2. "General Auditing Principles & Auditor Responsibilities"

PART- I DESCRIPTIVE QUESTIONS

2.1 - SA 240 "The Auditor's Responsibilities relating to Fraud in an Audit of F.S."

Q.1. CA. Ridhima, internal auditor of Track Store Limited, has pointed out following deficiencies in internal control of the company, in her reports:

(i) Receivables are not reconciled at stipulated intervals.

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

The statutory auditor of the company finds that no action has been taken by the company on the said deficiencies pointed out in reports of internal auditor. What does above situation allude to statutory auditor of company?

Ans: Risk of material misstatement due to fraudulent financial reporting:

- Management failing to remedy known significant deficiencies in internal control on a timely basis is a fraud risk factor for misstatements arising from fraudulent financial reporting.
- When management does not correct significant deficiencies in internal control on a timely basis, it reflects an attitude, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act.
- Failure to rectify known control deficiencies pertaining to reconciliation of receivables and review of customer credit limits has the potential to fraud. Lack of timely reconciliation of receivables may lead to intentional misstatements. Further, non-reviewing customer limit may lead to grant of credit beyond creditworthiness of customers. It may result in intentional tying up of company's funds with risky customers due to collusion.
- The above situation is a fraud risk factor for fraudulent financial reporting.

Q.2. M/s Honest Ltd. has entered into a transaction on 5th March, 2024, near year-end, whereby it has agreed to pay ₹ 5 lakhs per month to Mr. Y as annual retainership fee for "engineering consultation". No amount was actually paid, but ₹ 60 lakhs are provided in books of account as on March 31, 2024. Your inquiry elicits a response that need-based consultation was obtained round the year, but there is no documentary or other evidence of receipt of the service. As the auditor of M/s Honest Limited, what would be your approach? [RTP-Nov. 18]

Ans: Auditor's duties in case of suspected fraud:

- As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", fraud can be committed by management by various means including therein recording of fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- In the given case, Honest Ltd. has entered into an agreement with Mr. Y at year-end, for engineering consultation. It also provides ₹ 60 lakhs in the books of account, however, no documentary or other evidence of receipt of such service is available. It appears that company has passed fictitious journal entries, near year-end, to manipulate the operating results.

- SA 240 further provides that if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:
  (1) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
  (2) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted.
- Further, Sec. 143(12) of the Companies Act, 2013 read with Rule 13 of Companies (Audit & Auditor's) Rules, 2014 requires that if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the audit committee within 2 days of his knowledge (as amount involved is less than ₹ 1 Cr.) mentioning the following:
  (i) Nature of Fraud with description:
  (ii) Approximate amount involved; and
  (iii) Parties involved etc.
- Para 3(xi) of CARO, 2020 also requires the company auditor to report 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.

Q.3. In the course of audit of Quick Ltd, you suspect that the management has made misstatements in the financial statements intentionally to deceive the users and to succumb to pressures to meet market expectations.

Elucidate how the fraudulent financial reporting may be accomplished and also discuss the techniques of committing fraud by management overriding controls.

[Nov. 20 (5 Marks), MTP-Oct. 21]

Ans: **Ways to accomplish Fraudulent Financial Reporting:**

SA 240, "The Auditor's responsibilities relating to Fraud in an Audit of Financial Statements", discusses how fraudulent financial reporting may be accomplished and also discusses techniques of committing fraud by management overriding controls. Accordingly, fraudulent financial reporting may be accomplished by the following:

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

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

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

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

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

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

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

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

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

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

Q.4. Arihant Limited was engaged in the business of owning and managing hotels & resorts, selling tourism packages and performing airline bookings for corporate and individuals. It appointed Upadhyay & Co. as its statutory auditor for the financial year 2023-24. While planning the audit, the audit team decided that the risk of improper revenue recognition from hotel business should not be treated as a fraud risk. This conclusion was based on the assessment of earlier years, wherein no fraud was identified in revenue recorded from such business. While testing the internal financial controls over the process of revenue recognition, it was identified that the controls are not properly designed to mitigate the risk of fraud & risk of improper revenue recognition. As a result, the audit team decided to perform additional substantive testing. However, the audit team still were to the conclusion that there is no risk of fraud in revenue recognition. During the course of substantive testing, it was identified that the management did not account for revenue received from corporate hotel bookings amounting to ₹ 35 crore. These amounts were partially received in the company's bank accounts and partially received in the CFO's personal account. The amounts received in the bank account of the company were disclosed as advances received against the future bookings.

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

Ans: **Auditor's responsibility relating to fraud in an audit of F.S.:**

- As per SA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" and SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", auditor shall identify and assess the risks of material misstatement (RMM) due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.
- When identifying and assessing the RMM due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.
- In accordance with SA 240 and SA 330, auditor shall determine overall responses to address the assessed RMM due to fraud at the F.S. level and assertion level. The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no RMM due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property. However, when there is a complex revenue structure or when there is lack of controls on revenue recognition, then there is a high probability of fraud risk in revenue recognition.
- Obtaining an understanding of the entity and its environment, including the entity's internal control is a continuous, dynamic process of gathering, updating and analysing

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

- Therefore, the auditor while performing the risk assessment procedures should consider the complexity and nature of the revenue for determining the fraud risks in revenue recognition. Also, there were no adequate controls addressing the risk of improper revenue recognition or fraud risk, the audit team rebutted the fraud risk. Moreover, the audit team should have recognised fraud risk by identifying the deficiencies of internal control over the revenue recognition process and should have treated the risk of improper revenue recognition as a significant risk.
- Also, as per Sec. 143(12) of the Companies Act, 2013, the auditor is required to report all the frauds identified during the course of the audit involving amounts above 1 crore within the prescribed time frame to the C.G.

Q.5. M/s Kumar & Co, Chartered Accountants were appointed as statutory auditors of PC limited for the financial year 2023-24. During the course of audit, one of the partners CA Kumar observed that there is misappropriation of assets in the form of theft of entity's inventory and is perpetrated by employees in relatively small and immaterial amounts. CA Kumar is concerned with the existence of certain circumstances for increasing the susceptibility of assets to misappropriation.

Guide CA Kumar with respect to Risk factors related to misstatements arising from misappropriation of assets with reference to relevant Standard on Auditing

[Dec. 21 (5 Marks), MTP-March 23]

Ans: **Risk Factors relating to misstatements arising from misappropriation of Assets:**

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

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

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

(a) Incentives/Pressures

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

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets.

