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PAPER – 6: AUDITING AND ASSURANCE

PART – I : ACADEMIC UPDATE
(Legislative Amendments / Notifications / Circulars / Rules / Guidelines issued by Regulating Authority)

1. In exercise of powers conferred by section 143 read with sub-sections (1) and (2) of section 469 of the Companies Act, 2013 (18 of 2013), the Central Government hereby inserted the clause "(d) whether the company had provided requisite disclosures in its financial statements as to holdings as well as dealings in Specified Bank Notes during the period from 8th November, 2016 to 30th December, 2016 and if so, whether these are in accordance with the books of accounts maintained by the company.", after clause (c) in rule 11 of the Companies (Audit and Auditors) Rules, 2014.

2. In exercise of the powers conferred by section 139 read with sub-sections (1) and (2) of section 469 of the Companies Act, 2013 (18 of 2013), the Central Government hereby makes the following rules further to amend the Companies (Audit and Auditors) Rules, 2014, namely:—

"In the Companies (Audit and Auditors) Rules, 2014, in rule 5, in clause (b), for the word "twenty", the word "fifty" shall be substituted"

The impact of this amendment on the study material would be :

1. Point no. (II) - para 3.1 on page number 10.13 be read as -

   all private limited companies having paid up share capital of rupees fifty crores or more;

2. In diagram appearing at page number 10.14, line in the middle box be read as -

   all private limited companies having paid up share capital ≥ ₹ 50 crore

For more details students may refer below mentioned link: http://www.mca.gov.in/Ministry/pdf/CompaniesAuditandAuditorsSecondAmendmentRules2017.pdf

3. MCA vide Notification S.O. 2218(E) dated 13th July 2017 with respect to the Notification G.S.R. 583(E) Dated 13th June, 2017 (Corrigendum), stated that for the words "statement or" to read as "statement and" under section 143(3)(i).

4. Notification No. G.S.R. 583(E) dated 13th June, 2017 stated that requirements of reporting under section 143(3)(i) read Rule 10 A of the Companies (Audit and Auditors) Rules, 2014 of the Companies Act 2013 shall not apply to certain private companies. Clarification regarding applicability of exemption given to certain private companies under section 143(3)(i) (vide circular no. 08/2017 dated 25th July 2017) clarified that the exemption shall be applicable for those audit reports in respect of financial statements pertaining to

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financial year, commencing on or after 1st April, 2016, which are made on or after the date of the said notification.

5. The Central Government amends the Notification G.S.R. 464(E), dated 5th June 2015 Vide Notification G.S.R. 583(E) Dated 13th June, 2017. Amendments are given below:

(1) Section 143(3)(i), shall not apply to a private company:-

(i) which is a one person company or a small company; or

which has turnover less than rupees fifty crore as per latest audited financial **statement or** which has aggregate borrowings from banks or financial institutions or anybody corporate at any point of time during the financial year less than rupees twenty five crore."

PART – II: QUESTIONS AND ANSWERS

QUESTIONS

1. State with reason (in short) whether the following statements are true or false:

(i) The objective of audit is to obtain absolute assurance and to report on the financial statements.

(ii) Teeming and lading is one of the techniques of suppressing cash receipts.

(iii) There is direct relationship between materiality and the degree of audit risk.

(iv) As per SA 230 on "Audit Documentations", the working papers are not the property of the auditor.

(v) Control risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

(vi) As per section 138 of the Companies Act, 2013 private companies are not required to appoint internal auditor.

(vii) The term "internal audit" is defined as the "checks on day to day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud".

(viii) A Chartered Accountant holding securities of S Ltd. having face value of ₹ 950 is qualified for appointment as an auditor of S Ltd.

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(ix) Manner of rotation of auditor will not be applicable to company A, which is having paid up share capital of ₹ 15 crores and having public borrowing from nationalized bank of ₹ 50 crore because it is a Private Limited Company.

(x) If LLP (Limited Liability Partnership Firm) is appointed as an auditor of a company, every partner of a firm shall be authorized to act as an auditor.

Chapter 1- Nature, Objective and Scope of Audit

2. (a) As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement and when considering acceptance of a new engagement with an existing client. Explain

(b) GST & Co., a firm of Chartered Accountants has been appointed to audit the accounts of XYZ Ltd. The partner wanted to cover principal aspects while conducting its audit of financial statements. Advise those principal aspects.

3. (a) 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. Explain.

(b) "An auditor who before the completion of the engagement is requested to change the engagement to one which provides a lower level of assurance should consider the appropriateness of doing so." Discuss.

Chapter 2- Audit Strategy, Audit Planning and Audit Programme

4. (a) Surya and Chand Ltd is a manufacturing company engaged in the production of miscellaneous electrical goods. Trilochan and Co. has been appointed as the auditors to carry out its audit. Auditor thinks that Planning an audit would involve establishing the overall audit strategy for the engagement and developing an audit plan. Also, Adequate planning benefits the audit of financial statements in several ways. Analyse and Advise explaining the benefits of adequate planning.

(b) 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. Discuss stating the factors that may affect the identification of an appropriate benchmark

5. (a) Evolving one audit programme applicable to all audit engagements under all circumstances is not practicable. Explain

(b) Arpana Hospitals Ltd having Gross Professional Charges of ₹ 50 crores is engaged in providing healthcare services. STP & Co., a firm of auditors is appointed as its auditors.

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Advise what special points to be kept in mind for the purpose of construction of an Audit programme. Explain.

Chapter 3- Audit Documentation and Audit Evidence

6. (a) State the significant difficulties encountered during audit with reference to SA-260 (communication with those charged with governance).

   (b) Evaluating responses to inquiries is an integral part of the inquiry process. Explain.

7. (a) Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. Discuss.

   (b) The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement. Auditor's judgment as to sufficiency may be affected by few factors. Explain.

8. (a) "Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability". Explain. Also state clearly generalisations about the reliability of audit evidence.

