

PAPER – 6 : AUDITING AND ASSURANCE

Question No.1 is compulsory.

Attempt any **four** questions from the remaining **five** questions.

Question 1

State with reasons (in short) whether the following statements are correct or incorrect: (Answer any Seven)

- (a) The level of sampling risk that the auditor is willing to accept will not affect the sample size.
- (b) The area of co-operation between the statutory auditor and the internal auditor is limited.
- (c) According to SA 315, the objective of the auditor is to identify and assess the risk of material misstatement, whether due to fraud or error, only at assertion level.
- (d) There is an inverse relationship between detection risks and the combined level of inherent and control risks.
- (e) A company may distribute part of its profits during the two annual general meetings as dividend.
- (f) An auditor has to report on the matters specified in section 143(1) of the Companies Act, 2013.
- (g) In case of acquisition of an asset is on finance lease, lease payment should be recognized as an expense in the Statement of Profit and Loss on a straight line basis over the lease term.
- (h) Schedule III to the Companies Act, 2013 specifies that where the normal operating cycle cannot be identified, it is assumed to have duration of 15 months. **(2 x 7 = 14 Marks)**

Answer

- (a) **Incorrect:** As per SA 530, "Audit Sampling" the level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.
- (b) **Correct:** The area of co-operation between the statutory and the internal auditor is limited by the fact that the statutory auditor and the internal auditor owe their allegiance to separate authorities, the shareholders in one case and the management in the other. Therefore, the former is not protected against the liability for negligence which may arise in such case.
- (c) **Incorrect:** According to SA 315, the objective of the auditor is to identify and assess the risk of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control.

- (d) **Correct:** There is an inverse relationship between detection risks and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable detection risks need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risks and still reduce audit risks to an acceptably low level.
- (e) **Correct:** A company may distribute part of its profits during the two annual general meetings. That means, a company may declare dividends before the close of the accounting year and finalisation of the accounts. Section 123(3) of the Companies Act, 2013 provides that the Board of directors may declare interim dividend during any financial year.
- (f) **Incorrect:** The auditor is not required to report on the matters specified in section 143(1) of the Companies Act, 2013 unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. However, the auditor should make a report to the members in case he finds answer to any of these matters in adverse.
- (g) **Incorrect:** In case acquisition of an asset is on operating lease, lease payment should be recognized as an expense in the Statement of Profit and Loss on a straight-line basis over the lease term.
- In case acquisition of an asset is on finance lease, ensure all the substantial risks and rewards incidental to ownership are transferred, considering the indication as prescribed in AS-19. The lessee should recognize the lease as an asset and as a liability.
- (h) **Incorrect:** As per Schedule III to the Companies Act, 2013 an operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.

Question 2

- (a) *In a system based audit, explain how test checking approach assists an auditor to form his opinion on the financial statements.* **(4 Marks)**
- (b) *M/s RR and Associates, Chartered Accountants, have been appointed as a statutory auditor of PK Limited for the financial year 2019-20.*
- Mention any four examples or matters indicating to the auditor about non-compliance with laws and regulations by PK Limited.* **(4 Marks)**
- (c) *Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.*
- Illustrate any three techniques by which fraud can be committed by management overriding controls.* **(3 Marks)**

- (d) *M/s MP & Co, Chartered Accountants, have been appointed as auditors of LMP Private Limited. The partner of the firm asked the Audit assistant to carry out the 'examination-in-depth' of the payment made to a creditor. Advise him about the documents to be verified.*

(3 Marks)

Answer

- (a) **Test Checking in System Based Audit:** System-based audit is done by evaluating the accounting system and internal control and ascertaining their reliability through audit tests. Depending upon the size and nature of the business concerned, an accounting system will incorporate necessary internal control to provide assurance that -

- (i) All the transactions and information have been recorded,
- (ii) Fraud and errors, if any, in preparing the accounts will be identified,
- (iii) All the assets and liabilities recorded in the books of account do exist and are shown at correct amounts,

There is compliance with statutory regulations.