For example, adverse relationships may be created by the following:

(i) Known or anticipated future employee layoffs.

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

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

(b) Opportunities:

Certain circumstances may increase susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

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

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

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

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

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

(1) Inadequate segregation of duties or independent checks.

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

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

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

(5) Inadequate record keeping with respect to assets.

(6) Inadequate system of authorization & approval of transactions (for example, in purchasing).

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

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

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

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

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

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

(c) Attitudes/Rationalizations:

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

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

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

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

(v) Tolerance of petty theft.

Q.6. Comment on the following: On 15th March, 2024, the directors of Phony Ltd. instructed their accountant to enter purchases amounting ₹ 1.02 Crores from a company incorporated dated 11th March, 2024. However, no amount was actually paid and ₹ 1.02 Crores was provided in the books of account as purchases for the year ending on 31st March, 2024.

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

[MTP-May 20]

Ans: **Auditor's duties in case of suspected fraud:**

- As per SA 240 on "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements", fraud can be committed by management by various means including therein recording of fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- In the given case, directors of Phony Ltd. instructed their accountant to enter purchases amounting ₹ 1.02 Crores from a company incorporated dated 11th March, 2024. However, no amount was actually paid and ₹ 1.02 Crores was provided in the books of account as purchases for the year ending on 31st March, 2024. On inspection, no documentary or other evidence of such purchases was found. It appears that company has passed fictitious journal entries, near year-end, to manipulate the operating results.
- SA 240 further provides that if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:
  (1) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
  (2) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted.
- Further, Sec. 143(12) of the Companies Act, 2013 read with Rule 13 of Companies (Audit & Auditor's) Rules, 2014 requires that if an auditor of a company, in the course of the performance of his duties as statutory auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount of 1 Cr. or above, is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the C.G.
- Para 3(xi) of CARO, 2020 also requires the company auditor to report 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.

Q.7. MN & Associates are the statutory auditors of ABC Ltd. for the FY 2021-22. During the course of audit, the engagement partner, Mr. Manohar notices a misstatement resulting from a suspected fraud that brings into question the audit team's ability to continue performing the audit. How should the audit team deal with the situation?

Ans: **Auditor Unable to Complete the Engagement:**

As per SA 240 "Auditor's Responsibilities relating to fraud in an audit of financial statements", if the auditor concludes that it is not possible to continue performing the audit as a result of a misstatement resulting from fraud or suspected fraud, the auditor should:

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

(ii) consider the possibility of withdrawing from the engagement; and

(iii) If the auditor withdraws:

- discuss with the appropriate level of management and TCWG, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
- consider whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Q.8. My Décor Limited, presently engaged in manufacturing of fabrics, wants to set up a new plant for manufacturing of special kind of fabric providing an altogether different texture and feel. This kind of fabric has become a hit with retail customers. The company needs to set up plant for manufacturing the above kind of fabric involving huge capital outlays to stay competitive in the market. You are auditor of the company and find that company's revenue has increased in financial year 2023-24 to ₹ 1000 crore from ₹ 750 crore in last year. By the time, you started the audit, there was no change in plant capacity and information regarding need to set up new plant has become known to you during inquiry of company's personnel. Discuss, how you should proceed to deal with above situation, as auditor of the company, paying special attention to risk of material misstatement due to fraudulent financial reporting?

Ans: Risk of material misstatement due to fraudulent financial reporting:

- Given situation highlights need for the company to set up new plant for manufacturing of special kind of fabric to stay competitive in the market. Setting up of such plant involves huge capital outlays which could entail financing arrangements. Therefore, excessive pressure exists for management to be involved in fraudulent financial reporting. In such a situation, management may be tempted to inflate its revenues to show rosy picture. It is a fraud risk factor and needs to be evaluated by the auditor.
- Revenues of company have jumped from ₹ 750 crore in last year to ₹ 1000 crore in year 2023-24 without any change in plant capacity. The auditor may consider above said fraud risk factor for assessing risk of material misstatement due to fraud.
- In case of auditor assessing risk of material misstatement due to fraudulent financial reporting, audit procedures to address such risk like performing SAP relating to revenue, use of CAATs to identify unusual revenue transactions and testing controls pertaining to revenue transactions need to be performed.

2.2-SA 250 "Considerations of Laws & Regulations in an Audit of Financial Statements"

Q.9. You are auditor of a social media company. Of late, government has tightened noose around companies operating in this segment by bringing in a maze of regulatory legislations to protect interests of users. How you can proceed to verify that company is compliant with new regulatory requirements? Besides, what does above situation underscore to you as an auditor?

Ans: Aspects to be considered to ensure compliance of laws and regulations:

- SA 250 "Consideration of laws and regulations in an Audit of Financial statements" requires auditor to obtain SAAE regarding the compliance with the provisions of those laws and regulations generally recognized to have a direct impact on the determination of material amounts and disclosures in the financial statements including tax and labour laws. For other laws, auditor's responsibility is limited to undertake specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

- In the present case, auditor needs to verify whether the company has put in place systems and procedures to meet with new regulatory requirements. It can be verified by examining policies and procedures developed by company in this regard like-
  (a) devising appropriate system of internal control,
  (b) sensitizing employees regarding new rules,
  (c) engaging legal advisors etc.
- Further, financial stability of company may be threatened due to new regulatory requirements. The management may be under pressure. It is also a fraud risk factor and may need to be evaluated by auditor.

Q.10. CA Anand is the engagement partner for the audit assignment of NHT Ltd. engaged in manufacture of Iron and Steel bars. The company has its plants in the state of Sikkim. While verifying the wages record of the company, CA Anand found that maximum of the labour employed in the plants of the company was child labour. He questioned the management of the company about the same to which the management replied that looking into the compliance of such law is outside his scope of financial audit. Give your comments with respect to such situation.

Or

As a statutory auditor of a company, comment on the following: While verifying the employee records in a company, it was found that a major portion of the labour employed was child labour. On questioning the management, the auditor was told that it was outside his scope of the financial audit to look into the compliance with other laws.

