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 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 15**

While conducting statutory Audit of ABC Ltd., you come across I Owe you amounting to ₹ 2 crores as against a cash balance shown in books of ₹ 2.10 crores. You also observe that despite similar high balances throughout the year, small amounts of ₹ 50,000 are withdrawn from the bank to meet day-to-day expenses. As a Statutory Auditor, how would you deal?

**Answer**

According to SA 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements” when the auditor comes across such circumstances indicating the possible misstatements resulting from the fraud then the auditor needs to consider the impact of fraud on financial statements and its disclosure in the audit report. In this case, the circumstances indicate that the possible misstatement in financial statements is due to fraud and error and the auditor must investigate further to consider effect on financial statements.

The Guidance Note on Audit of Cash and Bank balances also mentions that if the entity is maintaining an unduly large balance of cash, he should carry out surprise verification of cash more frequently to ascertain whether it agrees. If cash in hand is not in agreement with the book balance, he should seek explanations and if the same are not satisfactory should state the said fact appropriately in his Audit Report.

**Question 16**

You notice a misstatement resulting from fraud or suspected fraud during the audit and conclude that it is not possible to continue the performance of audit. As a Statutory Auditor, how would you deal?

**Answer**

According to SA 240 “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, 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:

(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.

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.

**Question 17**

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?

**Answer**

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 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 18**

You are appointed as an auditor of Global Ltd. Explain the risk factors relating to misstatements arising from misappropriation of assets.

**Answer**

As per SA 240, “The Auditor’s Responsibilities Relating to Fraud in Audit of Financial Statements”, misappropriation of assets involves the theft of an 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.
Risk factors that relate to misstatements arising from misappropriation of assets are classified according to the three conditions generally present when fraud exists: incentives/pressures, opportunities, and attitudes/rationalization. The following are examples of risk factors related to misstatements arising from misappropriation of assets:

**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:
  1. Known or anticipated future employee layoffs.
  2. Recent or anticipated changes to employee compensation or benefit plans.
  3. 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:

- Inventory items that are small in size, of high value, or in high demand.
- 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.
- Inadequate segregation of duties or independent checks.

**Attitudes/Rationalizations:**

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets.
- 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.
- Behavior indicating displeasure or dissatisfaction with the entity or its treatment of the employee.
- Changes in behavior or lifestyle that may indicate assets have been misappropriated.
SA 250 – Consideration of Laws and Regulations in an Audit of Financial Statements

Question 19

What are the roles and responsibilities of the statutory auditors in relation to compliance with the laws and regulations by the entity?

Answer

As per SA 250 “Consideration of Laws and Regulations in an Audit of Financial Statements”, as part of obtaining an understanding of the entity and its environment the auditor shall obtain a general understanding of:

(i) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and

(ii) How the entity is complying with that framework.

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.

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:

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

(ii) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor’s attention. The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

Thus, 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.

Question 20

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 non-compliance with Laws and Regulations.

Answer

As per SA 250, “Consideration of Laws and Regulations, 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 by inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

However, when the auditor becomes aware of the existence of, or information about, the following matters, it may also be an indication of non-compliance with laws and regulations:
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.

Question 21

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.

Answer

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

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

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.

Question 22

State the reporting responsibility of an auditor in the context of non-compliance of Law and Regulation in an audit of Financial Statement.

Answer
According to SA 250 "Consideration of Laws and Regulations in an Audit of Financial Statements", the reporting responsibilities of an Auditor may be divided into the following categories:

**Reporting Non-Compliance to Those Charged with Governance:** Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor, the auditor shall communicate with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor’s attention during the course of the audit, other than when the matters are clearly inconsequential.

If, in the auditor’s judgment, the non-compliance referred above is believed to be intentional and material, the auditor shall communicate the matter to those charged with governance as soon as practicable.

If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

**Reporting Non-Compliance in the Auditor’s Report on the Financial Statements:** 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, in accordance with SA 705 express a qualified or adverse opinion on the financial statements.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with SA 705.

If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor’s opinion in accordance with SA 705.

**Reporting Non-Compliance to Regulatory and Enforcement Authorities:** If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity.
SA 260 – Communication with Those Charged with Governance

Question 23

“The auditors should communicate audit matters of governance interest arising from the audit of financial statements with those charged with the governance of an entity”. Briefly state the matters to be included in such Communication.

Answer

As per SA 260 “Communication with those Charged with Governance”, the auditor shall communicate with those charged with governance, the responsibilities of the auditor in relation to the financial statement audit, including that:

(a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and

(b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

The auditor shall communicate with those charged with governance the following:

(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, if any, arising from the audit that were discussed, or subject to correspondence with management; and
   (ii) Written representations the auditor is requesting; and

(d) Other matters, if any, arising from the audit that, in the auditor’s professional judgment, are significant to the oversight of the financial reporting process.
SA 265 – **Communicating Deficiencies in Internal Control to TCWG and Management**

**Question 24**

During the course of 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**

**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.
SA 299 – Joint Audit of Financial Statements

Question 25
Write a short note on Responsibility of Joint Auditors.

Answer
SA 299 on, “Joint Audit of Financial Statements” deals with the professional responsibilities, which the auditors undertake in accepting such appointments as joint auditors. The responsibilities of joint auditors, as a rule are no different from the responsibilities of individual auditors as enumerated in the Companies Act, 2013. Main features of the said SA are discussed below:

- **Division of Work:** Where joint auditors are appointed, they should, by mutual discussion, divide the audit of identifiable units or specified areas. Certain areas of work, owing to their importance or owing to the nature of work involved would not be divided and would be covered by all the joint auditors. Such a division affected by the joint auditors should be adequately documented and preferably communicated to the auditee.

- **Coordination:** Where in the course of his work, a joint auditor comes across matters which are relevant to the areas of other joint auditors and which require joint discussion, he should communicate the same to all the other joint auditors in writing before the finalisation of audit and preparation of audit report.

In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them.

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.

(c) in respect of 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) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute.

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

(f) it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.

(g) the responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.

(h) each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express his own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.
Question 26

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 2019-20. 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 briefly explain the responsibilities of auditors when they are jointly and severally responsible in respect of audit conducted by them and also guide Mr. Z in such situation.

Answer

SA 299 on, “Joint Audit of Financial Statements” deals with the professional responsibilities, which the auditors undertake in accepting such appointments as joint auditors. In respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

(i) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(ii) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors;

(iii) in respect of 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;

(iv) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute;

(v) for ensuring that the audit report complies with the requirements of the relevant statute;

(vi) it is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit;

(vii) the responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors;

(viii) each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express their own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

In the instant case, there are three auditors, namely, Mr. X, Mr. Y and Mr. Z, jointly appointed as an auditor of KRP Ltd. For the valuation of gratuity scheme of the Company they referred their own known Actuaries. Mr. Z (one of the joint auditor) is not satisfied with the report submitted by Mr. Y’s referred actuary. He is not agreed with the matters to be covered by the report whereas Mr. X agreed with the same.

Hence, as per SA 299, Mr. Z is suggested to express his own opinion through a separate report whereas Mr. X and Mr. Y may provide their joint report for the same.
Question 27

P Limited is a listed company and its business activities are divided into three regions. The company appointed PY & Co., KL & Co. and MK & Co., Chartered Accountants to conduct a Joint Audit and report on the financial statements for the Financial Year 2019-20. Explain the relationship among the joint auditors for the audit of the financial statements for the year 2019-20.

Answer

SA 299 “Joint Audit of Financial Statements” deals with the professional responsibilities which the auditors undertake in accepting appointments as joint auditors. According to this SA, in respect of the work divided amongst the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has made a separate report on the work performed by him.