After the auditor has ascertained the client's accounting system, he should assess it to satisfy the above mentioned requirements. The auditor, therefore, after evaluating internal control system, tests the same to ascertain whether it is actually in operation. For this purpose, he resorts to actual testing of the system in operation. This he does on a selective basis i.e.; he adopts test checking technique. He plans this testing in such a manner that all the important areas stated above are covered. The test checking is done by application of procedural test and/or by auditing in depth.

This approach is adopted in system-based audit which is the modern audit approach. The system-based audit approach begins by evaluating the accounting system and internal control and then by testing them to ascertain their reliability. By this, the auditor first establishes how reliable the system is and then decides how much detailed checking of the transactions and verification of assets and liabilities he must undertake. If the system is found to be good, the detailed checking could be curtailed, but if system is weak, more detailed checking would be necessary. However, checking cannot be completely eliminated; it can only be scaled down if state of the system is satisfactory. In case the initial evaluation itself shows weaknesses, extensive checking should invariably be undertaken.

- (b) **Non-compliance of Laws and Regulations by Management:** As per SA 250 on "Consideration of Laws and Regulation in an Audit of Financial Statements", M/s RR and Associates, Chartered Accountants of PK Limited becomes aware of the existence of, or information about, the following matters, it may be an indication of non-compliance with laws and regulations:

- (i) Investigations by regulatory organizations and government departments or payment of fines or penalties.

- (ii) Payments for unspecified services or loans to consultants, related parties, employees or government employees
 - (iii) Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
 - (iv) Purchasing at prices significantly above or below market price.
 - (v) Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
 - (vi) Unusual payment towards legal and retainer ship fees.
 - (vii) Unusual transactions with companies registered in tax heavens.
 - (viii) Payments for goods or services made other than to the country from which the goods or services originated.
 - (ix) Payments without proper exchange control documentation.
 - (x) Existence of an information system which foils, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
 - (xi) Unauthorized transactions or improperly recorded transactions.
 - (xii) Adverse media comment.
- (c) **Techniques of frauds committed by Management:** 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:
- (1) Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives
 - (2) Inappropriately adjusting assumptions and changing judgments used to estimate account balances
 - (3) Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period
 - (4) Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements
 - (5) Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity
 - (6) Altering records and terms related to significant and unusual transactions.
- (d) **Examination – in depth of the payment made to creditor:** The Audit Assistant of M/s MP & Co., should verify the following documents of LMP Private Limited in case of payment to a creditor is to be verified "in depth":
- (i) The invoice and statement of account received from the supplier.

- (ii) The entry in the inventory record showing that the goods were received.
- (iii) The Goods Received Note and Inspection Certificate showing that the goods on receipt were verified and inspected.
- (iv) The copy of the original order and authority showing that the goods in fact were ordered by an authority which was competent to do so.

Question 3

- (a) ABC Limited is engaged in the business of manufacture of Bags and Belts. CA Dinesh is appointed as an auditor of ABC Limited for the year 2019-20. CFO of ABC Limited approached CA Dinesh with following details while finalizing the books of account of the Company as on 31st March, 2020:

Particulars	Financial Year 2019-20	Financial Year 2018-19
Rate of Gross Profit on Sales	20%	8%

- Describe any four steps that CA Dinesh should carry out to satisfy himself on the sharp increase in rate of gross profit on sales as compared to the previous year. **(4 Marks)**
- (b) Explain the aspects to be considered by an auditor when designing and performing substantive analytical procedures, either alone or in combination with test of details, as substantive procedures in accordance with SA 330. **(4 Marks)**
- (c) In the course of audit of SMP Limited for the financial year ended 31st March, 2020 you have observed as an auditor that the company has provided a sum of ₹ 20 Lakhs in the books of account as Gratuity payable to employees based on certificate obtained from an actuary. Give your comments with reference to the Standard on Auditing. **(3 Marks)**
- (d) What are the points to be looked into by an auditor while verifying "Leasehold property" appearing in the Balance Sheet of a company? **(3 Marks)**