[RTP-May 18, MTP-May 20, April 21, March 23]

Ans: **Auditor's Responsibility for consideration of other Laws:**

- As per SA 250 "Considerations of Laws and Regulations in an Audit of Financial Statements", auditor is not responsible for preventing non-compliance and cannot be expected to detect non- compliance with all laws and regulations. For compliance with provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the F.S., auditor's responsibility is to obtain SAAE about compliance with the provisions of those laws and regulations.
- For other laws and regulations, auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.
- In the instant case, maximum of the labour employed was child labour. When auditor questioned the management about the same, management replied that looking into the compliance of such law is outside his scope of financial audit. Such reply by the management is not acceptable as such situation may have a material effect on the financial statements.

Conclusion: Auditor should ensure as to whether any penal provisions will be there for non-compliance of such law and also whether the same has been duly disclosed by the company. If he concludes that such non compliance has a material effect on the F.S. and the same has not been adequately reflected in F.S., he shall express an adverse or a qualified opinion on the F.S.

Q.11. As an Auditor of TRP Ltd., you are suspicious that there might be non-compliance with laws and regulations to which the company is subject to. Indicate the possible areas or aspects where you may have to look out for forming an opinion as to whether your suspicion has some based to further inquire. [May 18 (4 Marks), MTP-Oct. 21]

Or

During the course of Audit of POP Ltd., you as an auditor while performing the audit procedures become aware of the existence of certain instances which seem to be an indication of non- compliance with Laws and Regulations. List out any five such instances identified by you as an auditor, suggestive of non-compliance with Laws and Regulations.

[Jan. 21 (5 Marks)]

Or

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

[Dec. 21 (5 Marks)]

Ans: Indicators to be considered for verifying compliance with laws and regulations:

SA 250 "Consideration of Laws and Regulations in an audit of Financial Statements" deals with the auditor's responsibilities to consider laws and regulations when performing an audit. To verify compliance of laws and regulations, auditor is required to consider the following indicators:

1. Investigation by regulatory organisations, Government departments or payment of fines, additional taxes or penalties.
2. Payments for unspecified services or loans to consultants related parties or employees.
3. Sales commission or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
4. Purchases at prices significantly above or below market price.
5. Unusual payments in cash.
6. Unusual payments towards legal and retainership fees.
7. Unusual transactions with companies registered in tax havens.
8. Payments for goods or services made other than to the country from which the goods or services originated.
9. Payments without proper exchange control documentation.
10. Existence of an information system which fails to provide an adequate audit trail.
11. Unauthorised transactions or improperly recorded transactions.
12. Adverse media comment.

Q.12. CA Abhinanadan is an auditor of KM Private Limited. During the course of audit, CA Abhinanadan becomes aware of information concerning an instance of non-compliance or suspected non- compliance with laws and regulations. Being a senior partner of CA. Abhinanadan, guide him regarding audit procedures to be followed when non-compliance is identified or suspected.

Ans: Audit Procedures When Non-Compliance is Identified or Suspected:

- As per SA 250, "Consideration of Laws and Regulations in an Audit of Financial

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

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

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

- If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.
- If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.
- The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action.

Q.13. PQ Limited, a listed entity, is in the business of manufacturing of specialty chemicals. The company has appointed CA Jazz as CFO of the company. CA Jazz is concerned about compliance with the provisions of laws and regulations that determine the reported amounts and disclosure in financial statements of PQ Limited. Accordingly, CA Jazz wants to implement such policies and procedures that can assist him in the prevention and detection of non-compliance with laws and regulations. Help CA Jazz by citing examples of such policies and procedures. [Nov. 20 (5 Marks)]

Ans: **Management Responsibility for compliance with laws and regulation:**

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

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

Q.14. Discuss why the potential effects of inherent limitations of an auditor's ability to detect material misstatements described in SA 200 are far greater in respect of non-compliance with laws and regulations?

Ans: **Potential effects of inherent limitations on the auditor's ability to detect material misstatements in respect of non-compliance with laws and regulations:**

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

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

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

Q.15. FAS Insurance Brokers Limited is a leading online insurance intermediary. During the year, Director General of GST Intelligence (DGGI) has issued notice to the company for allegedly creating fictitious invoices for "marketing and sales services" amounting to ₹ 50 crores in favour of non-life insurance companies. The premises of company were also searched during the year by DGGI officials. The matter was also informed to IRDAI by DGGI for violation of norms and regulations in this regard. Does above situation has any bearing on your responsibilities as statutory auditor of the company? Outline briefly in context of possible non-compliance with laws by the company.

Ans: **Audit Procedures When Non-Compliance is Identified or Suspected:**

- When the auditor becomes aware of the existence of or has information about investigations by government departments and regulatory organizations, it may be an indication of noncompliance with laws and regulations.
- In the instant case, notice has been served upon the company by DGGI for allegedly creating fictitious invoices in guise of providing "marketing and sales services" for ₹ 50 crores. Issuing an invoice without supply of services is a serious offence under GST laws and it could involve penalties and imprisonment. Such suspected non-compliance may have a direct effect on financial statements. The matter has also been informed to regulator i.e. IRDAI. Violation of IRDAI regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.
- If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain:
  (a) An understanding of the nature of the act;
  (b) Circumstances in which it has occurred; and
  (c) Further information to evaluate the possible effect on the financial statements.
- If auditor suspects there may be non-compliance, he shall discuss the matter with management and, where appropriate, TCWG. If management or TCWG do not provide sufficient information that supports that the entity is in compliance with laws and regulations and in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice.

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

2.3 - SA 260 "Communication with Those Charged with Governance"

Q.16. CA. Shivani Behl is offered appointment as auditor of RUTE Limited, a listed company. The audit committee of the company wants her to justify independence in relation to company through proper communication. Although she has ensured that there are no threats to her independence, she feels requirement of audit committee to be beyond its purview. What is your opinion in this regard?

Ans: **Communicating Independence with TCWG:**

- SA 260 "Communication with Those charged with Governance", requires that in the case of listed entities, auditor shall communicate with TCWG, a statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence and
  - (i) All relationships and other matters between firm, network firms and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence.

    This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist TCWG in assessing the effect of services on the independence of the auditor and;
  - (ii) Related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.
- Further, as per the Companies Act, 2013 requires audit committee to review and monitor auditor's independence.

Conclusion: Audit committee requiring auditor to justify her independence is well within its purview.

Q.17. Whilst the Audit team has identified few matters, they need your advice to conclude on the same. Engagement Partner have asked them to review the Board minutes and other secretarial/ regulatory records based on which the following additional matters were brought to the attention of the Partner:

(i) The long-term borrowings from the parent company has no written terms and neither the interest nor the principal has been repaid so far.