I. On the other hand the joint auditors are jointly and severally responsible in respect of the audit conducted by them as under:

   (i) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;
   (ii) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.
   (iii) in respect of 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;
   (iv) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and
   (v) for ensuring that the audit report complies with the requirements of the relevant statute.

II. It is the separate and specific responsibility of each joint auditor to study and evaluate the prevailing system of internal control relating to the work allocated to him, the extent of enquiries to be made in the course of his audit.

The responsibility of obtaining and evaluating information and explanation from the management is generally a joint responsibility of all the auditors.

Each joint auditor is entitled to assure that the other joint auditors have carried out their part of work in accordance with the generally accepted audit procedures and therefore it would not be necessary for joint auditor to review the work performed by other joint auditors.

Normally, the joint auditors are able to arrive at an agreed report. However, where the joint auditors are in disagreement with regard to any matters to be covered by the report, each one of them should express their own opinion through a separate report. A joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.
SA 300 – Planning an Audit of Financial Statements

Question 28

Briefly discuss the following statements in view of SA 300 "Planning an Audit of Financial Statements": For an initial audit, the auditor may need to expand the planning activities.

Answer

Additional Considerations in Initial Audit Engagements: As per SA 300, Planning an Audit of Financial Statements, the purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements.

For initial audits, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor’s working papers.
- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.
- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances (as per SA 510 “Initial Audit Engagements– Opening Balances”).
- Other procedures required by the firm’s system of quality control for initial audit engagements (for example, the firm’s system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).
SA 315 - Identifying and Assessing Risks of MM through Understanding the Entity and its Environment

Question 29

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?

Answer

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 activities, relevant to that risk.

Question 30

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

Answer

SA 315 and SA 330 “Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment” and “The Auditor's Responses to Assessed Risks” establishes standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk. SA 315 and SA 330 require that the auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. “Detection risk” is the risk that an auditor’s substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material. The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. The auditor should use his professional judgement to assess audit risk.
and to design audit procedures to ensure that it is reduced to an acceptably low level. If it cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.

**Question 31**

IT systems also pose specific risks to an entity's internal control? What are those risks?

**Answer**

As per SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment", IT system also poses specific risks to an entity's Internal Control. They are-

(i) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both.

(ii) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risk may arise when multiple users access a common database.

(iii) The possibility of IT personnel gaining access beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.

(iv) Unauthorised changes to data in Master files.

(v) Unauthorised changes to systems or programs.

(vi) Failure to make necessary changes to systems or programs.

(vii) In appropriate manual intervention.

(viii) Potential loss of data or inability to access data as required.

**Question 32**

While commencing the statutory audit of ABC Company Limited, what should be the considerations of the auditor to assess Risk of Material Misstatement and his response to such risks?

**Answer**

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;

(ii) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(iii) 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

(iv) 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-

(i) 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

(ii) Obtain more persuasive audit evidence the higher the auditor’s assessment of risk.

Question 33
What are the points to be considered while evaluating the “Knowledge of the Business” in the conduct of an audit?

Answer
The broad matters to be considered while obtaining knowledge of business for a new audit assignment are set out in SA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment. These are:

(i) Relevant industry, regulatory, economic and other external factors including the applicable financial reporting framework.

(ii) The nature of the entity, including:
   (1) its operations;
   (2) its ownership and governance structures;
   (3) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
   (4) the way that the entity is structured and how it is financed; to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

(iii) The entity's selection and application of accounting policies.

(iv) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.

(v) The measurement and review of the entity's financial performance.

In addition to the importance of knowledge of the client’s business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgement regarding the appropriateness of accounting policies and disclosures.

Question 34
What are the major sources of obtaining information about the client’s business?

Answer
Information about the client’s business: The auditor can obtain information about client’s business from the following sources:
(i) The client’s annual Reports to shareholders;
(ii) Minutes of meetings of shareholders, board of directors and important committees;
(iii) Internal financial management report for current and previous periods, including budgets, if any;
(iv) The previous year’s audit working papers, and other relevant files;
(v) Firm personnel responsible for non-audit services to the client who may be able to provide information on matters that may affect the audit;
(vi) Discussions with the client;
(vii) The client’s policy and procedures manual;
(viii) Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publication, trade Journals, magazines, newspapers or text books;
(ix) Consideration of the state of the economy and its effects on the client’s business;
(x) Visits to the client’s premises and plant facilities to the management.
SA 320 – Materiality in Planning and Performing an Audit

Question 35

Mr. X was appointed as the auditor of M/s Easygo 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.

Answer

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 financial statements (for eg., 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 36

As an auditor of RST Ltd. Mr. P applied the concept of materiality for the financial statements as a whole. On the basis of obtaining additional information of significant contractual arrangements that draw attention to a particular aspect of a company's business, he wants to re-evaluate the materiality concept. Please, guide him.

Answer

In the instant case, Mr. P, as an auditor of RST Ltd. has applied the concept of materiality for the financial statements as a whole. But he wants to re-evaluate the materiality concept on the basis of additional information of significant contractual arrangements 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, Mr P can re-evaluate the materiality concepts after considering the necessity of such revision.
SA 330 – The Auditor’s Responses to Assessed Risks

Question 37
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 advisor to the auditor kindly caution him about the factors that may warrant a re-test of controls.

Answer
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 38
While carrying out the statutory audit of a large entity, what are the substantive procedures to be performed to assess the risk of material misstatement?

Answer
As per SA 330, “The Auditor’s Response to Assessed Risk”, substantive procedure is an audit procedure designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures.

Test of Details: The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size.

Substantive Analytical Procedure: Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of planned analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. However, the suitability of a particular analytical procedure will depend upon the auditor’s assessment of how effective it will be in detecting a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.

In some cases, even an unsophisticated predictive model may be effective as an analytical procedure. For example, where an entity has a known number of employees at fixed rates of pay
throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll. The use of widely recognised trade ratios (such as profit margins for different types of retail entities) can often be used effectively in substantive analytical procedures to provide evidence to support the reasonableness of recorded amounts.
SA 402 – Audit Considerations Relating to an Entity Using a Service Organization

Question 39

G Ltd. is a mobile phone operating company. Barring the marketing function it had outsourced the entire operations like maintenance of mobile infrastructure, customer billing, payroll, accounting functions, etc. Assist the auditor of G Ltd. as to how he can obtain an understanding of how G Ltd. uses the services of the outsourced agency in its operations.

Answer

As per SA 402 on “Audit Considerations Relating to an Entity Using a Service Organisation”, when obtaining an understanding of the user entity in accordance with SA 315 “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment”, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity’s operations, including:

(i) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity’s internal control;
(ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
(iii) The degree of interaction between the activities of the service organisation and those of the user entity; and
(iv) The nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation.

Question 40

A Company gets its accounting data processed by a third party to achieve cost reduction. As a Statutory Auditor of such a company, what are the additional precautions/checks that you would consider for conduct of the audit?

Answer

Processing of accounting data may be given to a third party on account of various considerations such as economy, own computer working to full capacity, an interim measures restricting accessibility to sensitive information, etc. A client may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data (e.g., a computer systems service organisation). If a client uses a service organisation, certain policies, procedures and records maintained by the service organisation might be relevant to the audit of the financial statements of the client. Consequently, the auditor would consider the nature and extent of activities undertaken by service organisations so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk.