   (b) The auditor P of PAR and Co., a firm of Chartered Accountants is conducting audit of AB Industries Ltd. The auditor requests management to provide Banker's certificate in support of Fixed deposits whereas management provides only written representation on the matter.

   Analyse how would you deal as an auditor

Chapter 4- Risk Assessment and Internal Control

9. (a) 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 judgment as to which risks are significant risks, state the factors which shall be considered by the auditor.

   Explain the above in context of SA-315.

   (b) Discuss what is included in risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls.

10. (a) "A satisfactory control environment is not an absolute deterrent to fraud although it may help reduce the risk of fraud." Explain.

    (b) The auditor of XYZ Ltd, engaged in FMCG (Fast Moving Consumable Goods) obtains an understanding of the control environment. As part of obtaining this understanding, the auditor evaluates whether:

    (i) Management has created and maintained a culture of honesty and ethical behavior; and

    (ii) The strengths in the control environment elements collectively provide an

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appropriate foundation for the other components of internal control.

Advise what is included in control environment. Also explain the elements of control environment.

Chapter 5- Fraud and Responsibilities of the Auditor in this Regard.

11. (a) Saburi Yarns Ltd is engaged in manufacturing and trading of yarns of different types. Its huge amount is locked up in account receivables. Moreover, Management of Saburi Yarns Ltd is worried about its Internal Control system over receipts from account receivables and other receipts. Management wants to understand from you as an auditor few techniques as to how receipts can be suppressed resulting into frauds and finally incurring losses.

    (b) Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Explain.

12. The scope of auditor's inquiry under **clause (x)** of paragraph 3 of Companies (Auditor's Report) Order, 2016 is restricted to frauds 'noticed or reported' during the year. Explain.

Chapter 6- Audit in an Automated Environment

13. Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.

    Explain stating the points that an auditor should consider to obtain an understanding of the company's automated environment.

14. Discuss the impact of IT related risks on Substantive Audit, Controls and Reporting.

Chapter 7- Audit Sampling

15. Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. Discuss explaining Statistical and Non Statistical sampling approaches.

16. XYZ Ltd is engaged in trading of electronic goods and having huge accounts receivables. For analysing the whole accounts receivables, auditor wanted to use sampling technique. In considering the characteristics of the population from which the sample will be drawn, the auditor determines that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques. Advise the auditor in accordance with SA 530.

Chapter 8 - Analytical Procedures

17. Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Explain stating the purpose of analytical procedures with examples.

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18. Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales).

    Explain stating the techniques available as substantive analytical procedures.

Chapter 9 - Audit of Items of Financial Statements

19. ABC Ltd. has issued shares for cash at a premium of Rs 450, that is, at amount in excess of the nominal value of the shares which is Rs 10 for cash. Section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account. Advise the means in which the amount in the account can be applied.

20. The auditor A of ABC & Co.- firm of auditors is conducting the audit of XYZ Ltd and while performing testing of additions wanted to verify that all PPE (Property Pland and Equipment) purchase invoices are in the name of the entity he is auditing. For all additions to land, building in particular, the auditor desires to have concrete evidence about ownership. The auditor is worried about whether the entity has valid legal ownership rights over the PPE claimed to be held by the entity and recorded in the financial statements. Advise the auditor.

Chapter 10 - The Company Audit

21. Examine the following:

    (a) "**Section 139(1)** of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an auditor who shall hold office till the conclusion of its sixth annual general meeting".

    (b) Filling of a casual vacancy of auditor in respect of a company audit.

22. (a) M/s RM & Co. is an audit firm having partners CA. R and CA. M. The firm has been offered the appointment as an auditor of Enn Ltd. for the Financial Year 2016-17. Mr. Bee, the relative of CA. R, is holding 5,000 shares (face value of ₹ 10 each) in Enn Ltd. having market value of ₹ 1,50,000. Whether M/s RM & Co. is disqualified to be appointed as auditors of Enn Ltd.? Advise.

    (b) CA. Poshin is providing the services of investment banking to C Ltd. Later on, he was also offered to be appointed as an auditor of the company for the current financial year. Advise.

23. (a) Rano Pvt. Ltd. is a private limited Company, having paid up share capital of ₹ 45 crore but having public borrowing from nationalized banks and financial institutions of

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₹ 40 crore. Advise the company on the applicability of rotation of auditors.

(b) Discuss the matters to be included in the auditor's report regarding statutory dues and repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders as per CARO, 2016.

Chapter 11 - Audit Report

24. Communicating Key Audit Matter is not a substitute for disclosure in the Financial Statements rather Communicating key audit matters in the auditor's report is in the context of the Auditor having formed an opinion on the financial statements as a whole. Analyse.

25. The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

    This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

    Advise about qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Chapter 12- Bank Audit

26. Your firm of Chartered Accountants has been appointed as the Auditor of two branches of OBC which are located in the Industrial area. Considering that the location of the branches of bank in industrial area, these would be "advances oriented branches and audit of advances would require the major attention of the auditors. Advise how would you proceed to obtain evidence in respect of audit of advances.

Chapter 13- Audit of Different Types of Entities

27. (a) An audit of Expenditure is one of the major components of Government Audit. In the context of 'Government Expenditure Audit', write in brief, what do you understand by:

    (i) Audit against Rules and Orders

    (ii) Audit of Sanctions

    (iii) Audit against Provision of Funds

    (iv) Propriety Audit

    (v) Performance Audit.

    (b) Explain in detail the duties of Comptroller and Auditor General of India.

28. What are the special steps involved in conducting the audit of an Educational Institution?

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SUGGESTED ANSWERS / HINTS

1. (i) **Incorrect:** As per SA-200 "Overall Objectives of the Independent Auditor", in conducting an audit of financial statements, the overall objectives of the auditor are:

   (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement; and

   (b) To report on the financial statements, and communicate as required by the SAs, in accordance with the auditor's findings.