(ii) Certain computers were received from the parent company free of cost, the value of which is ₹ 0.23 lakhs & no accounting or disclosure of the same has been made in the notes to accounts.

(iii) An amount of ₹ 3.25 Lakhs per month is paid to M/s WE CARE Associates, a partnership firm, which is a 'related party' in accordance with the provisions of the Companies Act, 2013 for the marketing services rendered by them. Based on an independent assessment, the consideration paid is higher than the arm's length pricing by ₹ 0.25 lakh per month. Whilst the transaction was accounted in the financial statements based on the amounts' paid, no separate disclosure of this related party transaction has been made in the notes to accounts forming part of the financial statements highlighting the same as a 'related party' transaction.

Audit Manager has reported that she had asked certain information relating to another 'related party' transaction (amounting to approx. ₹ 47 lakhs) but the CFO refused to provide the same since the same is perceived to be confidential and cannot be shared with the Auditors.

You are required to advise about items to be reported to those charged with governance, where applicable, based on your audit findings in the given situation. [MTP-Oct. 20]

Ans: Reporting to TCWG:

- SA 260 "Communication with Those charged with Governance" deals with auditor's responsibilities to communicate with TCWG in an audit of financial statements. As per SA 550, Related Parties, communicating significant matters arising during the audit in connection with the entity's related parties helps the auditor to establish a common understanding with those charged with governance of the nature and resolution of these matters. The auditor is also required to ensure the compliance of Ind AS 24/AS 18 Related Party Disclosures.
- In view of above in the given scenario, the auditor is required to prepare a brief summary of various items to be reported to TCWG in accordance with SA 260:
  (i) Receipt of long-term borrowing (on no agreed terms and repayment of interest and principal) and free of cost computers from the Parent Company need separate disclosure in financial statements as per Ind AS 24/AS 18.
  (ii) In respect of one of related party transaction amounting ₹ 3.25 lakhs per month, it is noticed that ₹ 0.25 lakh per month exceeds the arm's length price, which has not been disclosed highlighting the same as related party transactions as per Ind- AS 24/ AS 18.
  (iii) Refusal by CFO of the company to provide the details of related party transaction amounting to ₹ 47 lakhs on the ground that same is perceived to be confidential and cannot be shared with auditors, is not in order, as denying for the related party details of ₹ 47 lakhs is imposing limitation of scope of auditor in view of SA 705.
- The auditor would also need to assess his reporting requirements under clause (xiii) of Paragraph 3 of CARO, 2020 with respect to related party transactions that whether all transactions with the related parties are in compliance with sections 177 and 188 of Companies Act, 2013 where applicable and the details have been disclosed in the Financial Statements etc, as required by the applicable Accounting Standards.

Q.18. UVW & Associates are the statutory auditors of Moon Ltd., a listed company, for the financial year 2023-24. CA Udhav is the engagement partner for the audit assignment. He was of the understanding that as per the requirement of one of the SAs he has a responsibility to communicate following matters to those charged with governance:

(a) The auditor's responsibilities in relation to the financial statement audit.
(b) Planned scope and timing of the audit.
(c) Auditor independence Which of the matters is not included in the list prepared by CA Udhav.

Discuss such matter in detail.

Ans: Matters to be communicated with TCWG:

SA 260 "Communication with Those Charged with Governance" deals with auditor's responsibility to communicate with TCWG in relation to an audit of financial statements.

Among various matters as included in the list, one of the matters that is not mentioned in the list is Significant findings from the audit. With respect to such matter, the auditor shall communicate with TCWG:

(a) Auditor's views about significant qualitative aspects of entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to TCWG why the auditor considers a significant accounting practice, that is acceptable under the applicable FRF, not to be most appropriate to the particular circumstances of the entity;
(b) Significant difficulties, if any, encountered during the audit;
(c) Unless all of TCWG are involved in managing the entity:
    (i) Significant matters arising during the audit that were discussed, or subject to correspondence, with management;
    (ii) Written representations the auditor is requesting
(d) Circumstances that affect the form and content of the auditor's report, if any and
(e) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process.

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

Q.19. M/s Manidhari & Associates have been appointed as an auditor of JIN Limited, a multinational company dealing in spare parts. During the course of audit, CA Manidhari is facing many problems including the problem of not getting the desired information from the management. Accordingly, he decided to communicate with TCWG about significant difficulties encountered during the audit. CA Manidhari seeks your guidance on matters which can be considered as significant difficulties as per SA 260. [RTP-May 22]

Ans: **Significant Difficulties encountered during audit:**

As per SA 260, "Communication with Those Charged with Governance", significant difficulties encountered during the audit may include such matters as:

(i) Significant delays by management, the unavailability of entity personnel, or an unwillingness by management to provide information necessary for the auditor to perform the auditor's procedures.
(ii) An unreasonably brief time within which to complete the audit.
(iii) Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
(iv) The unavailability of expected information.
(v) Restrictions imposed on the auditor by management.
(vi) Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion as per SA 705 (Revised), Modifications to the Opinion in the Independent Auditor's Report.

Q.20. CA. Vallabh Sundar is auditor of a leading private sector bank. "IT Systems and controls" is under his consideration to be reported as "Key audit matter" in audit report of the bank due to high level of automation and complexity of the IT architecture and its impact on the financial reporting system.

At what time he should communicate such identified "Key audit matter"? What are relevant considerations in this regard and their usefulness?

Ans: **Communication with TCWG and KEY Audit Matters (KAM):**

- SA 260 requires the auditor to communicate with TCWG on a timely basis.
- SA 701 states that the appropriate timing for communications about KAM will vary with the circumstances of the engagement. However, auditor may communicate preliminary views about KAM when discussing the planned scope and timing of the audit, and may further discuss such matters when communicating about audit findings. Doing so may help to alleviate the practical challenges of attempting to have a robust two way dialogue about key audit matters at the time the financial statements are being finalized for issuance.
- Communication with TCWG enables them to be made aware of the KAM that the auditor intends to communicate in the auditor's report, and provides them with an opportunity to obtain further clarification where necessary. The auditor may consider it useful to provide TCWG with a draft of the auditor's report to facilitate this discussion.
- Communication with TCWG recognizes their important role in overseeing the financial reporting process, and provides the opportunity for TCWG to understand the basis for the auditor's decisions in relation to KAM and how these matters will be described in the auditor's report.
- It also enables TCWG to consider whether new or enhanced disclosures may be useful in light of the fact that these matters will be communicated in the auditor's report.