As per SA 402 “Audit Considerations relating to an Entity using a Service Organization”, when obtaining an understanding of the user entity in accordance with SA 315, the user auditor shall obtain an understanding of how a user entity uses the services of a service organisation in the user entity’s operations, including:

(a) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity’s internal control;
(b) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
(c) The degree of interaction between the activities of the service organisation and those of the user entity; and

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

Information on the nature of the services provided by a service organisation may be available from a wide variety of sources, such as user manuals; system overviews; technical manuals; the contract or service level agreement between the user entity and the service organisation; reports by service organisations, internal auditors or regulatory authorities on controls at the service organisation; reports by the service auditor, including management letters, if available.

Knowledge obtained through the user auditor's experience with the service organisation, for example through experience with other audit engagements, may also be helpful in obtaining an understanding of the nature of the services provided by the service organisation. This may be particularly helpful if the services and controls at the service organisation over those services are highly standardized.

Question 41

When a sub-service organization performs services for a service organization, there are two alternative methods of presenting the description of controls. The service organization determines which method will be used. As a user auditor what information would you obtain about controls at a sub-service organization?

Answer

In accordance with SA 402 “Audit Considerations relating to an Entity Using a Service Organisation”, a user entity may use a service organisation that in turn uses a sub-service organisation to provide some of the services provided to a user entity that are part of the user entity's information system relevant to financial reporting. The sub-service organisation may be a separate entity from the service organisation or may be related to the service organisation.

A user auditor may need to consider controls at the sub-service organisation. In situations where one or more sub-service organisations are used, the interaction between the activities of the user entity and those of the service organisation is expanded to include the interaction between the user entity, the service organisation and the sub-service organisations. The degree of this interaction, as well as the nature and materiality of the transactions processed by the service organisation and the sub-service organisations are the most important factors for the user auditor to consider in determining the significance of the service organisation’s and sub-service organisation’s controls to the user entity’s controls.

Further, the user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity’s internal control relevant to the audit has been obtained to provide a basis for the identification and assessment of risks of material misstatement.

If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding by application of the following two methods of presenting description of internal controls i.e. (I) Type 1 report; or (ii) Type 2 report.

If a service organisation uses a subservice organisation, the service auditor's report may either include or exclude the subservice organisation's relevant control objectives and related controls in the service organisation's description of its system and in the scope of the service auditor's engagement. These two methods of reporting are known as the inclusive method and the carve-out method respectively.

In either method, the service organisation includes in its description of controls a description of the functions and nature of the processing performed by the sub-service organisation.

If the Type 1 or Type 2 report excludes the control at a subservice organization and the services
provided by the subservice organization are relevant to the audit of the user entity's financial statements, the user auditor is required to apply the requirements of the SA 402 in respect of the subservice organization.

The nature and extent of work to be performed by the user auditor regarding the services provided by a subservice organization depend on the nature and significance of those services to the user entity and relevance of those services to the audit.

**Question 42**

Durafone Mobile Co. Ltd. have pan India presence and market leader in mobile operation. It has outsourced all its revenue operation including accounting functions to Set Solutions (P) Ltd. As an Auditor of the mobile company, enumerate the factors to be taken into consideration related to its financial reporting.

**Answer**

**Factors to be considered by Auditor related to Financial reporting of Service organisation:**

As per SA 402 "Audit Considerations relating to an Entity using a Service Organization", services provided by a service organisation are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's information system, including related business processes, relevant to financial reporting.

Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets. A service organisation's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:

(i) The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;

(ii) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

(iii) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect information and how information is transferred to the general ledger;

(iv) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;

(v) The financial reporting process used to prepare the user entity's financial statements,

(vi) including significant accounting estimates and disclosures; and

(vii) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

**Question 43**

How does an auditor report on the description, design and operating effectiveness of controls at a service organization?

**Answer**

**Report on the Description, Design and Operating Effectiveness of Controls at a Service**
Organization: As per SA 402 “Audit Considerations Relating to an Entity using a Service Organisation”, a report on the description, design and operating effectiveness of controls at a service organization shall comprise-

(i) A description, prepared by management of the service organisation, of the service organisation's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and

(ii) A report by the service auditor with the objective of conveying reasonable assurance that includes:

a. The service auditor’s opinion on the description of the service organisation's system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives, and the operating effectiveness of the controls; and

b. A description of the service auditor’s tests of the controls and the results thereof.
SA 450 – Evaluation of Misstatements Identified during the Audits

Question 44
In audit plan for T Ltd, as the audit partner you want to highlight the sources of misstatements, arising from other than fraud, to your audit team and caution them. Identify the sources of misstatements.

Answer
According to SA 450 “Evaluation of Misstatements identified during the Audit”, the following are the sources of misstatements arising from other than fraud:
(i) An inaccuracy in gathering or processing data from which the financial statements are prepared;
(ii) An omission of an amount or disclosure;
(iii) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of facts;
(iv) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

Question 45
Discuss the impact of uncorrected misstatements identified during the audit and the auditor’s response to the same.

Answer
In accordance with SA 450 "Evaluation of Misstatements identified during the Audit", the auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:
(i) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and
(ii) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

The auditor shall communicate this with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation.

The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected.

Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SA 320, to confirm whether it remains appropriate in the context of the entity’s actual financial results.

As per management, if effect of such uncorrected misstatement is immaterial then the auditor shall request for a written representation from management and, where appropriate, those charged with governance that whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

If the management refuses to adjust the financial information and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should report accordingly.
SA 500 – Audit Evidence

Question 46

Obtaining audit evidence in performing compliance and substantive procedures. Comment.

Answer

As per SA 500 “Audit Evidence”, in performing compliance and substantive procedures, the auditor may obtain audit evidence by following methods-

(i) **Inspection**: Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorisation.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

(ii) **Observation**: Observation consists of looking at a process or procedure being performed by the others. For example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed.

(iii) **External Confirmation**: An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a “side agreement” that may influence revenue recognition.

(iv) **Recalculation**: Recalculation consists of checking the arithmetical accuracy of documents or records. Recalculation may be performed manually or electronically.

(v) **Reperformance**: It involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

(vi) **Analytical Procedure**: Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.
(vii) **Inquiry:** Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

**Question 47**

M/s LNK's group gratuity scheme’s valuation by actuary shows wide variation compared to the previous year's figures. As a Statutory Auditor, how would you deal in this situation?

Or

The auditor of SS 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. Comment.

Or

Y Ltd. engaged an actuary to ascertain its employee cost, gratuity and leave encashment liabilities. As the auditor of Y Ltd., you would like to use the report of the actuary as an audit evidence. How do you evaluate the work of the actuary?

**Answer**

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.

The auditor has to evaluate the work of an expert, say, actuary, before adopting the same. This becomes more crucial since M/s LNK’s group gratuity scheme’s valuation by actuary shows wide variation compared to previous year figures. There is no doubt that relevance and reasonableness of assumptions and methods used are the responsibility of the expert, but the
auditor has to determine whether they are appropriate based on the auditor's knowledge of the client’s business and result of his audit procedures.

In the present case, the auditor must verify the reasonableness of assumptions made and methods adopted by the actuary in the evaluation particularly with reference to factors such as rate of return on investments, retirement age, number and salary of employees, etc. Accordingly, the auditor has to satisfy himself whether valuation done by the actuary can be adopted, otherwise he may report on his findings for wide variation.

**Question 48**

Gap Ltd. possesses some investment for which there is no ready market and to assess its fair market value it hires an expert, the result of which it can use in preparing its financial statement. Being an Auditor of the Company, state the matters which may affect the nature, timing and extent of audit procedure to be adopted by you in the instant case.