   (ii) Correct: Teeming and Lading is one of the techniques of suppressing cash receipts Money received from one customer is misappropriated and the account is adjusted with the subsequent receipt from another customer and so on.

   (iii) Incorrect: There is an inverse relationship between materiality and the degree of audit risk. The higher the materiality level, the lower the audit risk and vice versa. For example, the risk that a particular account balance or class of transactions could be misstated by an extremely large amount might be very low but the risk that it could be misstated by an extremely small amount might be very high.

   (iv) Incorrect: As per SA 230 on "Audit Documentations" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

   (v) Incorrect: Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

   (vi) Incorrect: Section 138 of the Companies Act, 2013 requires every private company to appoint an internal auditor having turnover of ₹ 200 crore or more during the preceding financial year; or outstanding loans or borrowings from banks or public financial institutions exceeding ₹ 100 crore or more at any point of time during the preceding financial year.

   (vii) Incorrect: As defined in scope of Standards on Internal Audit, "Internal Audit means an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's strategic risk management and internal control system".

   (viii) Incorrect: As per the provisions of the Companies Act, 2013, a person is disqualified to be appointed as an auditor of a company if he is holding any security of or interest in the company.

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As the chartered accountant is holding securities of S Ltd. having face value of ₹ 950, he is not eligible for appointment as an auditor of S Ltd.

(ix) **Incorrect:** According to section 139 of the Companies Act, 2013, the provisions related to rotation of auditor are applicable to all private limited companies having paid up share capital of ₹ 50 crore or more; and all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of ₹ 50 crore or more.

Although company A is a private limited company having paid up share capital of ₹ 15 crores yet it is having public borrowings from nationalized bank of ₹ 50 crores, therefore it would be governed by provisions of rotation of auditor.

(x) **Incorrect:** As per section 141(2) of the Companies Act, 2013, where a firm including a limited liability partnership (LLP) is appointed as an auditor of a company, only the partners who are Chartered Accountants shall be authorised to act and sign on behalf of the firm.

Chapter 1- Nature, Objective and Scope of Audit

2. **(a)** **Information which assist the Auditor in accepting and continuing of relationship with Client**: As per SA 220, "Quality Control for an Audit of Financial Statements" the auditor should obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement and when considering acceptance of a new engagement with an existing client. The following information would assist the auditor in accepting and continuing of relationship with the client:

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

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

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

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

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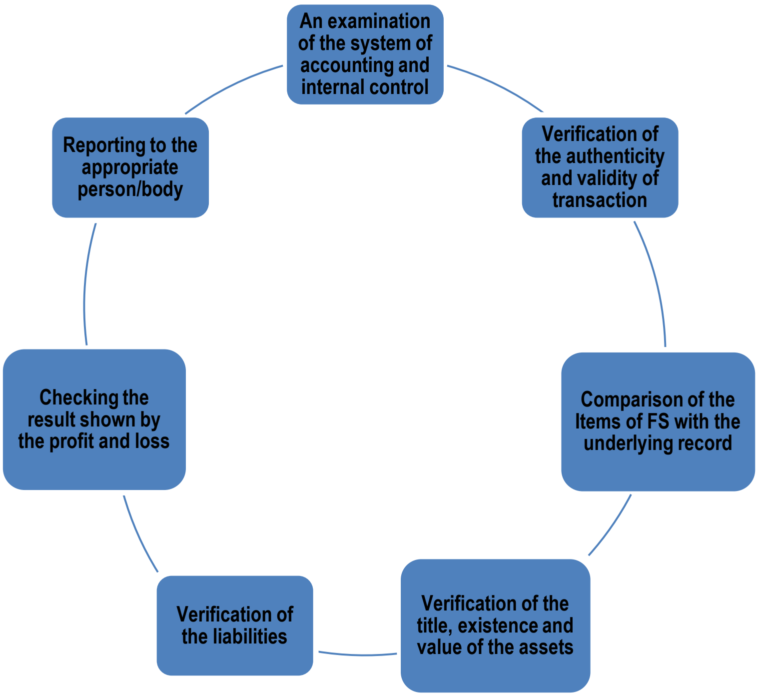
(b) The principal aspects to be covered in an audit concerning final statements of account are the following:



(i) **An examination of the system of accounting and internal control** to ascertain whether it is appropriate for the business and helps in properly recording all transactions.

(ii) **Reviewing the system and procedures** to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.

(iii) **Checking of the arithmetical accuracy of the books of account** by the verification of postings, balances, etc.

(iv) **Verification of the authenticity and validity of transaction** entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

(v) **Ascertaining that a proper distinction has been made between items of capital and of revenue nature** and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.

(vi) **Comparison of the balance sheet and profit and loss account or other statements with the underlying record** in order to see that they are in accordance therewith.

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(vii) **Verification of the title, existence and value of the assets** appearing in the balance sheet.

Assertions about account balances at the period end: (i) Existence—assets, liabilities, and equity interests exist. (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity. (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded. (iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(viii) **Verification of the liabilities** stated in the balance sheet.

(ix) **Checking the result shown by the profit and loss** and to see whether the results shown are true and fair.

(x) **Where audit is of a corporate body, confirming that the statutory requirements** have been complied with.

(xi) **Reporting to the appropriate person/body** whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

3. (a) Timeliness of Financial Reporting and the Balance between Benefit and Cost: 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. Appropriate planning assists in making sufficient time and resources available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. There is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

(b) Acceptance of a Change in Engagement: An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the

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scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement, especially any legal or contractual implications.

If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to-

(i) the original engagement; or

(ii) any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall-

(i) Withdraw from the audit engagement where possible under applicable law or regulation; and

(ii) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Chapter 2- Audit Strategy, Audit Planning and Audit Programme

4. (a) Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following:

1. Helping the auditor to devote appropriate attention to important areas of the audit.
2. Helping the auditor identify and resolve potential problems on a timely basis.
3. Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
4. Assisting in the selection of engagement team members with appropriate levels

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of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.