2.4 - SA 299 "Joint Audit of Financial Statements"

Q.21. Four audit firms viz. GPR & Co., MKS & Co., CY & Associates and DES & Associates have been appointed for conducting statutory audit of KNB Bank, a public sector bank in accordance with regulatory guidelines. The professional work was divided by audit firms on the basis of zones of bank. However, work relating to "IT Systems and controls" was not allocated by them due to its very nature.

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

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

Ans: **Responsibilities of Joint Auditors w.r.t. Common Areas of working:**

- As per SA 299 "Joint Audit of Financial Statements", in respect of common areas, joint auditors are only responsible for appropriateness of NTE of planned audit procedures agreed among them. The responsibility of individual execution lies with concerned joint auditor.
- In the instant case, audit procedures relating to testing design and operating effectiveness of controls over computer operations including back-up, batch-processing and data center security have been planned jointly as it is a common area. However, audit procedures relating to testing controls over batch processing were actually performed by team of DES & Associates although these were planned jointly.

Conclusion: In case of any lapses in performing such procedures, DES & Associates would be responsible.

Q.22. Magnet Interiors Ltd. is a listed company engaged in the manufacture of office furniture. The company has its activities divided into four geographic regions. The company has appointed two joint auditors, namely, AB & Co. and CD & Co. to conduct the joint audit of the financial statements of the company for the year ending 31.03.2024. The engagement partners from both the firms, CA Amar and CA Chetanya along with their audit teams had a meeting to discuss the areas of the work to be divided and their respective responsibilities. Explain the responsibilities of the joint auditors with respect to such joint audit.

Ans: Responsibilities of Joint Auditors:

- As per SA 299 "Joint Audit of Financial Statements", in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. In cases where specific divisions, zones or units are allocated to different joint auditors, it is the separate and specific responsibility of each joint auditor to obtain information and explanations from the management in respect of such divisions/zones/units and to evaluate the information and explanations so obtained by said Joint auditor.
- All the joint auditors shall be jointly and severally responsible for:
  - (a) the audit work which is not divided among the joint auditors and is carried out by all joint auditors.
  - (b) decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the NTE of the audit procedures to be performed by each of the joint auditors.
  - (c) matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors.
  - (d) examining that the F.S. of the entity comply with the requirements of the relevant statutes.
  - (e) presentation & disclosure of the financial statements as required by the applicable FRF.
  - (f) ensuring that the audit report complies with the requirements of the relevant statutes, the applicable Standards on Auditing and the other relevant pronouncements issued by ICAI.
- Where, in the course of the audit, a joint auditor comes across matters which are relevant to the areas of responsibility of other joint auditors and which deserve their attention, or which require disclosure or require discussion with, or application of judgment by other joint auditors, the said joint auditor shall communicate the same to all the other joint auditors in writing prior to the completion of the audit.
- It shall be the responsibility of each joint auditor to determine the NTE of audit procedures to be applied in relation to the areas of work allocated to said joint auditor. It is the individual responsibility of each joint auditor to study and evaluate the prevailing system of internal control and assessment of risk relating to the areas of work allocated to said joint auditor.
- As regards decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the NTE of the audit procedures to be performed by each of the joint auditors, all joint auditors are responsible only in respect of the

appropriateness of the decisions concerning the NTE of the audit procedures agreed upon among them, proper execution of these audit procedures is the individual responsibility of the joint auditor concerned.

Q.23. KRP Ltd., at its annual general meeting, appointed Mr. X, Mr. Y and Mr. Z as joint auditors to conduct auditing for the financial year 2023-24. For the valuation of gratuity scheme of the company, Mr. X, Mr. Y and Mr. Z wanted to refer their own known Actuaries. Due to difference of opinion, all the joint auditors consulted their respective Actuaries. Subsequently, major difference was found in the actuary reports. However, Mr. X agreed to Mr. Y's actuary report, though, Mr. Z did not. Mr. X contends that Mr. Y's actuary report shall be considered in audit report due to majority of votes. Now, Mr. Z is in dilemma.

You are required to briefly explain the responsibilities of auditors when they are jointly and severally responsible in respect of audit conducted by them and also guide Mr. Z in such situation. [RTP- Nov. 18]

Ans: **Responsibilities of Joint auditors:**

SA 299 "Joint Audit of Financial Statements" lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200.

Accordingly, in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. All the joint auditors shall be jointly and severally responsible for:

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

(b) decisions taken by all the joint auditors under audit planning in respect of common audit areas concerning the NTE of the audit procedures to be performed by each of the joint auditors;

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

(d) examining that the F.S. of the entity comply with the requirements of the relevant statutes;

(e) presentation and disclosure of the F.S. as required by the applicable FRF;

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

It shall be the responsibility of each joint auditor to determine the NTE of audit procedures to be applied in relation to the areas of work allocated to said joint auditor.

It is the individual responsibility of each joint auditor to study and evaluate the prevailing system of internal control & assessment of risk relating to the areas of work allocated to said joint auditor.

Reporting Responsibilities in case of differences of opinion:

- Joint auditors are required to issue common audit report.
- However, in case of any disagreement among joint auditors with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report.
- A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement.

- In case of separate reports, the audit report(s) issued by the joint auditor(s) shall make a reference to the separate audit report(s) issued by the other joint auditor(s). Such reference shall be made under the heading "Other Matter Paragraph" as per SA 706.

In the present case, Mr. Z does not agree with the opinion of Mr. X and Mr. Y, therefore he needs to issue a separate report.

Q.24. Your firm is one of the Joint Auditors of FMP Ltd. Under what circumstances joint auditors are jointly liable for the work in relation to audit of financial statements? Is there any restriction on a joint auditor to communicate a dissenting note differing from the majority opinion of the other joint auditors in the audit report issued under section 143 of the Companies Act, 2013? [Nov. 18 (5 Marks)]

Ans: **Circumstance in which joint auditors are jointly liable: Refer Answer of Q. No. 23**

Restrictions as to communication of dissenting note:

- SA 299 requires the Joint auditors to issue common audit report. However, in case of any disagreement among joint auditors with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report.
- A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement.
- In case of separate reports, the audit report(s) issued by the joint auditor(s) shall make a reference to the separate audit report(s) issued by the other joint auditor(s). Such reference shall be made under the heading "Other Matter Paragraph" as per SA 706.