**Answer**

**Nature, Timing and Extent of Audit Procedures:** As per SA 500 "Audit Evidence", the nature, timing and extent of audit procedures to be adopted by an auditor in case of 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.
(vii) The extent to which management can exercise control or influence over the work of the management’s expert.
(ix) Whether the management’s expert is subject to technical performance standards or other professional or industry requirements.
(x) The nature and extent of any controls within the entity over the management’s expert’s work.
(xi) The auditor’s knowledge and experience of the management's expert's field of expertise.
(xii) The auditor's previous experience of the work of that expert.
SA 501 – Audit Evidence - Specific Considerations for Selected Items

Question 49

You are the auditor of Easy Communications Ltd. for the year 2019–20. The inventory as at the end of the year i.e. 31.3.20 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?

Answer

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 50

LMN Ltd. supplies navy uniforms across the country. The company has 4 warehouses at different locations throughout the India and 5 warehouses at the borders. The major stocks are generally supplied from the borders. LMN Ltd. appointed M/s OPQ & Co. to conduct its audit for the financial year 2019-20. Mr. O, partner of M/s OPQ & 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 OPQ & Co.,

(i) How sufficient appropriate audit evidence regarding the existence and condition of inventory may be obtained?

(ii) How an auditor is supposed to deal when attendance at physical inventory counting is impracticable?

Answer

(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:

(a) 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;
Inspect the inventory; and
Perform test counts; and

Perfomrning audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

(b) 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 51

"If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence of inventory by attending the physical inventory counting unless impracticable". Discuss.

Answer

According to 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 attending the 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.

(iv) Perform test counts.

These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or ageing inventory.

Question 52

Your firm has been appointed as the statutory auditors of GBM Private Limited for the financial year 2019-20. While verification of company’s inventories as on 31st March 2020, 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?

Answer

**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.
SA 505 – **External Confirmations**

**Question 53**

The auditor of H Ltd. wanted to obtain confirmation from its trade payables. But the management made a request to the auditor not to seek confirmation from certain trade payables citing disputes. Can the auditor of H Ltd. accede to this request?

**Answer**

SA 505, "External Confirmations", establishes standards on the auditor's use of external confirmation as a means of obtaining audit evidence. It requires that the auditor should employ external confirmation procedures in consultation with the management. The auditor may come across certain situations in which the management may request him not to seek external confirmation from certain parties because of dispute with the trade payables, etc. The management, for example, might make such a request on the grounds that due to a dispute with the particular trade payable, the request for confirmation might aggravate the sensitive negotiations between the entity and the trade payables.

In such cases, when an auditor agrees to management’s request not to seek external confirmation regarding certain trade payables, the auditor should consider validity of grounds for such a request and assess management’s integrity and obtain evidence to support the same. The auditor should also ask the management to submit its request in a written form, detailing therein the reasons for such a request.

If the auditor of H Ltd. agrees to management’s request not to seek external confirmation regarding a particular matter, the auditor should document the reasons for acceding to the management’s request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter. While considering the validity of request, in case the auditor of H Ltd. reaches at a conclusion that the same was not valid, he may appropriately modify the report.

**Question 54**

During the course of audit of Star 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 ₹ 15 Lacs, of whom, no confirmation on the credit balance received. Comment with respect to Standard of Auditing.

**Answer**

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 ₹ 15 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 55

The accountant of C 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?

Answer

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 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.

Question 56

Moon Limited replaced its statutory auditor for the financial year 2019-20. During the course of audit, the new auditor found a credit item of ₹ 5 lakhs. On enquiry, the company explained him that it is, a very old credit balance. The trade payable had neither approached for the payment nor is he traceable. Under the circumstances no confirmation of the credit balance is available.

Answer

This is a case of external confirmation, covered by SA 505 "External Confirmations". The identities of trade payables are not traceable to confirm the credit balance as appearing in the financial statement of the company. It is also not a case of pending litigation.

It might be a case that an income of ₹ 5 lakhs had been hidden in previous year/s. The statutory auditor should examine the validity of the credit balance as appeared in the company’s financial statements. He should obtain sufficient evidence in support of the balance. He should apply alternative audit procedures to get documentary proof for the transaction/s and should not rely entirely on the management representation. Finally, he should include the matter by way of a qualification in his audit report to the members.

Question 57

Write a short note on Situations where external confirmations can be used.

Answer
Situations where external confirmations can be used:

(i) Bank balance from bankers
(ii) Account receivable balances
(iii) Inventories held by third parties
(iv) Property title deeds held by third parties
(v) Investments purchased but delivery not taken
(vi) Loan from lenders
(vii) Account payable balances
(viii) Long outstanding share application money.

Question 58

Mr. Z who is appointed as auditor of Elite Co. Ltd. wants to use confirmation request as audit evidence during the course of audit. What are the factors to be considered by Mr. Z when designing a confirmation request? Also state the effects of using positive external confirmation request by Mr. Z.

Answer

As per SA 505, "External Confirmation", factors to be considered when designing confirmation requests include:

(i) The assertions being addressed.
(ii) Specific identified risks of material misstatement, including fraud risks. The layout and presentation of the confirmation request.
(iii) Prior experience on the audit or similar engagements.
(iv) The method of communication (for example, in paper form, or by electronic or other medium).
(v) Management's authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
(vi) The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

A positive external confirmation request asks the confirming party to reply to the auditor in all cases, either by indicating the confirming party's agreement with the given information, or by asking the confirming party to provide information. A response to a positive confirmation request ordinarily is expected to provide reliable audit evidence. There is a risk, however, that a confirming party may reply to the confirmation request without verifying that the information is correct. The auditor may reduce this risk by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, and ask the confirming party to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the confirming parties.

Question 59

M/s ABC & Co, LLP are appointed auditors of Sharp Company Ltd. for the year ended 31st March, 2020. As part of the audit process, they want to use confirmation procedures as audit evidence during the course of audit. In view of the fact that positive confirmations are not responded favourably, the firm also intends to use negative confirmation requests. What are the factors to be considered for the same?
Answer

As per SA 505, "External Confirmation", factors to be considered when designing confirmation requests include:

(i) The assertions being addressed.
(ii) Specific identified risks of material misstatement, including fraud risks.
(iii) The layout and presentation of the confirmation request.
(iv) Prior experience on the audit or similar engagements.
(v) The method of communication (for example, in paper form, or by electronic or other medium).
(vi) Management’s authorisation or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management’s authorisation.
(vii) The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

Factors to be considered for Negative Confirmation requests: 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.

Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present:

(1) The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate evidence regarding the operating effectiveness of controls relevant to the assertion;
(2) The population of items subject to negative confirmation procedures comprises a large number of small, homogenous, account balances, transactions or conditions;
(3) A very low exception rate is expected; and
(4) The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

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.
SA 510 – Initial Audit Engagements-Opening Balances

Question 60
You have been appointed as the auditor of Good Health Ltd. for 2019-20 which was audited by CA Trustworthy in 2018-19. As the Auditor of the company state the steps you would take to ensure that the Closing Balances of 2018-19 have been brought to account in 2019-20 as Opening Balances and the Opening Balances do not contain misstatements.

Answer
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 61
(a) What are 'Initial Audit Engagements’?
(b) 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.
(c) 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 (b) above?

Answer
(a) Initial Audit Engagement: As per SA 510 “Initial Audit Engagements - Opening Balances”, initial audit engagement is an engagement in which either:

(i) The financial statements for the prior period were not audited; or

(ii) The financial statements for the prior period were audited by a predecessor auditor.

(b) (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.

(c) 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 62

In an initial audit engagement the auditor will have to satisfy about the sufficiency and appropriateness of 'Opening Balances' to ensure that they free from misstatements, which may materially affect the current financial statements. Lay down the audit procedure, you will follow, 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?