5. Facilitating the direction and supervision of engagement team members and the review of their work.

6. Assisting, where applicable, in coordination of work done by auditors of components and experts.

(b) Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. **Factors that may affect the identification of an appropriate benchmark include the following:**

- The elements of the financial statements

  Example - assets, liabilities, equity, revenue, expenses;

- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused

  Example - for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets.

- The nature of the entity, where the entity is at in its life cycle, and the industry and economic environment in which the entity operates;

  The entity's ownership structure and the way it is financed and

  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);

  The relative volatility of the benchmark.

5. (a) Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. On account of such variations, evolving one audit programme applicable to all businesses under all circumstances is not practicable. However, it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

(b) For the purpose of programme construction, the following points should be kept in mind

(1) Stay within the scope and limitation of the assignment.

(2) Determine the evidence reasonably available and identify the best evidence for

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deriving the necessary satisfaction.

(3) Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.

(4) Consider all possibilities of error.

(5) Co-ordinate the procedures to be applied to related items.

Chapter 3- Audit Documentation and Audit Evidence

6. (a) **Significant Difficulties Encountered During the Audit:** As per SA 260 "Communication with Those Charged with Governance", significant difficulties encountered during the audit may include such matters as:

- Significant delays in management providing required information.
- An unnecessarily brief time within which to complete the audit.
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- The unavailability of expected information.
- Restrictions imposed on the auditor by management.
- Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

(b) **Inquiry – Audit Procedure to obtain Audit Evidence:** 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.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry. In respect of some matters, the auditor may consider it necessary to obtain written representations from

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management and, where appropriate, those charged with governance to confirm responses to oral inquiries.

7. **(a)** Audit evidence may be defined as the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Explaining this further, audit evidence includes:-

(1) **Information contained in the accounting records:** Accounting records include the records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

(2) **Other information that authenticates the accounting records and also supports the auditor's rationale behind the true and fair presentation of the financial statements:** Other information which the auditor may use as audit evidence includes, for example minutes of the meetings, written confirmations from trade receivables and trade payables, manuals containing details of internal control etc. A combination of tests of accounting records and other information is generally used by the auditor to support his opinion on the financial statements.

(b) **Sufficiency of Audit Evidence:** Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality. **Auditor's judgment as to sufficiency may be affected by the factors such as:**

(i) Materiality

(ii) Risk of material misstatement

(iii) Size and characteristics of the population.

(i) **Materiality** may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand if assertions are more material to the users of the financial statements, more evidence would be required.

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(ii) **Risk of material misstatement** may be defined as the risk that the financial statements are materially misstated prior to audit. This consists of two components described as follows at the assertion level (a) Inherent risk—The susceptibility of an assertion to a misstatement that could be material before consideration of any related controls. (b) Control risk—The risk that a misstatement that could occur in an assertion that could be material will not be prevented or detected and corrected on a timely basis by the entity's internal control. Less evidence would be required in case assertions that have a lower risk of material misstatement. But on the other hand if assertions have a higher risk of material misstatement, more evidence would be required.

(iii) **Size of a population** refers to the number of items included in the population. Less evidence would be required in case of smaller, more homogeneous population but on the other hand in case of larger, more heterogeneous populations, more evidence would be required.

8. (a) Reliability of Audit Evidence: SA 500 on "Audit Evidence" provides that the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

(1) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

(2) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

(3) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

(4) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

(5) Audit evidence provided by original documents is more reliable than audit

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evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

(b) 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.

Applying the above to the given problem, the auditor would further request the management to provide him with the Banker's certificate in support of fixed deposits held by the company.

Chapter 4- Risk Assessment and Internal Control

9. (a) Identification of Significant Risks: SA 315 "Identifying and Assessing the Risk of Material Misstatement through understanding the Entity and its Environment" defines 'significant risk' as an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

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.

(b) Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include-

- Inquiring of entity personnel.

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- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

10. (a) **Satisfactory Control Environment – not an absolute deterrent to fraud:** The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330, the control environment also influences the nature, timing, and extent of the auditor's further procedures.

The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

(b) **Control Environment – Component of Internal Control:** The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

(i) Management has created and maintained a culture of honesty and ethical behavior; and

(ii) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control.

What is included in Control Environment?

The control environment includes:

(i) the governance and management functions and

(ii) the attitudes, awareness, and actions of those charged with governance and management.

(iii) The control environment sets the tone of an organization, influencing the control consciousness of its people.

Elements of the Control Environment: Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

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(a) **Communication and enforcement of integrity and ethical values** – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.

(b) **Commitment to competence** – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(c) **Participation by those charged with governance** – Attributes of those charged with governance such as:

- Their independence from management.
- Their experience and stature.
- The extent of their involvement and the information they receive, and the scrutiny of activities.
- The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(d) **Management's philosophy and operating style – Characteristics such as management's:**

- Approach to taking and managing business risks.
- Attitudes and actions toward financial reporting.
- Attitudes toward information processing and accounting functions and personnel.

(e) **Organisational structure** – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

(f) **Assignment of authority and responsibility** - Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

(g) **Human resource policies and practices** – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Chapter 5- Fraud and Responsibilities of the Auditor in this Regard.

11. (a) Few Techniques of how receipts are suppressed are:

(1) *Teeming and Lading*: Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued

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so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

(2) Adjusting unauthorised or fictitious rebates, allowances, discounts, etc. to customer' accounts and misappropriating amount paid by them.

(3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.

(4) Not accounting for cash sales fully.

(5) Not accounting for miscellaneous receipts, *e.g.,* sale of scrap, quarters allotted to the employees, etc.

(6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

(b) The Standard on Auditing (SA) 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" defines the term 'fraud' as-

"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".

Although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements.

Two types of intentional misstatements are relevant to the auditor–

- misstatements resulting from fraudulent financial reporting and
- misstatements resulting from misappropriation of assets.

Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

12. Reporting under Companies (Auditor's Report) Order, 2016 [CARO, 2016]: The auditor is also required to report under **clause (x)** of paragraph 3 of Companies (Auditor's Report) Order, 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.

The scope of auditor's inquiry under **clause (x)** of paragraph 3 of Companies (Auditor's Report) Order, 2016 is restricted to frauds 'noticed or reported' during the year. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud by the company or on the company by its Officer or employees has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this

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clause, the auditor is also required to comply with the requirements of SA 240, "The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements".

Audit Procedures and Reporting under CARO:

(1) While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.

(2) The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon.

The auditor should enquire from the management about any frauds on the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees including officers of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.

(3) The auditor should obtain written representations from management that:

(i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;

(ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;

(iii) it has

(a) disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and

(b) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

(4) Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the

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audit are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items constitute misstatements because [description of reasons]."

The auditor should consider if any fraud has been reported by them during the year under section 143(12) of the Act and if so whether that same would be reported under this Clause. It may be mentioned here that section 143(12) of the Act requires the auditor has reasons to believe that a fraud is being committed or has been committed by an employee or officer. In such a case the auditor needs to report to the Central Government or the Audit Committee. However, this Clause will include only the reported frauds and not suspected fraud.

(5) Where the auditor notices that any fraud by the company or on the company by its officers or employees has been noticed by or reported during the year, the auditor should, apart from reporting the existence of fraud, also required to report, the nature of fraud and amount involved. For reporting under this clause, the auditor may consider the following:

(i) This clause requires all frauds noticed or reported during the year shall be reported indicating the nature and amount involved. As specified the fraud by the company or on the company by its officers or employees are only covered.

(ii) Of the frauds covered under section 143(12) of the Act, only noticed frauds shall be included here and not the suspected frauds.

(iii) While reporting under this clause with regard to the nature and the amount involved of the frauds noticed or reported, the auditor may also consider the principles of materiality outlined in Standards on Auditing.

Chapter 6- Audit in an Automated Environment

13. **Understanding and Documenting Automated Environment:** Understanding the entity and its automated environment involves understanding how IT department is organised, IT activities, the IT dependencies, relevant risks and controls.

Given below are some of the points that an auditor should consider to obtain an understanding of the company's automated environment

- Information systems being used (one or more application systems and what they are)
- their purpose (financial and non-financial)
- Location of IT systems - local vs global
- Architecture (desktop based, client-server, web application, cloud based)
- Version (functions and risks could vary in different versions of same application)
- Interfaces within systems (in case multiple systems exist)
- In-house vs Packaged

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- Outsourced activities (IT maintenance and support)
- Key persons (CIO, CISO, Administrators)

14. **Impact of IT related risks i.e. on Substantive Audit, Controls and Reporting:** The above risks, if not mitigated, could have an impact on audit in different ways. Let us understand how:

Impact on Substantive Audit	Impact on Controls	Impact on Reporting
•cannot rely on the data obtained from systems •system data and reports should be tested substantively for completeness and accuracy •more audit evidence is needed	•cannot rely on automated controls, system calculations and accounting procedures built into applications •cannot rely on IT dependent manual controls •system data and reports should be tested substantively for completeness and accuracy. •more substantive audit work is needed	•communication to those charged with governance •modified auditors report

- First, we may not be able to rely on the data obtained from systems where such risks exist. This means, all forms of data, information or reports that we obtain from systems for the purpose of audit has to be thoroughly tested and corroborated for completeness and accuracy.
- Second, we will not be able to rely on automated controls, calculations, accounting procedures that are built into the applications. Additional audit work may be required in this case.
- Third, due to the regulatory requirement of auditors to report on internal financial controls of a company, the audit report also may have to be modified in some instances.

In all the above scenarios, it is likely that the auditor will be required to obtain more audit evidence and perform additional audit work. The auditor should also be able to demonstrate how the risks were identified and what audit evidence was obtained and validated to address these IT risks.

Here, we should remember that as the complexity, automation and dependence of business operations on IT systems increases, the severity and impact of IT risks too

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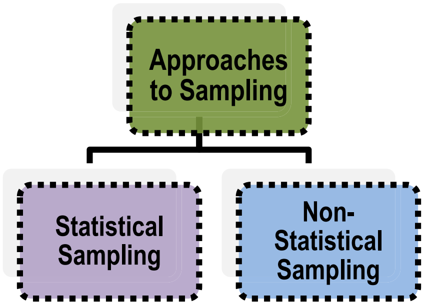
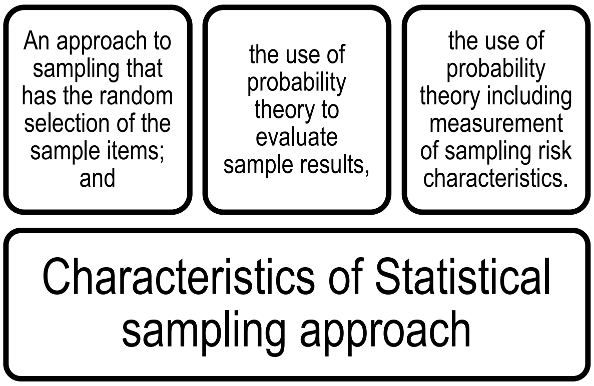
increases accordingly. The auditor should apply professional judgement in determining and assessing such risks and plan the audit response appropriately.

Chapter 7 Audit Sampling

15. Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.



Statistical sampling is an approach to sampling that has the random selection of the sample items; and the use of probability theory to evaluate sample results, including measurement of sampling risk characteristics. A sampling approach that does not have above characteristics is considered **non-statistical sampling**.



The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

Sample must be representative.

Whatever may be the approach non-statistical or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population

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although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

16. **Stratification and Value-Weighted Selection:** In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection technique is appropriate. SA 530 provides guidance to the auditor on the use of stratification and value-weighted sampling techniques.