Q.25. Dice Ltd. appointed two CA firms MN & Associates and PQ & Co. as joint auditors for conducting audit for the year ended on 31st March, 2024. In the course of audit, it has been observed that there is a major understatement in the value of inventory. The inventory valuation work was looked after by MN & Associates but there was no documentation for the division of the work between the joint auditors. Comment on the above situation with regard to responsibilities among joint auditors. [May 19 (5 Marks)]

Ans: **Responsibilities of Joint Auditor:**

- As per SA 299 "Joint Audit of Financial Statements" where joint auditors are appointed, they should, by mutual discussion, divide the work among themselves.
- After identification & allocation of work among the joint auditors, the work allocation document shall be signed by all the joint auditors and the same shall be communicated to TCWG of the entity. Documentation of allocation of work helps in avoiding any dispute or confusion which may arise among the joint auditors regarding the scope of work to be carried out by them. Further, the communication of allocation of work to the entity helps in avoiding any dispute or confusion which may arise between the entity & the joint auditors.
- In respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him.
- However, for the work not divided, all the joint auditors are jointly and severally responsible.
- In the present case, though the revenue aspects (inventory valuation work) were looked after by MN & Associates, but as there is no documentation for division of the work

between them, both the joint auditors will be held responsible for it.

Conclusion: Both Joint auditors are jointly and severally responsible.

Note: Conclusion given in suggested answer of ICAI is different stating that MN & Associates will be held responsible as inventory valuation work was looked after by them. Further, there is a violation of SA 299 as the division of work has not been documented.

Author's view: As the work is not documented, responsibility will be joint and several.

Q.26. Excellent Bank Ltd. is a Public Limited Company. The said Bank has various branches all over India. The Bank appoints 3 Joint Auditors for the financial year ending on 31/03/2024. All the 3 Joint Auditors divide the work with mutual consent. Verification of Consolidation, however, remained undivided. All branches and zones were divided amongst the 3 Joint Auditors. During audit of zones, CA Z, one of the joint auditors expressed a concern about internal control in one of the large corporate branches situated in his zone. The irregularity was not reported in the final accounts as the other 2 Joint Auditors were not in favour of reporting and decision of not reporting the same was taken on the basis of majority. Subsequently, fraud has been detected in the said branch which was audited by CA Z.

The Bank seeks your advice about the responsibility of the 3 Joint Auditors in the above situation. [Nov. 19 (5 Marks)]

Ans: **Responsibilities of Joint auditors:**

SA 299 "Joint Audit of Financial Statements" lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200. As per SA 299, where joint auditors are appointed, they should, by mutual discussion, divide the work among themselves.

Accordingly, in respect of audit work divided among the joint auditors, each joint auditor shall be responsible only for the work allocated to such joint auditor including proper execution of the audit procedures. On the other hand, all the joint auditors shall be jointly and severally responsible for:

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

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

In the present case, all the 3 Joint Auditors divide the work with mutual consent , except for the verification of consolidation, which remained undivided. Hence, in accordance with SA 299, all the joint auditors are responsible for the same.

Reporting Responsibilities in case of differences of opinion:

- Joint auditors are required to issue common audit report.
- However, in case of any disagreement among joint auditors with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report.
- A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement.
- In case of separate reports, the audit report(s) issued by the joint auditor(s) shall make a reference to the separate audit report(s) issued by the other joint auditor(s). Such reference shall be made under the heading "Other Matter Paragraph" as per SA 706.

In the present case, CA Z, one of the joint auditors expressed a concern about internal control in one of the large corporate branches situated in his zone. The irregularity was not reported in the final accounts as the other 2 Joint Auditors were not in favour of reporting and decision of not reporting the same was taken on the basis of majority. Subsequently, fraud has been detected in the said branch which was audited by CA Z.

Conclusion: Mr. Z was required to issue a separate report. He was not bound by the views of other joint auditors. Mr. Z will be held responsible for non-reporting of the matter.

Note: Alternatively, it may be concluded that all the 3 joint auditors will be held responsible for the fraud detected in the branch audited by CA Z, as decision for not reporting the irregularity observed was taken on majority basis.

Q.27. A, B and C are joint auditors of a company. B is of the opinion that there are material misstatements in financial statements of a company which, if accounted for, would turn profit reflected in financial statements for ₹ 25 crore to a loss of ₹ 5 crore. He, therefore, wants an adverse opinion to be expressed in audit report. However, A and B do not concur with his views and are inclined to accept management's version. Is B required to go by majority opinion of 2-1?

Ans: Disagreement among joint Auditors:

- As per SA 299 "Joint Audit of Financial Statements", where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report.
- A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement. Therefore, B is not required to go by majority opinion of 2-1.
- In the given situation, audit report issued by the joint auditors shall make a reference to the separate audit report issued by the other joint auditor. Further, separate audit report shall also make reference to the audit report issued by other joint auditors. Such reference shall be mad under the heading "Other Matter Paragraph" as per SA 706.

Q.28. NMN & Co., LLP and ABC & Associates, LLP are the joint statutory auditors of BHS Ltd. BHS Ltd. is a listed company and has been in existence for the last 50 years. Since beginning this company was audited by MQS & Associates but due to audit rotation, the company had to bring in new auditors. Considering the size of the company, two auditors were appointed as joint auditors. Since the company is new to these auditors and the concept of joint auditors to whom audit work has been divided, management had a discussion and understood that each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. Advise. [MTP-April 19]

Ans: Reporting in case of Joint Auditors:

- SA 299 "Joint Audit of Financial Statements" lays down the principles for effective conduct of joint audit to achieve the overall objectives of the auditor as laid down in SA 200.
- SA 299 requires the Joint auditors to issue common audit report. However, in case of any disagreement among joint auditors with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report.
- A joint auditor is not bound by the views of the majority of the joint auditors regarding the opinion or matters to be covered in the audit report and shall express opinion formed by the said joint auditor in separate audit report in case of disagreement.

- In case of separate reports, the audit report(s) issued by the joint auditor(s) shall make a reference to the separate audit report(s) issued by the other joint auditor(s). Such reference shall be made under the heading "Other Matter Paragraph" as per SA 706.