Answer

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 -

(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) 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: 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 and in case where 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, in accordance with SA 705.

Question 63
CA. Ashutosh has been appointed as an auditor of Awesome Health Ltd. for the financial year 2019-20 which was audited by CA. Amrawati in 2018-19. 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 2018-19 have been brought to account in 2019-20 as Opening Balances and the Opening Balances do not contain any misstatements.

Answer
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 64
CA. Jack, a recently qualified practicing Chartered Accountant got his first audit assignment of Futura (P) Ltd. for the financial year 2019-20. 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. Jack left out obtaining appropriate audit evidence, say, confirmations, from the outstanding Accounts Receivable amounting ₹ 150 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. Jack, 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.
Answer

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.

In the given case, the management of Futura (P) Ltd. has restrained CA. Jack, its auditor, from obtaining appropriate audit evidence for balances of Accounts Receivable outstanding as it is from the preceding year. CA. Jack, 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. Jack 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. Consequently, CA. Jack shall also be held guilty for professional misconduct for not exercising due diligence, or grossly negligence in the conduct of his professional duties as per the Code of Ethics.
SA 520 – Analytical Procedures

Question 65
What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client?

Answer
As per "SA 520 (Revised) Analytical Procedure", when the auditor intends to perform analytical procedures on data prepared by the client, he should consider the following:

(i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and tests of details, if any, for these assertions;

(ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation;

(iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated; and

(iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation and 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:

(1) Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and

(2) Performing other audit procedures as necessary in the circumstances.

Question 66
The reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained. Accordingly, what are the relevant criteria which determine whether the data is reliable for the purposes of designing substantive analytical procedures?

Answer
Relevant Criteria for Determining Reliability of Data: SA 520 on 'Analytical Procedures' provides that the reliability of data is influenced by its source and nature and is dependent on the circumstances under which it is obtained.

Accordingly, the following are relevant criteria when determining whether data is reliable for purposes of designing substantive analytical procedures:

(i) Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;

(ii) Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products;

(iii) Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
(iv) Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

Question 67

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.

Answer

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.

Question 68

You have been appointed as an auditor of M/s Excellent Hotels Ltd. As a senior partner, you want to use analytical procedures in respect of room rentals as well as payroll expenses. Discuss.

Answer

Analytical Procedures: As per SA 520 on “Analytical Procedures”, in some cases, even an unsophisticated predictive model may be effective as an analytical procedure.

Analytical Procedures in case of Payroll cost- Where an entity has a known number of employees at fixed rates of pay throughout the period, it may be possible for the auditor to use this data to estimate the total payroll costs for the period with a high degree of accuracy, thereby providing audit evidence for a significant item in the financial statements and reducing the need to perform tests of details on the payroll.

Analytical Procedures in case of Room Rental Income of Hotel- Different types of analytical procedures provide different levels of assurance. Analytical procedures involving the prediction of total rental income in case of Hotel taking the room tariff rates, the number of rooms and vacancy rates into consideration, can provide persuasive evidence and may eliminate the need for further verification by means of tests of details, provided the elements are appropriately verified.
SA 530 – Audit Sampling

Question 69
Write a short note on Sampling Risk.

Or
While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind?

Answer
As per SA 530 “Audit Sampling”, the 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. Sampling risk can lead to two types of erroneous conclusions:

(i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.

(ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, 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 70
Write short notes on Statistical and Non-Statistical Sampling.

Answer
Statistical and Non-statistical Sampling: Audit sampling means the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

As per SA 530, “Audit Sampling”, the auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

There are two major methods in which the size of the sample and the selection of individual items of the sample are determined. These methods are statistical and non-statistical sampling.

(i) Statistical sampling: This is a method of audit testing which is more scientific than testing based entirely on the auditor’s own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, trade receivables’ confirmation, payroll checking, vouching of invoices and petty cash vouchers.

(ii) Non-statistical sampling: Under this method, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor. This method has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. For example, March, June & September may be selected in year one and different months would be selected in the next year. An attempt
would be made to avoid establishing a pattern of selection year after year to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.

Question 71
Describe the principal methods of selection of samples.

Answer

Principle methods of selection of samples: According to SA 530 “Audit Sampling”, the principal methods of selecting samples are the use of random selection, systematic selection, monetary unit sampling selection, haphazard selection and block selection. Each of these methods is discussed below-

(i) Random selection: This method is applied through random number generators, for example, random number tables.

(ii) Systematic selection: In this method the number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerised random number generator or random number tables.

(iii) Monetary Unit sampling: This method is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

(iv) Haphazard selection: In this method the auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

(v) Block selection: This method involves selection of a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.
SA 540 – **Auditing Accounting Estimates, Including Fair Value AE, and Related Disclosures**

**Question 72**

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**

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.

(iii) 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.

(iv) 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 73**

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**

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 recognised 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 74**

During the Audit of Data Solutions Ltd., a listed company, your audit manager observed that several estimates are made by the Company. He seeks your guidance to know areas of accounting estimates that may give rise to lower level of risk of material misstatement. Guide him with examples.

**Answer**

As per SA 540 "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures", some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.
- Accounting estimates that are frequently made and updated because they relate to routine transactions.
- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as “observable” in the context of a fair value accounting estimate.
- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.
- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.

**Question 75**

With reference to the Standards on Auditing state the examples of accounting estimates that may have a high estimation uncertainty.

**Answer**
Examples of Accounting Estimates that may have a High Estimation Uncertainty: As per SA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures", the auditor shall determine whether, in the auditor’s judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are highly dependent upon judgment, for example, judgments about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.
- Accounting estimates that are not calculated using recognised measurement techniques.
- Accounting estimates where the results of the auditor’s review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.
- Fair value accounting estimates for which a highly specialised entity-developed model is used or for which there are no observable inputs.
SA 550 – Related Parties

Question 76
Elaborate how the Statutory Auditor can verify the existence of related parties for the purpose of reporting under Accounting Standard 18.

Answer
As per 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. Example-

(i) Entity Income Tax Returns.
(ii) Information supplied by the entity to regulatory authorities.
(iii) Shareholder registers to identify the entity's principal shareholders.
(iv) Statements of conflicts of interest from management and those charged with governance.
(v) Records of the entity's investments and those of its pension plans.
(vi) Contracts and agreements with key management or those charged with governance.
(vii) Significant contracts and agreements not in the entity's ordinary course of business.
(viii) Specific invoices and correspondence from the entity's professional advisors.
(ix) Life insurance policies acquired by the entity.
(x) Significant contracts re-negotiated by the entity during the period.
(xi) Internal auditors' reports.
(xii) Documents associated with the entity's filings with a securities regulator (e.g., prospectuses).
(xiii) Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions.

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:

(i) Bank, legal and third party confirmations obtained as part of the auditor's procedures;
(ii) Minutes of meetings of shareholders and of those charged with governance; and
(iii) Such other records or documents as the auditor considers necessary in the circumstances of the entity.

Question 77
In the course of audit of Q 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.

Answer
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 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 (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 78

In the course of your audit you have come across a related party transaction which prima facie appears to be biased. How would you deal with this?

Answer

The duties of an auditor with regard to reporting of transactions with related parties as required by Accounting Standard 18 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. Since it is the management, which is primarily responsible for identification of related parties, 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 relationships and transactions.
In this case, the auditor is finding a related party transaction which prima facie appears to be biased. So the auditor is required to confirm the same. For identified significant related party transactions outside the entity’s normal course of business, the auditor shall inspect the underlying contracts or agreements, if any, and evaluate whether:

(i) The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets,

(ii) The terms of the transactions are consistent with management’s explanations; and

(iii) The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

The auditor should also obtain audit evidence that the transactions have been appropriately authorised and approved.