Stratification: Audit efficiency may be improved if the auditor stratifies a population by dividing it into discrete sub-populations which have an identifying characteristic. The objective of stratification is to reduce the variability of items within each stratum and therefore allow sample size to be reduced without increasing sampling risk.

When performing tests of details, the population is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items, as these items may contain the greatest potential misstatement in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of misstatement, **for example, when testing the allowance for doubtful accounts in the valuation of accounts receivable, balances may be stratified by age.**

The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the auditor will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population.

For example, 20% of the items in a population may make up 90% of the value of an account balance. The auditor may decide to examine a sample of these items. The auditor evaluates the results of this sample and reaches a conclusion on the 90% of value separately from the remaining 10% (on which a further sample or other means of gathering audit evidence will be used, or which may be considered immaterial).

If a class of transactions or account balance has been divided into strata, the misstatement is projected for each stratum separately. Projected misstatements for each stratum are then combined when considering the possible effect of misstatements on the total class of transactions or account balance.

Value-Weighted Selection: When performing tests of details it may be efficient to identify the sampling unit as the individual monetary units that make up the population. Having selected specific monetary units from within the population, **for example, the accounts receivable balance, the auditor may then examine the particular items, for example, individual balances, that contain those monetary units.** One benefit of this approach to defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

This approach may be used in conjunction with the systematic method of sample selection and is most efficient when selecting items using random selection.

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Chapter 8- Analytical Procedures

17. Purpose of Analytical Procedures

Analytical procedures use comparisons and relationships to assess whether account balances or other data appear reasonable. Analytical procedures are used for the following purposes:

(i) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and

(ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

For instance, establishing the relationship that exists between certain balances included in the Balance Sheet and the Statement of Profit and Loss and comparing them with those that existed between the same set of balances in the previous year's reconciling the physical balances of assets with the relevant financial record; obtaining of account from the bankers, account receivables and account payables and reconciling with relevant balances in books of account; confirming amounts of outstanding income and expenses by preparing reconciliation statements, etc. These are helpful in the detection of unusual state of affairs and mistakes in accounts.

Example:

In XYZ Ltd., after applying analytical procedures as comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio. Therefore, it became necessary for the auditor to make further enquiries as it may be due to pilferage of inventories/ misappropriation of a part of the sale proceeds/ a change in the cost of sales without a corresponding increase in the sales price.

Likewise, on verifying the balances of sundry account receivables and account payables by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of an account receivable is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him. Also whether in the case of account payable, the discrepancy is due to failure to afford him credit for one or more consignments of goods supplied by him or failure to debit him with an amount of remittance.

Similarly, by taking inventories of raw materials and stores at the end of the year any excesses or shortages therein shall be detected. The investigation of their causes might disclose that the shortages were the result of a misappropriation of inventory or that the excess were due to requisitions having been entered before the inventories were issued.

In the same way, by reconciling the amounts of interest and dividends collected with the amounts which had accrued due and that which are outstanding for payment, the mistake, if any, in the adjustment of such an income would be detected.

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The overall tests can be extended for making inter-firm and intra-firm comparison of trading results.

For example, if balances included in the Statement of Profit and Loss of an entity are compared with those contained in the Statement of Profit and Loss for the same period of another entity engaged in the same trade and working under similar circumstances, it would be possible to find out the cause of the variation in the rate of profitability that exists.

Similarly, it would also be possible to compare the balances on the Statement of Profit and Loss with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years. By setting up certain expenses ratios on the basis of balances included in the Statement of Profit and Loss, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of trading profit in relation to sales. If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

An abnormal fall in the cost of manufacture or that in the administrative cost, apart from economy in expenses, there could be no provision or less provision for expenses incurred in the year. When it is suspected, the auditor should compare the entries in the outstanding book with those in the previous year. He must also check the vouchers for one month immediately before the close of the following years. To verify that none of the expenses in the accounts under audit have been charged to the accounts of the following years.

Often it is possible to independently verify the correctness of some of the items of expenses included in the Statement of Profit and Loss. For instance the cost of importing goods which are subjected to an ad valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar sold by sugar mill can be verified independently from the amount of excise duty paid. Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, *e.g.,* commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

Thus, it is important to note that Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

18. **Techniques available as substantive analytical procedures:** The design of a substantive analytical procedure is limited only by the availability of reliable data and the experience and creativity of the audit team. Substantive analytical procedures generally take one of the following forms:

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- **Trend analysis** — A commonly used technique is the comparison of current data with the prior period balance or with a trend in two or more prior period balances. We evaluate whether the current balance of an account moves in line with the trend established with previous balances for that account, or based on an understanding of factors that may cause the account to change.
- **Ratio analysis** — Ratio analysis is useful for analysing asset and liability accounts as well as revenue and expense accounts. An individual balance sheet account is difficult to predict on its own, but its relationship to another account is often more predictable (e.g., the trade receivables balance related to sales). Ratios can also be compared over time or to the ratios of separate entities within the group, or with the ratios of other companies in the same industry.
  - ***For example,*** Financial ratios may include:
  - Trade receivables or inventory turnover
  - Freight expense as a percentage of sales revenue
- **Reasonableness tests** — Unlike trend analysis, this analytical procedure does not rely on events of prior periods, but upon non-financial data for the audit period under consideration (e.g., occupancy rates to estimate rental income or interest rates to estimate interest income or expense). These tests are generally more applicable to income statement accounts and certain accrual or prepayment accounts.
- **Structural modelling** — A modelling tool constructs a statistical model from financial and/or non-financial data of prior accounting periods to predict current account balances (e.g., linear regression).

Chapter 9 - Audit of Items of Financial Statements

19. Shares Issued at Premium: In case a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, section 52 of the Companies Act, 2013 provides that a Company shall transfer the amount received by it as securities premium to securities premium account and state the means in which the amount in the account can be applied. As per the section, where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account" and the provisions of this Act relating to reduction of share capital of a company shall apply as if the securities premium account were the paid-up share capital of the company.