Answer

- (a) **Causes for Increase in the Rate of Gross Profit on Sales:** There are several possible causes of the sharp increase in the rate of gross profit on sales as compared with that of the previous year. CA. Dinesh, the auditor of ABC Limited should carry out following steps to satisfy himself on the sharp increase in rate of gross profit on sales as compared to the previous year.
- (i) **Increase in Sales Prices:** The selling price of the finished products may have been increased. Enquiries should be made as to whether there have been general or specific price increase and the reasons for the same. The auditor should obtain copies of the company price lists prevailing at different point of time and make the relevant comparison.

- (ii) **Reduction in Cost of manufacturing:** The cost of manufacturing may have reduced substantially. The auditor should examine the inventory and purchases records in respect of large purchases of raw materials, comparing current costs with those in the previous year and detailed information supporting the possibility should be sought from the company.
 - (iii) **Alteration in Sales-mix:** The mix of sales may have been altered, resulting in the sales of more profitable items. Detailed sales analysis should be made for the period in order to ascertain whether the more profitable lines constituted a large proportion of the total sales.
 - (iv) **Impact of Automation:** The mechanization or automation of certain manufacturing processes may have resulted in considerable saving in labour cost and this possibility could be easily verified by comparisons of wages records.
 - (v) **Adherence to Cut-off Procedures:** The company cut-off procedures as regards closing inventory and work-in-progress should be investigated, as any change in the procedure as compared with the previous year would cause a difference in the gross profit ratio. It should also be seen that the procedure laid down has been observed by the concerned personnel and rightly adhered to. The auditor should test relevant transaction and ensure that everything is incorporated in the financial statement.
 - (vi) **Manipulating Sales:** The possibility of items which have been sent to customers on "sale or return" basis being included in sales should be investigated, as this would give effect for increase in the rate of gross profit.
- (b) **Analytical procedures used as substantive tests:** When designing and performing substantive analytical procedures, either alone or in combination with test of details as, substantive procedures in accordance with SA 330, the auditor shall:
- (i) Determine the suitability of particular substantive analytical procedures for given assertions, taking account of the assessed risks of material misstatement and test of details, if any, for these assertions.
 - (ii) Evaluate the reliability of data from which the auditor's expectation of recorded amounts or ratios is developed, taking account of source, comparability, and nature and relevance of information available, and controls over preparation.
 - (iii) Develop an expectation of recorded amounts or ratios and evaluate whether the expectation is sufficiently precise to identify a misstatement that, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated.
 - (iv) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation.
- (c) **Certificate from a Management's Expert:** In the given case, SMP Limited has provided a sum of 20 lakh in the books of accounts as gratuity payable on the basis of certificate

obtained from an actuary. The liability towards gratuity payable to the employees at the time of cessation of service should be ascertained and provided for in the accounts when the employees are in service, it is an ascertained present liability accruing over the period of service but payable upon cessation of service.

The auditor should check the quantification of the gratuity liability. He should ascertain whether the same had been actuarially determined. The auditor should treat the actuary as managements' expert and conduct procedures relevant to checking the opinion of an expert in accordance with SA 500.

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

1. Evaluate the competence, capabilities and objectivity of that expert;
2. Obtain an understanding of the work of that expert; and
3. Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

(d) Verification of Leasehold Property: Following are the main steps involved in verification/vouching of lease hold property-