After 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. Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that they have disclosed to the auditor the identity of the entity’s related parties and all the related party relationships and transactions of which they are aware; and they have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

Finally, the auditor should report on the basis of this fact that the related party relationships and transactions prevent the financial statements from achieving true and fair presentation (for fair presentation frameworks); or they are not cause for the financial statements to be misleading (for compliance frameworks).

**Question 79**

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.

**Answer**

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 80**

You are the Auditor of Power Supply Corporation Limited, a Government Company for the year ended on 31st March 2020. 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 in compliance with Ind AS for the year ended on 31/03/2020 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.

Analyse this issue in finalizing the Audit Report.

**Answer**

**Related Party Disclosures** : As per Ind AS 24, "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 referred 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:
   - the nature and amount of each individually significant transaction; and
   - for other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent.

Further, as per SA 550 Related Parties, in forming an opinion on the financial statements in accordance with SA 700, 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.
SA 560 – Subsequent Events

Question 81
Briefly describe the auditor’s responsibility regarding subsequent events.

Answer
When the auditor draws up his audit plan, checking of subsequent events is an important audit procedure irrespective of the level of test checks employed for checking of the transactions during the year. In fact more detailed check is normally required for subsequent events to confirm certain assertions contained in the financial statements, e.g., the payment made by debtors after the close of accounting period would confirm that outstanding debtors on the date of the balance sheet date have been realised. SA 560 on “Subsequent Events” establishes standards on the auditor's responsibility regarding subsequent events. SA 560 on "Subsequent Events" states that the term "subsequent events" refers to events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report. AS 4 on " Contingencies and Events Occurring after the Balance Sheet Date" deals with all those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and by the corresponding approving authority in the case of any other entity. As per AS 4, two types of events can be identified:(a) those which provide further evidence of conditions that existed at the balance sheet date; and (b) those which are indicative of conditions that arose subsequent to the balance sheet date. SA 560 lays down that the auditor should consider the effect of subsequent events on the financial statements and on the auditor's report. When the time between the close of the year-end and the adoption of accounts is about to take place, examination of subsequent events gains more importance.

SA 560 further requires that 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 above 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. 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 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.
Question 82
A fire broke out on 15th May, 2020, in which material worth ₹ 50 lakhs which was lying in inventory since 1st March, 2020 was totally destroyed. The financial statements of the company have not been adopted till the date of fire. The management of the company argues that since the loss occurred in the year, 2020-21, no provision for the loss needs to be made in the financial statements for 2019-20.

Answer
This case requires attention to SA 560 "Subsequent Events" and AS 4 "Contingencies and Events occurring after the Balance Sheet Date".

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 or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

AS 4 also requires disclosure of the non-adjusting event, in the report of the approving authority.

Further, 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.

The event took place after the close of the accounting year and does not relate to conditions existing at the balance sheet date. Thus, it will have no effect on items appearing at the balance sheet date because as per AS 4 "Contingencies and Events Occurring after Balance Sheet Date" have to be adjusted that provide evidence of conditions existing as at the balance sheet date. However, the auditor has to ensure that this loss will not materially affect the substratum of the enterprises as per its size, nature and complexity of operations.

Thus, subject to satisfaction in respect of non-violation of going concern concept, the company has correctly accounted by not providing provision. However, the auditor is required to ensure the proper disclosure of abovementioned event.

Question 83
A Co. Ltd. has not included in the Balance Sheet as on 31-03-2020 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 30-04-2020. The auditor wants to sign the said Balance Sheet and give the audit report on 31-05-2020. The auditor came to know the result of the negotiations on 15-05-2020. Comment.

Answer
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. 31-3-2020 to the date of Auditors Report i.e. 31-05-2020. 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 2018-19 and 2019-20 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 cores by making provision for expenses. If the management does not accept the request the auditor should qualify the audit report.

### Question 84

Amudhan & Co., are the Auditors of XYZ Company Ltd., for the year ended on 31/03/2020. The Audit Report for that year was signed by the Auditors on 04/05/2020. The Annual General Meeting was decided to be held during the month of August 2020. On 06/05/2020, the Company had received a communication from the Central Government that an amount of ₹ 5800 crore kept pending on account of incentives pertaining to Financial Year 2019-20 had been approved and the amount would be paid to the Company before the end of May 2020. To a query to Chief Financial officer of the Company by the Board, it was informed that this amount had not been recognised in the Audited Financial Statements in view of the same not being released before the close of the Financial Year and due to uncertainty 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 31/03/2020. On 08/05/2020, 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 31/03/2020. Analyse 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

**Facts Which Become Known to the Auditor After the Date of the Auditor's Report but Before the Date the Financial Statements are Issued:** 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

(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 2019-20 in the month of May 2020 i.e. after finalisation of financial
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statements and signing of audit report. Board of Directors of XYZ Ltd. amended the accounts, approved the same and requested the Amudhan & Co. (auditor) to consider this event and issue a fresh audit report on the financial statements for the year ended on 31.03.2020.

After applying the conditions given in SA 560, Amudhan & 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 85

M/s LMP Associates, Chartered Accountants, while conducting the audit of PQR 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 LMP Associates with the matters where specific enquiry may be conducted to evaluate subsequent events.

Answer

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.
SA 570 – Going Concern

Question 86

ABC Company files a law suit against Unlucky Company for ₹ 5 crores. The Attorney of Unlucky Company feels that the suit is without merit, so Unlucky Company merely discloses the existence of the law suit in the notes accompanying its financial statements. As an auditor of Unlucky Company, how will you deal with the situation?

Answer

As per AS 29 "Provisions, Contingent liabilities and Contingent Assets", a contingent liability is a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

Further, 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 event will occur.

As per SA 570 “Going Concern”, there are certain examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy is one of the example of such event.

When the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements adequately describe 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 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, there may be unable to realize its assets and discharge its liabilities in the normal course of business.

In the instant case, ABC Company has filed a law suit against Unlucky Company for ₹ 5 crores. Though, the attorney of Unlucky Company feels that the suit is without merit so the company merely discloses the existence of law suit in the notes accompanying its financial statements. But the auditor may evaluate the source data on which basis the opinion is formed. If the auditor finds the uncertainty, he may request the management to adjust the sum of ₹ 5 crore by making provision for expenses as per AS 29. If the management does not accept the request the auditor should qualify the audit report.

Question 87

A Company's net worth is eroded and trade payables are unpaid due to liquidity constraints. The management represents to the statutory auditor that the promoter's wife is expected to give an unsecured loan to meet the liquidity constraints and that negotiations are underway to secure large export orders.

Answer

In this case, it is subjective, but prima-facie a mere expectation of future cash flows from the promoter's wife without any firm commitment and the possibility of an export order being negotiated, may not that be sufficient appropriate audit evidence of mitigating factors for resolving the going concerns question under SA 570 “Going Concern".
Question 88

While examining the going concern assumption of an entity, what important indications should be evaluated and examined?

Answer

SA 570 "Going Concern", requires that while planning a performing audit procedure and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements. In assessing such a risk, the auditor should examine the following indications-

Financial Indications:

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows. Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating Indications:

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labor difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other Indications:

- Non-compliance with capital or other statutory or regulatory requirements, such as solvency or liquidity requirements for financial institutions.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management’s plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

**Question 89**

M/s T K Projects Limited, a manufacturing company in the Steel industry was allegedly involved in some irregularity relating to allotment of coal blocks for which a complaint was lodged against the company by the government. The financial institutions stopped additional working capital finance which caused a financial crisis resulting in stoppage of production. The company incurred a massive loss during the year 2019-20. There were delays in salary and other payments. Certain key managerial personnel including GM Finance and certain other employees left the company. The company has no sound action plan to mitigate these situations. Guide the statutory auditor on how he should deal with this situation.