Application of securities premium account: The securities premium account may be applied by the Company:

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the Company;

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(c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68.

The auditor needs to verify whether the premium received on shares, if any, has been transferred to a "securities premium account" and whether the application of any amount out of the said "securities premium account" is only for the purposes mentioned above

20. In addition to the procedures undertaken for verifying completeness of additions to PPE during the period under audit, the auditor while performing testing of additions should also verify that all PPE purchase invoices are in the name of the entity that entitles legal title of ownership to the respective entity. For all additions to land, building in particular, the auditor should obtain copies of conveyance deed/ sale deed to establish whether the entity is mentioned to be the legal and valid owner.

The auditor should insist and verify the original title deeds for all immoveable properties held as at the balance sheet date. In case the entity has given such immoveable property as security for any borrowings and the original title deeds are not available with the entity, the auditor should request the entity's management for obtaining a confirmation from the respective lenders that they are holding the original title deeds of immoveable property as security. In addition, the auditor should also verify the register of charges, available with the entity to assess the PPE that has been given as security to any third parties.

Chapter 10 - The Company Audit

21. (a) Appointment of Subsequent Auditors in case of Non Government Companies: Section 139(1) of the Companies Act, 2013 provides that every company shall, at the first annual general meeting appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

The following points need to be noted in this regard-

(i) The company shall place the matter relating to such appointment of ratification by member at every Annual General Meeting.

(ii) Before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.

(iii) The certificate shall also indicate whether the auditor satisfies the criteria provided in **section 141**.

(iv) The company shall inform the auditor concerned of his or its appointment, and

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also file a notice of such appointment with the Registrar within 15 days of the meeting in which the auditor is appointed.

(b) Filling of a Casual Vacancy

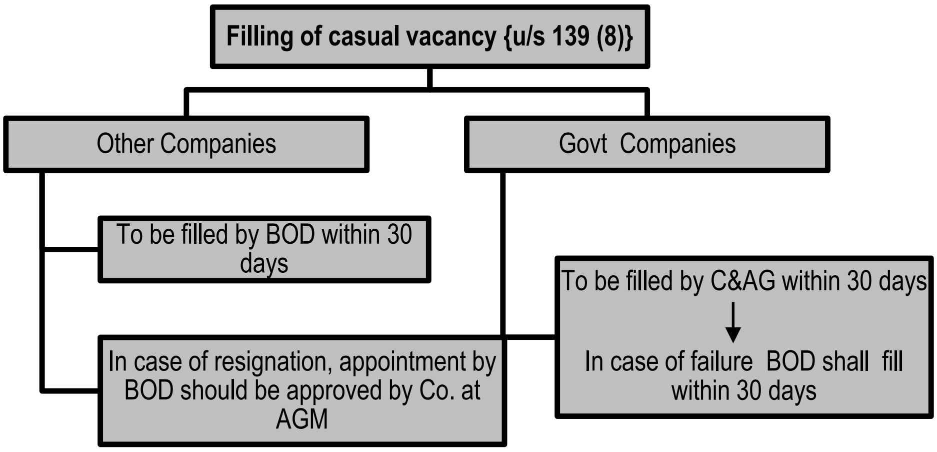
As per **Section 139(8),** any casual vacancy in the office of an auditor shall-

(i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within 30 days.

If such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

(ii) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within 30 days.

It may be noted that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period the Board of Directors shall fill the vacancy within next 30 days.



Casual Vacancy by Resignation: As per **section 140(2)** the auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed **Form ADT-3** (as per Rule 8 of CAAR) with the company and the Registrar, and in case of the companies referred to in **section 139(5)** i.e. Government company, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating

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the reasons and other facts as may be relevant with regard to his resignation. In case of failure the auditor shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees as per **section 140(3).**

22. (a) As per section 141(3)(d)(i), a person shall not be eligible for appointment as an auditor of a company, who, or his relative or partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However, as per proviso to this section, the relative of the person may hold the securities or interest in the company of face value not exceeding of ₹ 1,00,000.

In the instant case, M/s RM & Co. is an audit firm having partners CA. R and CA. M. Mr. Bee is a relative of CA. R and he is holding shares of Enn Ltd. of face value of ₹ 50,000 only (5,000 shares x ₹ 10 per share).

Therefore, M/s RM & Co. is not disqualified for appointment as an auditors of Enn Ltd. as the relative of CA. R (i.e. partner of M/s RM & Co.) is holding the securities in Enn Ltd. which is within the limit mentioned in proviso to section 141(3)(d)(i) of the Companies Act, 2013.

(b) Section 141(3)(i) of the Companies Act, 2013 disqualifies a person for appointment as an auditor of a company who is engaged as on the date of appointment in consulting and specialized services as provided in section 144. Section 144 of the Companies Act, 2013 prescribes certain services not to be rendered by the auditor which includes investment banking services.

Therefore, CA. Poshin is advised not to accept the assignment of auditing as the investment banking service is specifically notified in the list of services not to be rendered by him as per section 141(3)(i) read with section 144 of the Companies Act, 2013.

23. (a) **Applicability of Section 139(2) Rotation of Auditor**: As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the class of companies shall mean the following classes of companies excluding one person companies and small companies-

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Class of Companies for Rotation of Auditor

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including Listed Companies

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excluding OPC (One Person Company) and Small Companies

All unlisted public companies having paid up share capital ≥ ₹ 10 crore	**All private limited companies having paid up share capital ≥ ₹ 50 crore**	**All companies having paid up share capital of below threshold limit mentioned, but having public borrowings from financial institutions, banks or public deposits ≥ ₹ 50 crore**

(I) all unlisted public companies having paid up share capital of rupees ten crore or more;

(II) all private limited companies having paid up share capital of rupees fifty crore or more;

(III) all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

From the above, it can be concluded that rotational provisions would not be applicable.