- (i) Inspect the lease or assignment thereof to ascertain the amount of premium, if any, for securing the lease, and its terms and conditions; and that the lease has been duly registered. A lease exceeding one year is not valid unless it has been granted by a registered instrument (section 107 of the Transfer of Property Act, 1882).
- (ii) Ascertain that all the conditions, the failure to comply with which might result in the forfeiture or cancellation of the lease, e.g., payment of ground rent on the due dates, insurance of property, its maintenance in a satisfactory state of repairs, etc. prescribed by the lease, are being duly complied with.
- (iii) Examine the counterpart of the tenant's agreements, if part of the leasehold property has been sublet.
- (iv) Make certain that due provisions for any claim that might arise under the dilapidation clause on the expiry of the lease has been made, and, if no such provision has been made, draw the client's attention to the matter.
- (v) Ensure that the outlay as well as any legal expenses incurred to acquire the lease which are shown as an asset in the Balance Sheet is being written off at a rate which could completely wipe off the asset over the unexpired term of the lease.

Question 4

- (a) XYZ Limited is engaged in the business of Shoes having geographical presence across India. Following details are available from the last audited financial statements of XYZ Limited for the financial year 2018-19 :

Particulars	₹
Paid-up Capital as on 31st March, 2019	9.8 Crores
Turnover for Financial Year 2018-19	98 Crores
Outstanding Loan from Bank as on 31st March, 2019	25 Crores
Liability on Outstanding Debentures as on 31st March, 2019	26 Crores

Comment on the applicability of constitution of Audit Committee for XYZ Limited for the financial year 2019-20 based on the above information. **(4 Marks)**

- (b) AS Ltd. is regular in depositing undisputed statutory dues except Employee's State Insurance (ESI) which is outstanding as at the last day of the financial year for a period of more than four months from the date they became payable. Further AS Ltd has not remitted an Income- tax Demand on account of appeal which is pending in High Court.

State the reporting requirements of the auditor under CARO, 2016. **(4 Marks)**

- (c) Mention the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph. **(3 Marks)**

- (d) Enumerate the circumstances under which the retiring auditor can be re-appointed. **(3 Marks)**

Answer

- (a) **Applicability of Constitution of Audit Committee:** According to Section 177 of the Companies Act, 2013, in addition to listed public companies, following classes of companies shall constitute and Audit Committee -

- All public companies with a paid-up capital often crore rupees or more;
- All public companies having turnover of one hundred crore rupees or more;
- All public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

Explanation- The paid-up share capital or turnover or outstanding loans or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purposes of this rule.

Therefore, provisions of constitution of audit committee are applicable only to listed companies and public companies satisfying criteria as stated above.

In the given case, XYZ Limited, engaged in the business of Shoes, is a public company and it's having paid-up capital of 9.8 crore rupees and turnover of 98 crore which is less than prescribed limit (i.e., 10 crores for paid-up capital and 100 crores for turnover). However, aggregate of its outstanding loan from bank (25 crores) and liability on outstanding debentures (26 crore) is exceeding the prescribed limit i.e., 50 crore rupees. Therefore, provisions relating to constitution of Audit Committee will be applicable for XYZ Limited.

- (b) **Reporting requirement under CARO 2016:** As per clause (vii) (a) of Para 3 of CARO, 2016, the auditor of a company has to report whether the company is regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, Goods and Services Tax (with effect from July 1, 2017), service tax, duty of customs, duty of excise, value added tax, cess and any other statutory dues to the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as on 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.

Further, as per clause (vii) (b) of Para 3 of CARO, 2016, the auditor of a company has to report 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 be treated as a dispute).

In the instant case, AS Ltd. is regular in depositing undisputed statutory dues except ESI. ESI is outstanding for a period of more than 4 months. AS Limited has also not deposited income tax demand on account of an appeal which is pending before High Court.

As per CARO 2016, the auditor is required to indicate in his report, extent of the arrears of outstanding statutory dues as on the last day of the financial year concerned for a period of more than six months from the date, they became payable. Thus, Auditor of AS Ltd. is not required to report the outstanding ESI as same is outstanding for a period less than 6 months.

However, the auditor is required to report income tax demand which is not deposited on account of pending appeal in accordance with clause (vii)(b).