**Answer**

As per SA 570 on “Going Concern”, it is the responsibility of the auditor to obtain sufficient appropriate audit evidence about the appropriateness of management’s use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity’s ability to continue as a going concern. The auditor shall evaluate management’s assessment of the entity’s ability to continue as a going concern. In evaluating management’s assessment, the auditor shall consider whether management’s assessment includes all relevant information of which the auditor is aware as a result of the audit.

In the instant case, M/s T K Projects Limited has incurred massive loss during the year 2019-20 as the financial institutions have stopped financing additional working capital to the company because of a complaint which was lodged against the company by government for involvement in some irregularity relating to allotment of coal blocks. There were delays in salary and other payments. Besides this, certain key managerial personnel, GM Finance and certain other employees have also left the company. The company, in addition, has no sound action plan to mitigate these situations. Thus, there are clear indications that there is danger to entity’s ability to continue in future. Considering the fact that there is no sound plan of action to mitigate these factors, the going concern assumption does not seem appropriate.

Therefore, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified opinion or adverse opinion, as appropriate, in accordance with SA 705 (Revised). But, if the result of the appropriate assumption used in the preparation of financial statements is material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion 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.

**Question 90**

MNO 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 2019. The company invited prospective lenders, investors and others to submit their resolution plans to the Resolution Professional (RP) latest by 1 January 2020. 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 2020 and the resolution plan submitted by PQR Ltd. was evaluated as highest evaluated Compliant Resolution Plan. CoC of MNO Ltd. approved the Resolution Plan submitted by PQR Ltd. on 2 March 2020. The approval of NCLT was finally obtained on 4 May 2020.

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 you would deal with this situation as the auditors of MNO Ltd.

**Answer**

**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 include:

(i) 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.

(ii) 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.

(iii) 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 -

1. Evaluating the reliability of the underlying data generated to prepare the forecast; and
2. Determining whether there is adequate support for the assumptions underlying the forecast.

(iv) Considering whether any additional facts or information have become available since the date on which management made its assessment.

(v) 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 MNO 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 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 91

Toddle Limited had definite plan of its business being closed within a short period from the close of the accounting year ended on 31st March, 2020. The Financial Statements for the year ended 31/03/2020 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.

Answer

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 emphasises 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 Toddle Limited had definite plan of its business being closed down within short period from 31 March, 2020. However, financial statements for the year ended 31.03.2020 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. 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, be made at the time of cessation only by the auditor in his report is not sufficient.

Question 92

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 31/03/2020 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

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.
SA 580 – Written Representations

Question 93

Explain what is meant by "Written Representations" and indicate to what extent an auditor can place reliance on such representations.

Answer

A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Thus written representations are necessary information that the auditor requires in connection with the audit of the entity’s financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management’s responsibilities, or about specific assertions.

The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement. Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations.

Extent of Reliance: SA 580, "Written Representations", states that If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general.

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

Question 94

State briefly the basic elements of Management Representation Letter.

Answer

As per SA 580 "Written Representations", some of the basic elements of a Management Representation letter are-

(1) It is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

(2) It does not include financial statements, assertions therein, or supporting books and records.
(3) The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.

(4) The written representations shall be for all financial statements and period(s) referred to in the auditor’s report.

**Question 95**

In the course of audit of ABC Ltd. its management refuses to provide written representations. As an auditor what is your duty?

**Answer**

As per SA 580 “Written Representations”, if the management does not provide one or more of the requested written representations, the auditor shall:

(i) Discuss the matter with management,

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

(iii) Take appropriate actions, including determining the possible effect on the opinion in the auditor’s report.

The auditor should disclaim an opinion on the financial statements if management does not provide written representations in accordance with SA 705 “Modifications to the Opinion in the Independent Auditor’s Report”.

**Question 96**

An auditor of Sagar Ltd. was not able to get the confirmation about the existence and value of certain machineries. However, the management gave him a certificate to prove the existence and value of the machinery as appearing in the books of account. The auditor accepted the same without any further procedure and signed the audit report. Is he right in his approach?

**Answer**

The physical verification of fixed assets is the primary responsibility of the management. The auditor, however, is required to examine the verification programme adopted by the management. He must satisfy himself about the existence, ownership and valuation of fixed assets. In the case of Sagar Ltd., the auditor has not been able to verify the existence and value of some machinery despite the verification procedure followed in routine audit. He accepted the certificate given to him by the management without making any further enquiry.

As per SA 580 “Written Representations”, when representation relate to matters which are material to the financial information, then the auditor should seek corroborative audit evidence from other sources inside or outside the entity.

He should evaluate whether such representations are reasonable and consistent with other evidences and should consider whether individuals making such representations can be expected to be well informed on the matter. “Written Representations” cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available.

If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter. Therefore, the approach adopted by the auditor is not right.
Question 97

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

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 98

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.

Answer

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.
SA 580, "Written Representations" discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognised 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.

(iv) That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.
SA 600 – Using the Work of Another Auditor

Question 99

“There should be sufficient liaison between a principal auditor and other auditors”. Discuss the above statement and state in this context the reporting considerations, when the auditor uses the work performed by other auditor.

Answer

SA 600 on “Using the Work of Another Auditor” lays down the procedure to be applied in situations where a principal auditor reporting on the financial statement of the entity uses the work of another independent auditor. SA 600 contemplates coordination between auditors and requires that there should be sufficient liaison between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue written communication(s) to the other auditor.

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 any significant findings requiring to be dealt with at entity level, adhering to the time-table for audit of the component, etc. He should ensure compliance with the relevant statutory requirements. Similarly, 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.

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. The other auditor should respond to such questionnaire on a timely basis.

When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation on the scope of audit.

In all circumstances, if the other auditor issues, or intends to issue, a modified auditor’s report, the principal auditor should consider whether the subject of the modification is of such nature and significance, in relation to the financial information of the entity on which the principal auditor is reporting that it requires a modification of the principal auditor’s report.

Question 100

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?

Answer

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.

**Question 101**

B Ltd is the Subsidiary company of A Ltd. ABC & Associates has been appointed as auditor of A Ltd. for the Financial Year 2019-20 and XYZ & Associates has been appointed as auditor of B Ltd for the year 2019-20. Explain the role of ABC & Associates and XYZ & Associates as auditors of the parent company and subsidiary respectively.

**Answer**

**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 (ABC & Associates- Auditor of Parent Company):**

1. It is necessary to issue written communication(s) as a principal auditor to the other auditor.
2. 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 (XYZ & 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 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 on a timely basis sent by Principal Auditor.
SA 610 – Using the Work of Internal Auditors

Question 102

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?

Answer

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.

Question 103

OPQ Ltd is in the business of software consultancy. The company has had large balances of accounts receivables in the past years which have been assessed as area of high risk. For the year ended 31 March 2020, in respect of the valuation of accounts receivable, the statutory auditor has assigned the checking of the accuracy of the aging of the accounts receivables and provision based on ageing to the internal auditor providing direct assistance to him. Please advise.

Answer

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 104

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.

(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?

Answer

(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.
Question 105

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 2019-20. 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.

Explain the responsibility of auditors, in case, report made by Mr. Y’s actuary, later on, found faulty.

Answer

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 an auditor 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 found faulty. Further, Mr. Z is not agreed 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 grossly 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 106

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?