(b) Matters to be included in the auditor's report- statutory dues and repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders (CARO, 2016) –

Clause (vii) (a) whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated;

(b) where dues of income tax or sales tax or service tax or duty of customs or duty of excise or value added tax have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. (A mere representation to the concerned Department shall not constitute a dispute).

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Clause (viii) whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).

Chapter 11- Audit Report

24. Communicating key audit matters in the auditor's report is not:

(i) A substitute for disclosures in the financial statements that the applicable

Financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation;

(ii) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705 (Revised);

(iii) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or

(iv) A separate opinion on individual matters.

25. Evaluations by the Auditor

The auditor shall evaluate whether the financial statements are prepared in accordance with the requirements of the applicable financial reporting framework.

This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.

Qualitative Aspects of the Entity's Accounting Practices

1. Management makes a number of judgments about the amounts and disclosures in the financial statements.
2. SA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.
3. In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that lack of neutrality together with uncorrected misstatements causes the financial statements to be materially misstated. Indicators of a lack of neutrality include the following:

   (i) The selective correction of misstatements brought to management's attention during the audit

   Example

   ✐ Correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings.

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- The combination of several deficiencies affecting the same significant account or disclosure (or the same internal control component) could amount to a significant deficiency (or material weakness if required to be communicated in the jurisdiction). This evaluation requires judgment and involvement of audit executives.

(ii) Possible management bias in the making of accounting estimates.

4. SA 540 addresses possible management bias in making accounting estimates.

   Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

Chapter 12- Bank Audit

26. Audit of Advances: Advances generally constitute the major part of the assets of the bank. There are large number of borrowers to whom variety of advances are granted. The audit of advances requires the major attention from the auditors.

In carrying out audit of advances, the auditor is primarily concerned with obtaining evidence about the following:

a. Amounts included in balance sheet in respect of advances are outstanding at the date of the balance sheet.

b. Advances represent amount due to the bank.

c. Amounts due to the bank are appropriately supported by Loan documents and other documents as applicable to the nature of advances.

d. There are no unrecorded advances.

e. The stated basis of valuation of advances is appropriate and properly applied, and that the recoverability of advances is recognised in their valuation.

f. The advances are disclosed, classified and described in accordance with recognised accounting policies and practices and relevant statutory and regulatory requirements.

g. Appropriate provisions towards advances have been made as per the RBI norms, Accounting Standards and generally accepted accounting practices.

   The auditor can obtain sufficient appropriate audit evidence about advances by study and evaluation of internal controls relating to advances, and by:

   - examining the validity of the recorded amounts;
   - examining loan documentation;
   - reviewing the operation of the accounts;
   - examining the existence, enforceability and valuation of the security;

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- checking compliance with RBI norms including appropriate classification and provisioning; and
- carrying out appropriate analytical procedures.

In carrying out his substantive procedures, the auditor should examine all large advances while other advances may be examined on a sampling basis. The accounts identified to be problem accounts however need to be examined in detail unless the amount involved is insignificant.

Advances which are sanctioned during the year or which are adversely commented by RBI inspection team, concurrent auditors, bank's internal inspection, etc. should generally be included in the auditor's review.

Chapter 13- Audit of Different Types of Entities

27 (a) Government Expenditure Audit: Audit of government expenditure is one of the major components of government audit conducted by the office of C&AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. **Briefly, these standards are explained below:**

(i) **Audit against Rules & Orders:** The auditor has to see that the expenditure incurred conforms to the relevant provisions of the statutory enactment and is in accordance with the financial rules and regulations framed by the competent authority.

(ii) **Audit of Sanctions:** The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, accorded by the competent authority, authorising such expenditure.

(iii) **Audit against Provision of Funds:** It contemplates that there is a provision of funds out of which expenditure can be incurred and the amount of such expenditure does not exceed the appropriations made.

(iv) **Propriety Audit:** It is required to be seen that the expenditure is incurred with due regard to broad and general principles of financial propriety. The auditor aims to bring out cases of improper, avoidable, or in fructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. Audit aims to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions.

(v) **Performance Audit:** This involves that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or

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function and is oriented towards identifying opportunities for greater economy, and effectiveness.

(b) Duties of C&AG: The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under-

(i) **Compile and submit Accounts of Union and States -** The C&AG shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account.

(ii) **General Provisions Relating to Audit - It shall be the duty of the C&AG –**

(a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

(b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

(c) to audit and report on all trading, manufacturing profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) **Audit of Receipts and Expenditure -** Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

(iv) **Audit of Grants or Loans -** Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

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(v) **Audit of Receipts of Union or States** - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make this purpose such examination of the accounts as he thinks fit and report thereon.

(vi) **Audit of Accounts of Stores and Inventory -** The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and inventory kept in any office or department of the Union or of a State.

(vii) **Audit of Government Companies and Corporations -** The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 2013. The comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 (i.e. appointment of First Auditor or Subsequent Auditor) and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

28. The Special Steps Involved in the Audit of an Educational Institution are the following:

(i) Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.

(ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.

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(iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

(v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

(vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.

(vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.

(viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.

(ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.

(x) Verify rental income from landed property with the rent rolls, etc.

(xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

(xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.

(xiii) Report any old heavy arrears on account of fees, dormitory rents, etc, to the Managing Committee.

(xiv) Confirm that caution money and other deposits paid by students on admission have been shown as liability in the balance sheet and not transferred to revenue.

(xv) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.

(xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.

(xvii) Vouch donations, if any, with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.

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(xviii) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

(xix) Vouch in the usual manner all establishment expenses and enquire into any unduly heavy expenditure under any head.

(xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.

(xxii) Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. These should be checked by reference to Inventory Register and values applied to various items should be test checked.

(xxiii) Confirm that the refund of taxes deducted from the income from investment (interest on securities, etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.

(xxiv) Verify the annual statements of accounts and while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of Staff, etc.

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