- (c) **Examples of circumstances to include Emphasis of Matter Paragraph:** As per SA 706 (Revised) on "Emphasis of Matter Paragraphs and Other Matter Paragraphs In The Independent Auditor's Report", the examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are;

- (a) An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- (b) A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.

- (c) Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- (d) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.
- (d) **Re-appointment of auditor:** A retiring auditor may be re-appointed at an annual general meeting, if-
 - (i) he is not disqualified for re-appointment.
 - (ii) he has not given the company a notice in writing of his unwillingness to be re-appointed; and
 - (iii) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.
 - (iv) Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

Question 5

- (a) *As an auditor how will you verify the hire purchase transaction in the case of an entity engaged in the business of hire purchase?* **(4 Marks)**
- (b) *You have been appointed as an auditor of ABC Hotel, a three star hotel, for Financial Year 2019-20. As an auditor what are the special points that need to be considered in verifying the Inventories in the nature of food and beverages?* **(4 Marks)**
- (c) *The Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 provides certain powers to the C & AG in connection with performance of his duties. Discuss.* **(3 Marks)**
- (d) *Explain briefly the aspects that would be imminent on the part of the auditor to understand financial administration of Local bodies before embarking upon the audit.* **(3 Marks)**

Answer

- (a) **Verification of Hire-purchase transactions:** While checking the hire-purchase transaction, the auditor may examine the following:
 - 1. Hire purchase agreement is in writing and is signed by all parties.
 - 2. Hire purchase agreement specifies clearly -
 - (i) The hire-purchase price of the goods to which the agreement relates;
 - (ii) The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;
 - (iii) The date on which the agreement shall be deemed to have commenced;
 - (iv) The number of instalments by which the hire-purchase price is to be paid, the amount of each of those instalments, and the date, or the mode of determining

the date, upon which it is payable, and the person to whom and the place where it is payable; and

- (v) The goods to which the agreement relates, in a manner sufficient to identify them.

3. Ensure that payments are being received regularly as per the agreement.

- (b) **Verification of inventories in the nature of food and beverages:** The inventories in any hotel are both readily portable and saleable particularly the food and beverage inventories. It is therefore extremely important that all movements and transfers of such inventories should be properly documented to enable control to be exercised over each individual stores' areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed. Therefore, following may be noted in this regard:

- (a) All movement and transfer of inventories must be properly documented.
- (b) Areas where inventories are kept must be kept locked and the key retained by the departmental manager.
- (c) The key should be released only to trusted personnel and unauthorized persons should not be permitted in the stores area.
- (d) Many hotels use specialized professional valuers to count and value the inventories on a continuous basis throughout the year.
- (e) The auditor should ensure that all inventories are valued at the year end and that he should himself be present at the year-end physical verification, to the extent practicable, having regard to materiality consideration and nature and location of inventories.

- (c) **Powers of C & AG in performance of his duties:** The Comptroller and Auditor General's (Duties, Powers and Condition of Service) Act, 1971 gives the following powers to the C&AG in connection with the performance of his duties:

- (i) To inspect any an office accounts under the control of the union or a State Government including office responsible for creation of initial or subsidiary accounts.
- (ii) To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.
- (iii) To put such questions or make such observations as he may consider necessary to the person- in charge of the office and to call for such information as he may require for preparation of any account or report, which is his duty to prepare.

In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transaction as he may determine.

(d) **Aspects to understand financial administration of Local Bodies:** It would be imminent on the part of the auditor to understand financial administration of local bodies before embarking upon the audit. Some of the aspects are as under:

(i) **Budgetary Procedure:** This is geared to subserve the twin considerations of financial accountability and control of expenditure. The main objective is to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the legislature or council. Budget preparation is usually the occasion for determining the levels of taxation and rates and the ceilings on expenditure.

Municipal budget formats and heads of accounts vary from state to state. There are variations between the corporation and municipalities. One important feature of the municipal budgets is that there is no strict separation between revenue and capital items; usually there is a 'head' called extraordinary items which cover most of the capital transactions. There are, however, a number of special funds (e.g., roads) or in some cases separate budgets for specific municipal functions (e.g., education) or enterprise activities (e.g., water supply and sanitation, transport, electricity, etc.)