Answer

As 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.

Question 107

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

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 108

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.

Or

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.

Answer

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.

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.
Question 109

Mr. Mohan, an auditor of KTEN Limited wants to use the work of an expert. With reference to the Standard on Auditing state the factors which suggest the need for detailed and written agreement between the auditor and the auditor’s expert.

Answer

As per SA 620, “Using the work of an Auditor’s Expert”, some of the matters may affect the level of detail and formality of the agreement between the auditor and the auditor’s expert, including whether it is appropriate that the agreement be in writing. For example, the following factors may suggest the need for more a detailed agreement than would otherwise be the case, or for the agreement to be set out in writing:

- The auditor’s expert will have access to sensitive or confidential entity information.
- The respective roles or responsibilities of the auditor and the auditor’s expert are different from those normally expected.
- Multi-jurisdictional legal or regulatory requirements apply.
- 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.
SA 700 – Forming an Opinion and Reporting on Financial Statements

Question 110

Enumerate the 'Basic Elements of Audit Report' as enshrined in SA 700.

Answer

As per SA 700, "Forming an Opinion and Reporting on Financial Statements", the auditor’s report includes the following basic elements:

1. **Title:** The auditor’s report shall have a title that clearly indicates that it is the report of an independent auditor.

2. **Addressee:** The auditor’s report shall be addressed as required by the circumstances of the engagement.

3. **Auditor's Opinion:** The first section of the auditor’s report shall include the auditor's opinion, and shall have the heading "Opinion."

   **The Opinion section of the auditor’s report shall also:**
   
   (a) Identify the entity whose financial statements have been audited;
   
   (b) State that the financial statements have been audited;
   
   (c) Identify the title of each statement comprising the financial statements;
   
   (d) Refer to the notes, including the summary of significant accounting policies; and
   
   (e) Specify the date of, or period covered by, each financial statement comprising the financial statements.

4. **Basis for Opinion:** The auditor’s report shall include a section, directly following the Opinion section, with the heading “Basis for Opinion”, that:

   (a) States that the audit was conducted in accordance with Standards on Auditing;
   
   (b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the SAs;
   
   (c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall refer to the Code of Ethics issued by ICAI;
   
   (d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

5. **Going Concern:** Where applicable, the auditor shall report in accordance with SA 570

6. **Key Audit Matters:** For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor’s report in accordance with SA 701.

   When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor’s report, the auditor shall do so in accordance with SA 701.

7. **Responsibilities for the Financial Statements:** The auditor’s report shall include a section with a heading “Responsibilities of Management for the Financial Statements.” The auditor’s report shall use the term that is appropriate in the context of the legal framework applicable to the entity and need not refer specifically to "management". In some entities, the appropriate reference may be to those charged with governance.

8. **Auditor's Responsibilities for the Audit of the Financial Statements.**

9. **Location of the description of the auditor's responsibilities for the audit of financial statements.**

10. **Other Reporting Responsibilities.**

11. **Signature of the Auditor.**
SA 701 – **Communicating Key Audit Matters in the Independent Auditor’s Report**

**Question 111**

Write a short note on the purpose of communicating key audit matters.

**Answer**

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 112**

As an auditor of a listed company for the year ended 31st March, 2020, how would you determine the 'Key Audit Matters'?

**Answer**

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, “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.

The auditor shall determine which of the matters determined above were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.
SA 705 – **Modifications to the Opinion in the Independent Auditor's Report**

**Question 113**

What are the professional obligations of the auditor who has withdrawn from the audit before completion of his term due to non co-operation of the Management in completing certain audit procedures?

**Answer**

SA 705 "Modifications to the Opinion in the Independent Auditor's Report" provides the consequence of an inability to obtain sufficient appropriate audit evidence due to a management – imposed limitation after the auditor has accepted the engagement.

The practicability of withdrawn from the audit may depend upon the stage of completion of the engagement at the time that management imposes the scope limitation.

When the auditor concludes that withdrawn from the audit is necessary because of a scope limitation, there may be a professional, regulatory or legal requirement for the auditor to communicate matters relating to the resignation from the engagement to regulators or the entity's owners.

In the case of resignation from the company, provisions of the Companies Act, 2013 applies. Section 140(2) of the Companies Act, 2013, requires the auditor, who has resigned from the company, to file within a period of 30 days from the date of resignation, a statement with the company and the registrar, and in case of government companies, the auditor shall file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor will be liable for penal provisions.

**Question 114**

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**

Modifications in Audit Report: As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", 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.

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.

Types of Modification to the Auditor's Opinion: As per SA 705, "Modifications to the Opinion in the Independent Auditor's Report", modified opinion may be defined as a qualified opinion, an adverse opinion or a disclaimer of opinion.

Types of modifications possible to the said report are below-mentioned:

(i) **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.

(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.
SA 706 – Emphasis of Matter Paragraphs & Other Matter Paragraphs in Independent Auditor's Report

Question 115
Write a short note on Emphasis of matter paragraph in Audit Reports.

Answer

Emphasis of Matter Paragraph in Audit Reports: An auditor's report can be modified for matters that do not affect the auditor's opinion. An “emphasis of matter” paragraph is such a type of modification in an audit report. In certain circumstances, such a paragraph is added to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such a paragraph does not affect the auditor's opinion.

SA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", deals with additional communication in the auditor's report when 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 the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements.

Specific requirements for the auditor to include Emphasis of Matter paragraphs in the auditor’s report in certain circumstances. These circumstances include:

• When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
• To alert users that the financial statements are prepared in accordance with a special purpose framework.
• When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).

Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

• An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
• A significant subsequent event that occurs between the date of the financial statements and the date of the auditor’s report.1
• Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
• A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

However, a widespread use of Emphasis of Matter paragraphs may diminish the effectiveness of the auditor’s communication about such matters.
SA 710 – Comparative Information – Corresponding Figures and Comparative Financial Statements

Question 116
Write a short note on Auditor's responsibilities regarding comparatives.

Answer
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.

Question 117
Write a short note on Corresponding figures.

Answer
As per SA 710 “Comparative Information—Corresponding Figures and Comparative Financial Statements”, “corresponding figures” is a comparative information where amounts and other disclosures for the preceding period are included as part of the current period financial statements, and are intended to be read in relation to the amounts and other disclosures relating to the current period. These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures.

Question 118
What are the auditor's responsibilities in respect of corresponding figures?

Answer
As per SA 710 “Comparative Information—Corresponding Figures and Comparative Financial Statements”, in respect of corresponding figures, the auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor
shall evaluate whether:

(a) The comparative information agrees with the amounts and other disclosures presented in the prior period; and

(b) 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 "Subsequent Events".

As required by SA 580, "Written Representations", 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.

**Question 119**

The audit report of P Ltd. for the year 2018-19 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2019-20, how would you report, if:

(i) The company does not make provision for doubtful debts in 2019-20?

(ii) The company makes adequate provision for doubtful debts in 2019-20?

**Answer**

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.
SA 720 – The Auditor’s Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements

Question 120
LMP Associates, Chartered Accountants, conducting the audit of PQR Ltd., a listed Company for the year ended 31st March 2020 is concerned with the auditor's responsibilities relating to other information, both financial and non-financial, included in the Company's annual report. While reading other information, LMP Associates considers whether there is a material inconsistency between other information and the financial statements. As a basis for the consideration the auditor shall evaluate their consistency, compare selected amounts or other items in the other information with such amounts or other items in the financial statements. Guide LMP Associates with examples of "Amounts" or "other items" that may be included in the "other information" with reference to SA 720.

Answer
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 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.