Review of work by other joint auditor:

- Each joint auditor is entitled to assume that the other joint auditors have carried out their part of the audit work & the work has actually been performed in accordance with the SAs.
- It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests in order to ascertain whether the work has actually been performed in such a manner.
- Each joint auditor is entitled to assume that the other joint auditors have brought to said joint auditor's notice any departure from applicable FRF or significant observations that are relevant to their responsibilities noticed in the course of the audit.
- Before finalizing audit report, the joint auditors shall discuss and communicate with each other their respective conclusions that would form the content of the audit report.

2.5 - SA 402 "Audit Considerations in an Entity using Service Organisation"

Q.29. Durafone Mobile Co. Ltd. have pan India presence and market leader in mobile operation. It has outsourced all its revenue operation including accounting functions to Set Solutions (P.) Ltd. As an Auditor of the mobile company, enumerate the factors to be taken into consideration related to its financial reporting. [May 18 (5 Marks)]

Ans: **Factors to be taken into consideration related to financial reporting in case of user entities using services of Service Organisation:**

- SA 402 "Audit Considerations relating to an Entity Using a Service Organisation" deals with the user auditor's responsibility to obtain sufficient appropriate audit evidence when a user entity uses the services of one or more service organisations.
- Services provided by a service organisation are relevant to the audit of a user entity's financial statements when those services, and the controls over them, are part of the user entity's Information system, including related business processes, relevant to financial reporting.
- Although most controls at the service organisation are likely to relate to financial reporting, there may be other controls that may also be relevant to the audit, such as controls over the safeguarding of assets.
- A service organisation's services are part of a user entity's information system, including related business processes, relevant to financial reporting if these services affect any of the following:
  - (a) The classes of transactions in the user entity's operations that are significant to the user entity's financial statements;
  - (b) The procedures, within both information technology (IT) and manual systems, by which the user entity's transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
  - (c) The related accounting records, either in electronic or manual form, supporting information and specific accounts in the user entity's financial statements that are used to initiate, record, process and report the user entity's transactions; this includes the correction of incorrect Information and how information is transferred to the general ledger,

(d) How the user entity's information system captures events and conditions, other than transactions, that are significant to the financial statements;
(e) The financial reporting process used to prepare the user entity's financial statements, including significant accounting estimates and disclosures; and
(f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

Q.30. ENN Limited is availing the services of APP Private Limited for its payroll operations. Payroll cost accounts for 65% of total cost for ENN Limited. APP Limited has provided the type 2 report as specified under SA 402 for its description, design and operating effectiveness of control.

APP Private Limited has also outsourced a material part of payroll operation M/s SMP & Associates in such a way that M/s SMP & Associates is sub-service organisation to ENN Limited. The Type 2 report which was provided by APP Private Limited was based on carve-out method as specified under SA 402.

CA Raman while reviewing the unmodified audit report drafted by his assistant found that, a reference has been made to the work done by the service auditor. CA Raman hence asked his assistant to remove such reference and modify report accordingly.

Comment whether CA Raman is correct in removing the reference of the work done by service auditor? [RTP-Nov. 20; MTP-April 21, Sep. 22]

Ans: **Reporting by the User Auditor:**

- As per SA 402, "Audit Considerations Relating to an Entity Using a Service Organisation", the user auditor shall modify the opinion in the user auditor's report in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report", if he is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organisation relevant to the audit of the user entity's financial statements.
- The User Auditor shall not refer to report of Service auditor unless required by Laws & Regulations.
- If such reference is required by laws or regulations, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion.
- In the given case, CA Raman while reviewing the unmodified audit report drafted by his assistant found that, a reference has been made to the work done by the service auditor. CA Raman hence asked his assistant to remove such reference and modify report accordingly.

Conclusion: Contention of CA Raman in removing reference of the work done by service auditor is in order as in case of unmodified audit report, user auditor cannot refer to the work done by service auditor.

Q.31. In the course of audit of Tech Limited you observed that processing of accounting data was given to a third party on account of certain considerations like cost reduction, own computer working to full capacity. Tech Limited used a service organisation to record transactions and process related data. As an auditor, what would be your considerations regarding the nature and extent of activities undertaken by service organisation so as to determine whether those activities are relevant to the audit and, if so, to assess their effect on audit risk.

Discuss with reference to relevant Standard on Auditing. [Dec. 21 (5 Marks); MTP-March 23]

Ans: **Considerations regarding the nature and extent of activities undertaken by service organisation:**

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

(i) The nature of the services provided by the service organisation and the significance of those services to the user entity, including the effect thereof on the user entity's internal control;

(ii) The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;

(iii) The degree of interaction between the activities of the service organisation and those of the user entity; and

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

Based on above, the auditor will assess the effect on the audit risk and take necessary steps while conducting the audit.

Q.32. MNO Ltd. gets its accounting data processed by a service organisation. CA Riya is the statutory auditor of MNO Ltd. CA Riya wants to obtain an understanding as to how MNO Ltd. is using the services of the service organisation. What all understanding should she obtain?

Or

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

[MTP-Oct. 18, RTP-Nov. 18, MTP-Oct. 19]

Ans: **Matters of which understanding is required by user auditor w.r.t. services of a services organisation:**

SA 402 on "Audit Considerations relating to an Entity Using a Service Organisation" deals with the user auditor's responsibility to obtain SAAE when a user entity uses the services of one or more service organisations. Accordingly, when obtaining an understanding of user entity in accordance with SA 315, auditor shall obtain an understanding of how user entity uses the services of a service organisation in its operations, including:

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

(b) Nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation.

(c) Degree of interaction between the activities of the service organisation and those of the user entity. The degree of interaction refers to the extent to which a user entity is able to and elects to implement effective controls over the processing performed by the service organisation.

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

PART- II MULTIPLE CHOICE QUESTIONS

1. Ms. Kee, the engagement partner of Best Hospitality Limited's audit team did not perform the necessary communication with those charged with governance over some critical issues identified during the course of the audit. Moreover, when management identified that the engagement partner has not communicated to those charged with governance of the Best Hospitality Limited, they also chose not to communicate. Upon identification of this issue, the personnel charged with governance Inquired with management and auditors as to why there was no communication of the critical matters to them.

Upon such inquiry, Engagement Partner contended that it was the responsibility of Management to communicate first, then only the audit team should communicate. However, Management was of the view that they are not liable to communicate to those charged with governance. As an Engagement Quality Control Reviewer, what will be your opinion?

(a) The auditor is responsible for communicating matters required by SA 260 to those charged with governance. Also, management has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of its responsibility.