(ii) **Expenditure Control:** The system of financial control existing in the state and central government level is conditioned by the fact that there is a clear demarcation between the legislature and executive. The integration of legislation and executive powers in the municipal council makes it difficult for its executive to function as its inquisitorial body as well. Moreover, the separation of executive powers and functions in municipal government cannot accommodate the existence of an independent finance officer responsible to the municipal council or its executive committee. This leaves the system of external audit by state government as the only instrument of controlling municipal expenditure.

(iii) **Accounting System:** Municipal accounting and budget format have been criticized as neither simple nor comprehensible, sometimes providing inadequate information and at other times a surfeit of information. Both these situations are not conducive to a proper system of management information.

Question 6

(a) *Enumerate the factors to be considered by an auditor while relying on internal control system in Computerized Information System (CIS) environment.* **(4 Marks)**

OR

State the matters that the auditor shall include in the written communication of 'significant deficiencies in internal control' to those charged with governance.

(b) *Mention any four financial events or conditions that, individually or collectively, may cast significant doubt on the Going Concern assumption of an entity.* **(4 Marks)**

(c) *CA. Tom is offered statutory audit of UV Limited for the financial year 2019-20. Mention*

any three information that CA. Tom should obtain before accepting the audit engagement with the new client as per SA 220 "Quality Control for an Audit of financial statements".

(3 Marks)

(d) List out the areas where surprise checks can be employed while conducting an audit.

(4 Marks)

Answer

(a) Reliability of Internal Control System in CIS Environment: For evaluating the reliability of internal control system in CIS environment, the auditor would consider the following -

- (i) that authorised, correct and complete data is made available for processing.
- (ii) that it provides for timely detection and correction of errors.
- (iii) that in case of interruption due to mechanical, power or processing failures, the system restarts without distorting the completion of entries and records.
- (iv) that it ensures the accuracy and completeness of output.
- (v) that it provides security to application software & data files against fraud etc.
- (vi) that it prevents unauthorized amendments to programs.

OR

(a) Matters to be included in the written communication of deficiencies in Internal Control

The auditor shall include in the written communication of significant deficiencies in internal control:

1. A description of the deficiencies and an explanation of their potential effects; and
2. Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that:
 - (i) the purpose of the audit was for the auditor to express an opinion on the financial statements;
 - (ii) the audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and
 - (iii) the matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

(b) Financial indicator that may cast significant doubt about the going concern assumption:

- (i) Net liability or net current liability position.

- (ii) Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short term borrowings to finance long term assets.
 - (iii) Indications of withdrawal of financial support by trade payables.
 - (iv) Negative operating cash flows indicated by historical or prospective financial statements.
 - (v) Adverse key financial ratios.
 - (vi) Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
 - (vii) Arrears or discontinuance of dividends.
 - (viii) Inability to pay trade payables on due dates.
 - (ix) Inability to comply with terms of loan agreements.
 - (x) Change from credit to cash-on-delivery transactions with suppliers.
 - (xi) Inability to obtain financing for essential new product development or other essential investments.
- (c) **Information to be obtained by auditor before accepting audit engagement:** CA. Tom, an engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement offered by UV Limited. As per SA 220, "Quality Control for an Audit of Financial Statements" in doing so, CA. Tom 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.
- (d) **Areas of Surprise checks to improve effectiveness of audit:** Surprise checks constitute an important part of normal audit procedure. An element of surprise both with regard to the time of checking and selection of items, significantly improves the effectiveness of an audit. Normally, areas over which surprise check can be employed are-
- (i) Verification of cash.

- (ii) Verification of investments.
- (iii) Test-verification of stores and inventories and the records relating thereto.
- (iv) Verification of books of prime entry and statutory registers normally required to be examined for the purposes of audit.