(b) SAs are not applicable to the management and hence the management was not responsible for communicating the same to those charged with governance. Also, as per SA 260, Auditor can only communicate when management has already informed those charged with governance about the matters. Auditors cannot communicate first without management's communication.

(c) Communication by management with those charged with governance of matters that the auditor is required to communicate does relieve the auditor of the responsibility to also communicate them if the management has already communicated. Hence, in the current case Management should have communicated as it was their responsibility.

(d) SA 260 requires the auditor to perform procedures specifically to identify any other matters to communicate with those charged with governance which includes matters already communicated by the management of non-material nature. Hence, It was the responsibility of the Auditor to communicate.

2. A significant deficiency exists in the process of flow of approval of travel reimbursements of the officials. This was communicated in the previous year to those charged with Governance and no remedial action was taken on the same so far. The auditors are of the opinion that it need not be communicated again. Is the opinion of the auditors on not to communicate the deficiency in internal control reported in the previous year correct?

(a) Yes, the auditor is not required to communicate the same again as it is the duty of the management and those charged with governance to maintain the internal control system.

(b) No, the current year's communication may repeat the description from previous communication or simply reference the previous communication.

(c) Yes, the auditor is not required to communicate the same again as written representation is being obtained from management and those charged with governance that they are responsible for maintaining internal control.

(d) No, it needs to be communicated again but an oral reminder to those charged with governance on the matter may suffice. [MTP-May 20]

3. A small concern has approached CA. Ajeet Nath for audit of accounts for year 2022-23. It later on transpired that preparation of accounts of the concern was outsourced to a third party which was engaged in preparation of books of this concern on a cloud server and was also preparing financial statements. The discussion amongst partners regarding agreeing to audit engagement remained inconclusive. Which of the following statements is MOST APPROPRIATE regarding agreeing to audit engagement of small concern?

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

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

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

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

4. You are the audit senior in charge of the audit of Swadhyay Co. and have been informed by your audit manager that during the current year a fraud occurred at the client. A payroll clerk sets up fictitious employees and the wages were paid into the clerk's own bank account. This clerk has subsequently left the company, but the audit manager is concerned that additional frauds have taken place in the wages department. Which of the following audit procedures would be undertaken during the audit of wages as a result of the manager's assessment of the increased risk of fraud?

(1) Discuss with the payroll manager the nature of the payroll fraud, how it occurred and the financial impact of amounts incorrectly paid into the payroll clerk's bank account.

(2) Review the supporting documentation to confirm the total of the fraudulent payments made and assess the materiality of this misstatement.

(3) Review and test the internal controls surrounding setting up of and payments to new joiners to assess whether further frauds may have occurred.

(4) Review the legal action taken by the management against the payroll clerk who was involved in the fraud and see whether he is punished for his actions.

(a) Audit procedures 1,2,3.

(b) Audit procedures 2,3,4.

(c) Audit procedures 1,3,4.

(d) Audit procedures 1,2,4. [MTP-April 23]

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

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

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

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

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

[MTP-Apr. 22]

6. M/s ABC & Associates are the statutory auditors of PQR Ltd. for the FY 2022-23. While conducting the audit, CA Aman, the engagement partner noticed the following:

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

CA Aman should consider the above as indicative of:

(a) Doubt on Internal Controls of PQR Ltd.

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

(c) Doubt on the accounting system of PQR Ltd.

(d) Doubt on the going concern assumption of PQR Ltd.

Answer Key

1. (a) The auditor is responsible for communicating matters required by SA 260 to those charged with governance. Also, management has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of its responsibility.

2. (b) No, the current year's communication may repeat the description from previous communication or simply reference the previous communication.

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

4. (a) Audit procedures 1,2,3.

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

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

PART- III INTEGRATED CASE SCENARIO

CA. Biswajit is conducting audit of "Have More Limited". He is auditor of the company since last three years and has found nothing unusual in operations and financial statements of the company. The company has many locations where substantial inventories are stored and lying. During his fourth year stint, he finds that inventory quantities have risen disproportionately as compared to past few years trends. He has assessed existence of risk of material misstatement due to fraud. The company has revenue of 750 crore during the year. He has deeply verified all aspects pertaining to revenue recognition of the company and has concluded that there is no risk of material misstatement due to fraud related to revenue recognition.

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

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

On the basis of above, answer the following questions:

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

(a) Observing inventory counts at all locations at same date by employing necessary resources.
(b) Observing inventory counts at certain locations after prior intimation.
(c) More rigorous examination of packed items during observing inventory count process.
(d) Observing inventory count at end of reporting period to minimize risk of manipulation.

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

(a) The auditor needs to document reasons for arriving at conclusion that there is no risk of material misstatement due to fraud related to revenue recognition.
(b) Identified and assessed risks of material misstatement due to fraud need to be documented. Since no risk of material misstatement due to fraud pertaining to revenue recognition was identified, separate documentation in this respect is not needed.
(c) The auditor needs only to document that no risk of material misstatement due to fraud relating to revenue recognition was identified.
(d) The auditor needs to give reference to discussion among engagement team members to document that no risk of material misstatement due to fraud relating to revenue recognition was identified.

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

(a) Sufficient appropriate evidence needs to be obtained by auditor to verify compliance.
(b) Physical verification of workability of such systems is required from an auditor.
(c) Only inquiry of company management personnel and review of correspondence with regulatory authorities are suffice to verify compliance.
(d) Only physical verification of workability of such systems and review of correspondence with regulatory authorities are suffice to verify compliance.

Q.4. The auditor has observed non-compliance of law prohibiting employment of child labour. Which is the most appropriate course of action for him to proceed in this matter?
(a) He should obtain further information to evaluate the possible effect on financial statements.
(b) He must report the matter to concerned government department.
(c) He should obtain further information to evaluate the possible effect on financial statements. Besides, he should evaluate implications of non-compliance for audit risk assessment.
(d) He should express a modified opinion in audit report.

Q.5. Which of the following statements is most appropriate about documentation of noncompliance with laws and regulations by an auditor in context of SA 250?
(a) Instances of identified non-compliance with laws and regulations need to be documented.
(b) Instances of suspected non-compliance with laws and regulations need to be documented.
(c) Instances of non–compliance with laws and regulations finally determined by Courts of law need to be documented.
(d) Instances of identified as well as suspected non-compliance with laws and regulations need to be documented.

Answer Key

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

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

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

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

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